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 June 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.

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

48 Documents

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8925 / June 2, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13052

In the Matter of **ALLIXON INTERNATIONAL CORPORATION,** **Respondent.**	**Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933**

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 Allixon International Corporation ("Allixon" or "Respondent").

II.

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

Document 1 of 48

III.

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

Respondent

A. Allixon is a company incorporated under the laws of the State of Delaware whose principal place of business is located in Seoul, South Korea. Allixon's stock is traded in the Pink Sheets under the symbol AXCP. Allixon has not filed a registration statement with the Commission and is not a public reporting company.

Background

B. In July 2005 a South Korean entity known as Allixon Company, Ltd., entered into a reverse merger with Classic Vision Entertainment, Inc., a public shell company traded on the pink sheets. Classic Vision's name was changed after the merger to "Allixon International Corporation."

C. Contemporaneously with the reverse merger, Allixon's board authorized the issuance of 1.3 million shares to two Turks and Caicos entities pursuant to Rule 504 of Regulation D. The shares were issued without a restrictive legend based on an opinion letter prepared by Allixon's outside counsel.[2] The 1.3 million "free trading" shares represented 94% of the company's entire public float. One of the entities that received 800,000 shares was controlled by Allixon's secretary, an affiliate of Allixon. The shares were issued to the two Turks and Caicos entities for no consideration.

D. All of the 1.3 million shares were deposited with Temple Securities, Ltd., a Turks and Caicos brokerage firm.[3] In July 2005 Allixon's secretary negotiated an escrow agreement with the brokerage firm that specified that the Allixon shares were to be sold and for the purpose of paying transaction costs of the reverse merger.

E. Temple Securities began publicly selling Allixon shares through a U.S. brokerage firm on August 29, 2005, coincident with the dissemination of spam emails touting the company.

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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 Allixon shares were issued by the transfer agent without a restrictive legend based on instructions from Allixon's outside counsel, whose opinion letter of July 15, 2005, advised that the securities were "sold pursuant to Section (sic) 504 of Regulation D." Allixon never filed a registration statement with the Commission or any state in compliance with Rule 504(b)(1)(i), and accordingly, there was never a valid registration statement in effect with respect to the sale of its shares. On January 24, 2007, the Commission filed a civil injunctive action against Allixon's outside counsel alleging he violated the federal securities laws in connection with his participation in the unregistered distribution of Allixon shares. See Lit. Rel. 19987 (February 1, 2007).

[3] Temple Securities consented to the entry of a public administrative and cease-and-desist order addressing its conduct in this matter. See In the Matter of Temple Securities, Ltd., and Gregory Greatrex, Exchange Act Release No. 55224 (February 1, 2007).

Approximately 943,000 shares of Allixon were sold for more than $4.3 million in proceeds. Of this amount, $175,000 was used to pay a portion of the merger costs. Allixon did not receive, either directly or indirectly, any of the remaining stock sale proceeds.

F. No registration statement was filed with the Commission or was in effect as to the transactions in Allixon shares described above and the transactions were not otherwise exempt from registration. Therefore, the securities transactions described above violated Sections 5(a) and 5(c) of the Securities Act.

Violations

G. As a result of the conduct described above, Respondent violated 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.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions specified in Respondent Allixon International Corporation's Offer.

ACCORDINGLY, IT IS HEREBY ORDERED:

Respondent Allixon International Corporation shall cease and desist from committing or causing any violations and any future violations of Sections 5(a) and 5(c) of the Securities Act.

By the Commission.

Florence E. Harmon
Acting 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. 57908 / June 3, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13054

In the Matter of **GERALD KINGSTON,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDING 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 Gerald Kingston ("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, the 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:

Document 2 of 48

1. From January 18, 2002 to April 27, 2005 and from to May 11, 2006 to July 3, 2007, Respondent was a registered representative associated with Jefferson Pilot Securities Corporation ("Jefferson"), a broker-dealer registered with the Commission. From April 10, 1994 to February 25, 1996, Respondent was a registered representative associated with Midwest Discount Brokers, Inc. From August 2, 1994 to December 30, 1994, Respondent was a registered representative associated with American Express Financial Advisors, Inc. From April 29, 1996 to November 14, 1997, Respondent was a registered representative associated with Pacific Century Investment Services, Inc. From November 17, 1997 to May 14, 1998, Respondent was a registered representative associated with Tradestar Investments, Inc. From May 18, 1998 to April 1, 2001, Respondent was a registered representative associated with Bank United Securities Corp. From April 1, 2001 to January 11, 2002, Respondent was a registered representative associated with WM Financial Services, Inc. From April 14, 2005 to May 11, 2006, Respondent was a registered representative associated with Frost Brokerage Services, Inc.

2. On November 13, 2007, Respondent pled guilty and was convicted of one count of Conspiracy to Commit Securities Fraud [18 U.S.C. § 371 (15 U.S.C. §§ 78j(b) and 78ff and 17 C.F.R. § 240.10b-5)] in an action filed in the United States District Court for the Northern District of Texas (*See United States v. Gerald Kingston,* Case # 3:07-cr-00344, NDTX).

3. According to the plea agreement and information upon which Respondent's conviction was based, Respondent and other co-conspirators, from approximately August 2006 until approximately July 10, 2007, opened brokerage accounts in the names of nominees and obtained large blocks of shares of InterFinancial Holdings Corporation ("IFCH"), a company with minimal assets or capitalization that was quoted on the Over-the-Counter securities market by the Pink Sheet, L.L.C. Respondent and his co-conspirators then executed numerous matched trades of significant volume for the purpose of profiting from the manipulation of the price of IFCH shares.

4. Respondent's conviction is an offense specified in Section 15(b)(6)(A)(ii) of the Exchange Act.

IV.

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

Accordingly, IT IS HEREBY ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act, that the Respondent 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.

Florence E. Harmon
Acting Secretary

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

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 232

[Release Nos. 33-8926; 34-57914; 39-2456; IC-28296]

Adoption of Updated EDGAR Filer Manual

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (the Commission) is adopting revisions to the Electronic Data Gathering, Analysis, and Retrieval System (EDGAR) Filer Manual to reflect updates to the EDGAR system. The revisions are being made to address the removal of rescinded EDGAR submission types: S-4EF/A, F-4EF/A, N-14AE, and N-14AE/A, the addition of XBRL Standard Taxonomies, and the inclusion of new links for USGAAP XBRL Taxonomies.

The revisions to the Filer Manual reflect changes within Volume II entitled EDGAR Filer Manual, Volume II: "EDGAR Filing," Version 8 (May 2008). The updated manual will be incorporated by reference into the Code of Federal Regulations.

EFFECTIVE DATE: [Insert date of publication in the Federal Register.] The incorporation by reference of the EDGAR Filer Manual is approved by the Director of the Federal Register as of [insert date of publication in the Federal Register].

FOR FURTHER INFORMATION CONTACT: In the Office of Information Technology, Rick Heroux, at (202) 551-8800; in the Division of Corporation Finance for questions regarding EDGAR submission types S-4EF/A and F-4EF/A contact Cecile Peters, Office of Information Technology, Office Chief, at (202) 551-8135; in the Division of Investment Management for questions regarding EDGAR submission types N-14AE and N-14AE/A contact Ruth Armfield Sanders, Senior Special Counsel, Office of Legal and Disclosure, at (202) 551-6989; in the Office

Document 3 of 48

of Interactive Disclosure for questions concerning XBRL filings contact Jeffrey W. Naumann, Assistant Director of the Office of Interactive Disclosure, at (202) 551-5352.

SUPPLEMENTARY INFORMATION: Today we are adopting an updated EDGAR Filer Manual, Volume II. The Filer Manual describes the technical formatting requirements for the preparation and submission of electronic filings through the EDGAR system.[1] It also describes the requirements for filing using EDGARLink[2] and the Online Forms/XML Web site.

The Filer Manual contains all the technical specifications for filers to submit filings using the EDGAR system. Filers must comply with the applicable provisions of the Filer Manual in order to assure the timely acceptance and processing of filings made in electronic format.[3] Filers should consult the Filer Manual in conjunction with our rules governing mandated electronic filing when preparing documents for electronic submission.[4]

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[1] We originally adopted the Filer Manual on April 1, 1993, with an effective date of April 26, 1993. Release No. 33-6986 (April 1, 1993) [58 FR 18638]. We implemented the most recent update to the Filer Manual on August 20, 2007. See Release No. 33-8834 (August 15, 2007) [72 FR 46559].

[2] This is the filer assistance software we provide filers filing on the EDGAR system.

[3] See Rule 301 of Regulation S-T (17 CFR 232.301).

[4] See Release Nos. 33-6977 (February 23, 1993) [58 FR 14628], IC-19284 (February 23, 1993) [58 FR 14848], 35-25746 (February 23, 1993) [58 FR 14999], and 33-6980 (February 23, 1993) [58 FR 15009] in which we comprehensively discuss the rules we adopted to govern mandated electronic filing. See also Release No. 33-7122 (December 19, 1994) [59 FR 67752], in which we made the EDGAR rules final and applicable to all domestic registrants; Release No. 33-7427 (July 1, 1997) [62 FR 36450], in which we adopted minor amendments to the EDGAR rules; Release No. 33-7472 (October 24, 1997) [62 FR 58647], in which we announced that, as of January 1, 1998, we would not accept in paper filings that we require filers to submit electronically; Release No. 34-40934 (January 12, 1999) [64 FR 2843], in which we made mandatory the electronic filing of Form 13F; Release No. 33-7684 (May 17, 1999) [64 FR 27888], in which we adopted amendments to implement the first stage of EDGAR modernization; Release No. 33-7855 (April 24, 2000) [65 FR 24788], in which we implemented EDGAR Release 7.0; Release No. 33-7999 (August 7, 2001) [66 FR 42941], in which we implemented EDGAR Release 7.5; Release No. 33-8007 (September 24, 2001) [66 FR 49829], in which we implemented EDGAR Release 8.0; Release No. 33-8224 (April 30, 2003) [68 FR 24345], in which we implemented EDGAR Release 8.5; Release Nos. 33-8255 (July 22, 2003) [68 FR 44876] and 33-8255A (September 4, 2003) [68 FR 53289] in which we implemented EDGAR Release 8.6; Release No. 33-8409 (April 19, 2004) [69 FR 21954] in which we implemented EDGAR

For EDGAR Release 9.10, submission template 1 will be updated to remove the aforementioned submission type changes. It is highly recommended that filers download, install, and use the new EDGARLink submission templates to ensure that submissions will be processed successfully. Previous versions of the templates may not work properly. Notice of the update has previously been provided on the EDGAR Filing Web site and on the Commission's public Web site. The discrete updates are reflected on the EDGAR Filing Web site and in the updated Filer Manual, Volume II.

Along with adoption of the Filer Manual, we are amending Rule 301 of Regulation S-T to provide for the incorporation by reference into the Code of Federal Regulations of today's revisions. This incorporation by reference was approved by the Director of the Federal Register in accordance with 5 U.S.C. 552(a) and 1 CFR Part 51.

You may obtain paper copies of the updated Filer Manual at the following address: Public Reference Room, U.S. Securities and Exchange Commission, 100 F Street, NE, Room 1580, Washington DC 20549, on official business days between the hours of 10:00am and 3:00pm. We will post electronic format copies on the Commission's Web site; the address for the Filer Manual is http://www.sec.gov/info/edgar.shtml. You may also obtain copies from Thomson Financial, the paper document contractor for the Commission, at (800) 638-8241.

Release 8.7; Release No. 33-8454 (August 6, 2004) [69 FR 49803] in which we implemented EDGAR Release 8.8; Release No. 33-8528 (February 3, 2005) [70 FR 6573] in which we implemented EDGAR Release 8.10; Release No. 33-8573 (May 19, 2005) [70 FR 30899] in which we implemented EDGAR Release 9.0; Release No. 33-8612 (September 21, 2005) [70 FR 57130] in which the Commission granted the authorization to publish the release adopting the reorganized EDGAR Filer Manual; Release No. 33-8633 (November 1, 2005) [70 FR 67350] in which we implemented EDGAR Release 9.2; Release No 33-8656 (January 27, 2006) [71 FR 5596] in which we implemented EDGAR Release 9.3; Release No. 33-8834 (August 15, 2007)[72 FR 46559] in which we implemented EDGAR Release 9.7; and Release No. 33-3899 (May 30, 2008) in which we implemented EDGAR Release 9.8 and Release 9.9.

Since the Filer Manual relates solely to agency procedures or practice, publication for notice and comment is not required under the Administrative Procedure Act (APA)[5]. It follows that the requirements of the Regulatory Flexibility Act[6] do not apply.

The effective date for the updated Filer Manual and the rule amendments is [Insert date of publication in the Federal Register]. In accordance with the APA[7], we find that there is good cause to establish an effective date less than 30 days after publication of these rules. The EDGAR system upgrade to Release 9.10 is scheduled to become available on May 5, 2008. The Commission believes that it is necessary to coordinate the effectiveness of the updated Filer Manual with the system upgrade.

Statutory Basis

We are adopting the amendments to Regulation S-T under Sections 6, 7, 8, 10, and 19(a) of the Securities Act of 1933,[8] Sections 3, 12, 13, 14, 15, 23, and 35A of the Exchange Act ,[9] Section 319 of the Trust Indenture Act of 1939,[10] and Sections 8, 30, 31, and 38 of the Investment Company Act of 1940.[11]

List of Subjects in 17 CFR Part 232

Incorporation by reference, Reporting and recordkeeping requirements, Securities.

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[5] 5 U.S.C. 553(b).

[6] 5 U.S.C. 601- 612.

[7] 5 U.S.C. 553(d)(3).

[8] 15 U.S.C. 77f, 77g, 77h, 77j, and 77s(a).

[9] 15 U.S.C. 78c, 78l, 78m, 78n, 78o, 78w, and 78ll.

[10] 15 U.S.C. 77sss.

[11] 15 U.S.C. 80a-8, 80a-29, 80a-30, and 80a-37.

TEXT OF THE AMENDMENT

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

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

1. The authority citation for Part 232 continues to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a), 77z-3, 77sss(a), 78c(b), 78l, 78m, 78n, 78o(d), 78w(a), 78ll, 80a-6(c), 80a-8, 80a-29, 80a-30, 80a-37, and 7201 et seq.; and 18 U.S.C. 1350.

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2. Section 232.301 is revised to read as follows:

§232.301 EDGAR Filer Manual.

Filers must prepare electronic filings in the manner prescribed by the EDGAR Filer Manual, promulgated by the Commission, which sets out the technical formatting requirements for electronic submissions. The requirements for becoming an EDGAR Filer and updating company data are set forth in the updated EDGAR Filer Manual, Volume I: "General Information," Version 4 (August 2007). The requirements for filing on EDGAR are set forth in the updated EDGAR Filer Manual, Volume II: "EDGAR Filing," Version 8 (May, 2008). Additional provisions applicable to Form N-SAR filers are set forth in the EDGAR Filer Manual, Volume III: "N-SAR Supplement," Version 1 (September 2005). All of these provisions have been incorporated by reference into the Code of Federal Regulations, which action was approved by the Director of the Federal Register in accordance with 5 U.S.C. 552(a) and 1 CFR Part 51. You must comply with these requirements in order for documents to be timely received and accepted. You can obtain paper copies of the EDGAR Filer Manual from the following address: Public Reference Room, U.S. Securities and Exchange Commission, 100 F Street, NE, Room 1580, Washington, DC 20549, on official business days between the hours of 10:00am and 3:00pm, or by calling Thomson Financial at (800) 638-8241. Electronic copies are available on the Commission's Web site. The address for the Filer Manual is http://www.sec.gov/info/edgar.shtml. You can also photocopy the document at the National Archives and Records Administration (NARA). For information on the availability of this material at NARA, call (202) 741–6030, or go to: http://www.archives.gov/federal_register/code_of_federal_regulations/ibr_locations.html.

By the Commission.

Florence E. Harmon

Florence E. Harmon
Acting Secretary

June 4, 2008

SECURITIES AND EXCHANGE COMMISSION

Release No. 34-57917

June 4, 2008

Notice of Proposed Order Approving Proposal by NYSE Arca, Inc. To Establish Fees for Certain Market Data and Request for Comment

I. Introduction

On May 23, 2006, NYSE Arca, Inc. ("NYSE Arca" or "Exchange") filed with the Securities and Exchange Commission ("Commission), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act")[1] and Rule 19b-4 thereunder,[2] a proposed rule change ("Proposal") to establish fees for the receipt and use of certain market data that the Exchange makes available. We are publishing this notice and a proposed order approving the Proposal ("Draft Order")[3] to provide interested persons with further opportunity to comment.

The Proposal was published for comment in the Federal Register on June 9, 2006.[4] The Commission received 6 comment letters regarding the Proposal. On October 12, 2006, the Commission issued an order, by delegated authority, approving the Proposal.[5] On November 6, 2006, NetCoalition ("Petitioner") submitted a notice, pursuant to Rule 430 of the Commission's Rules of Practice, indicating its intention to

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

2 17 CFR 240.19b-4.

3 The Draft Order is included as Appendix A.

4 Securities Exchange Act Release No. 53952 (June 7, 2006), 71 FR 33496 (June 9, 2006).

5 Securities Exchange Act Release No. 54597 (October 12, 2006), 71 FR 62029 (October 20, 2006) ("Delegated Order").

Document 4 of 48

file a petition requesting that the Commission review and set aside the Delegated Order.[6] On November 8, 2006, the Exchange submitted a response to the Petitioner's Notice.[7] On November 15, 2006, Petitioner submitted its petition requesting that the Commission review and set aside the Delegated Order.[8] On December 27, 2006, the Commission issued an order: (1) granting Petitioner's request for the Commission to review the Delegated Order; (2) allowing any party or other person to file a statement in support of or in opposition to the action made by delegated authority; and (3) continuing the effectiveness of the automatic stay provided in Rule 431(e) of the Commission's Rules of Practice.[9]

The Commission received 32 comments regarding the Petition. These comment letters,[10] along with other materials the Commission has placed in the comment file, are available on our website. The Commission has considered the Petition and the comments submitted on the Petition, as well as the comments submitted on the Proposal. Although not required by Section 19(b) of the Exchange Act, in the context of the Proposal we nonetheless are affording the public an additional opportunity to provide comment by publishing the Draft Order.

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6 Letter from Markham C. Erikson, Executive Director and General Counsel, NetCoalition, to the Honorable Christopher Cox, Chairman, SEC, dated November 6, 2006 ("Notice").

7 Letter from Mary Yeager, Corporate Secretary, NYSE Arca Inc., to the Honorable Christopher Cox, Chairman, SEC, dated November 8, 2006 ("NYSE ARCA Petition Response").

8 Petition for Commission Review submitted by Petitioner, dated November 14, 2006 ("Petition").

9 Securities Exchange Act Release No. 55011 (December 27, 2006).

10 While the comment period on the Petition closed on January 17, 2007, we have included in the public comment file on the Petition all comment letters received after the close of the comment period.

II. Brief Overview of the Proposal and Draft Order

Under Section 19 of the Exchange Act, the Commission must approve a proposed rule change related to setting fees for market data if it finds that the proposed rule change is consistent with the requirements of the Exchange Act and the rules thereunder. The attached Draft Order describes the relevant Exchange Act provisions and rules.

The Proposal involves assessing fees for non-core market data. Core data is the best-priced quotations and comprehensive last sale reports of all markets that the Commission requires a central processor to consolidate and distribute to the public pursuant to joint-SRO plans. In contrast, individual exchanges and other market participants distribute non-core data voluntarily. The Commission believes it is able to incorporate the existence of competitive forces in its determination of whether an exchange's proposal to distribute non-core data meets the standards of the Exchange Act provisions and rules. This approach follows the clear intent of Congress in adopting Section 11A of the Exchange Act that, whenever possible, competitive forces should dictate the services and practices that constitute the U.S. national market system for trading equity securities.

This market-based approach to non-core data has two parts. The first is to ask whether the exchange was subject to significant competitive forces in setting the terms of its proposal for non-core data, including the level of any fees. If an exchange was subject to significant competitive forces in setting the terms of a proposal, the Commission would approve the proposal unless it determines that there is a substantial countervailing basis to find that the terms nevertheless fail to meet an applicable requirement of the Exchange Act or the rules thereunder. If, however, the exchange was not subject to significant competitive forces in setting the terms of a proposal for non-core data, the Commission would require the exchange to provide a substantial basis, other than competitive forces, in its proposed rule change demonstrating that the terms of the proposal are equitable, fair, reasonable, and not unreasonably discriminatory.

The Commission believes that, when possible, reliance on competitive forces is the most appropriate and effective means to assess whether terms for the distribution of non-core data are equitable, fair and reasonable, and not unreasonably discriminatory. If competitive forces are operative, the self-interest of the exchanges themselves will work powerfully to constrain unreasonable or unfair behavior. As discussed further in the attached Draft Order, when an exchange is subject to competitive forces in its distribution of non-core data, many market participants would be unlikely to purchase the exchange's data products if it sets fees that are inequitable, unfair, unreasonable, or unreasonably discriminatory. As a result, competitive forces generally will constrain an exchange in setting fees for non-core data because it should recognize that its own business will suffer if it acts unreasonably or unfairly.

As discussed in the attached Draft Order, the Commission believes that at least two broad types of significant competitive forces applied to NYSE Arca in setting the terms of its Proposal: (1) NYSE Arca's compelling need to attract order flow from market participants; and (2) the availability to market participants of alternatives to purchasing its data. The Commission requests comment on whether NYSE Arca was subject to competitive forces in setting the terms of its Proposal, including the level of fees and the different rates for professional and non-professional subscribers.

The Draft Order states that broker-dealers are not required to obtain depth-of-book order data, including the NYSE Arca data, to meet their duty of best execution and notes the established principles of best execution that support this statement.[11] The Commission requests comment on whether the discussion in the Draft Order makes it clear that broker-dealers are not required to purchase depth-of-book order data because of their best execution obligations. If not, what else could we say to make this point more clear?

III. Request for Comment

Interested persons are invited to submit written data, views, and arguments concerning any aspect of the Draft Order. 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-NYSEArca-2006-21 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-NYSEArca-2006-21. 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

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11 Draft Order, notes 223-226 and accompanying text.

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 the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NYSEArca-2006-21 and should be submitted on or before [insert date 30 days from publication in the Federal Register].

By the Commission.

Florence E. Harmon

Florence E. Harmon
Acting Secretary

Appendix A to Release No. 34-57917

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-XXXXX; File No. SR-NYSEArca-2006-21)

[Month], 2008

Self-Regulatory Organizations; NYSE Arca, Inc.; Order Setting Aside Action by Delegated Authority and Approving Proposed Rule Change Relating to NYSE Arca Data

On May 23, 2006, NYSE Arca, Inc. ("NYSE Arca" or "Exchange") filed with the Securities and Exchange Commission ("Commission" or "SEC"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act")[1] and Rule 19b-4 thereunder,[2] a proposed rule change ("Proposal") to establish fees for the receipt and use of certain market data that the Exchange makes available. The Proposal was published for comment in the Federal Register on June 9, 2006.[3] On October 12, 2006, the Commission issued an order, by delegated authority, approving the Proposal.[4] On November 6, 2006, NetCoalition ("Petitioner") submitted a notice, pursuant to Rule 430 of the Commission's Rules of Practice, indicating its intention to file a petition requesting that the Commission review and set aside the Delegated Order.[5] On November 8, 2006, the Exchange submitted a response to the Petitioner's Notice.[6] On November 15, 2006,

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

2 17 CFR 240.19b-4.

3 Securities Exchange Act Release No. 53952 (June 7, 2006), 71 FR 33496 (June 9, 2006).

4 Securities Exchange Act Release No. 54597 (October 12, 2006) 71 FR 62029 (October 20, 2006) ("Delegated Order").

5 Letter from Markham C. Erikson, Executive Director and General Counsel, NetCoalition, to the Honorable Christopher Cox, Chairman, SEC, dated November 6, 2006 ("Notice").

6 Letter from Mary Yeager, Corporate Secretary, NYSE Arca Inc., to the Honorable

Petitioner submitted its petition requesting that the Commission review and set aside the Delegated Order.[7] On December 27, 2006, the Commission issued an order: (1) granting Petitioner's request for the Commission to review the Delegated Order; (2) allowing any party or other person to file a statement in support of or in opposition to the action made by delegated authority; and (3) continuing the effectiveness of the automatic stay provided in Rule 431(e) of the Commission's Rules of Practice.[8] The Commission received 25 comments regarding the Petition.[9]

The Commission has considered the Petition and the comments submitted on the Petition, as well as the comments submitted on the Proposal. For the reasons described below, it is setting aside the earlier action taken by delegated authority and approving the Proposal directly.

Christopher Cox, Chairman, SEC, dated November 8, 2006 ("NYSE ARCA Petition Response").

7 Petition for Commission Review submitted by Petitioner, dated November 14, 2006 ("Petition").

8 Securities Exchange Act Release No. 55011 (December 27, 2006).

9 The comments on the Petition, as well as the earlier comments on the Proposal, are identified and summarized in section III below. NYSE Arca's responses to the commenters are summarized in section IV below.

Table of Contents

I. Introduction

The Commission's Rules of Practice set forth procedures for the review of actions made pursuant to delegated authority. Rule 431(b)(2) provides that the Commission, in deciding whether to accept or decline a discretionary review, will consider the factors set forth in Rule 411(b)(2). One of these factors is whether an action pursuant to delegated authority embodies a decision of law or policy that is important and that the Commission should review.

The Petitioner and commenters raised a number of important issues that the Commission believes it should address directly at this time. In particular, section V below addresses issues related to the nature of the Commission's review of proposed rule changes for the distribution of "non-core" market data, which includes the NYSE Arca data that is the subject of the Proposal. Individual exchanges and other market participants distribute non-core data independently. Non-core data should be contrasted with "core" data -- the best-priced quotations and last sale information of all markets in U.S.-listed equities that Commission rules require to be consolidated and distributed to the public by a single central processor.[10] Pursuant to the authority granted by Congress under Section 11A of the Exchange Act, the Commission requires the self-regulatory organizations ("SROs") to participate in joint-industry plans for disseminating core data, and requires broker-dealers and vendors to display core data to investors to help inform their trading and order-routing decisions. In contrast, no Commission rule requires exchanges or market participants either to distribute non-core data to the public or to display non-core data to investors.

Price transparency is critically important to the efficient functioning of the equity markets. In 2006, the core data feeds reported prices for more than \$39.4 <u>trillion</u> in transactions in U.S.-listed equities.[11] In 2006, U.S. broker-dealers earned \$21.7 <u>billion</u> in commissions from trading in U.S.-listed equities – an amount that does not include any

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10 <u>See</u> section V.A below for a fuller discussion of the arrangements for distributing core and non-core data.

11 Source: ArcaVision (available at www.arcavision.com).

revenues from proprietary trading by U.S. broker-dealers or other market participants.[12] Approximately 420,000 securities industry professionals subscribe to the core data products of the joint-industry plans, while only about 5% of these professionals have chosen to subscribe to the non-core data products of exchanges.[13]

In December 2007, NYSE Arca executed a 15.4% share of trading in U.S.-listed equities.[14] The reasonably projected revenues from the proposed fees for NYSE Arca's non-core data are $8 million per year.[15] Commenters opposing the Proposal claimed that NYSE Arca exercised monopoly power to set excessive fees for its non-core data and recommended that the Commission adopt a "cost-of-service" ratemaking approach when reviewing exchange fees for non-core data – an approach comparable to the one traditionally applied to utility monopolies.[16]

In 2005, however, the Commission stated its intention to apply a market-based approach that relies primarily on competitive forces to determine the terms on which non-core data is made available to investors.[17] This approach follows the clear intent of Congress in adopting Section 11A of the Exchange Act that, whenever possible, competitive forces should dictate the services and practices that constitute the U.S.

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12 Frank A. Fernandez, Securities Industry and Financial Markets Association Research Report, "Securities Industry Financial Results: 2006" (May 2, 2006) ("SIFMA Research Report"), at 7-9, 21.

13 <u>See</u> note 202 below and accompanying text.

14 <u>See</u> note 180 below and accompanying text.

15 <u>See</u> note 230 below and accompanying text.

16 The commenters' views are summarized in section III.A.2 below.

17 Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496, 37566-37568 (June 29, 2005) ("Regulation NMS Release").

national market system for trading equity securities. Section V discusses this market-based approach and applies it in the specific context of the Proposal by NYSE Arca. The Commission is approving the Proposal primarily because NYSE Arca was subject to significant competitive forces in setting the terms of the Proposal. The Commission believes that reliance on competitive forces, whenever possible, is the most effective means to assess whether proposed fees for non-core data meet the applicable statutory requirements.

The Petitioner and commenters discussed and recommended solutions for a wide range of market data issues that were beyond the scope of the Proposal. The Petitioner particularly called attention to the data needs of users of advertiser-supported Internet web sites, many of whom are individual retail investors. In this regard, the Commission recognizes that exchanges have responded by developing innovative new data products specifically designed to meet the reference data needs and economic circumstances of these Internet users.[18]

Some commenters also suggested that, pending a comprehensive resolution of all market data issues, the Commission impose a moratorium on all proposed rule changes related to market data, including the Proposal. The Commission recognizes the importance of many of the issues raised by commenters relating to core data that are beyond the scope of the Proposal. It is continuing to consider these issues, and others, as

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18 See Securities Exchange Act Release No. 55354 (February 26, 2007), 72 FR 9817 (March 5, 2007) (notice of filing of File No. SR-NYSE-2007-04) ("New York Stock Exchange ("NYSE") Internet Proposal"); Securities Exchange Act Release No. 55255 (February 8, 2007), 72 FR 7100 (February 14, 2007) (notice of filing of File No. SR-NASDAQ-2006-060) ("Nasdaq Reference Data Proposal").

part of its ongoing review of SRO structure, governance, and transparency.[19] The Commission does not, however, believe that imposing a moratorium on the review of proposed rule changes related to market data products and fees would be appropriate or consistent with the Exchange Act. A primary Exchange Act objective for the national market system is to promote fair competition.[20] Failing to act on the proposed rule changes of particular exchanges would be inconsistent with this Exchange Act objective, as well as with the requirements pertaining to SRO rule filings more generally. Accordingly, the Commission will continue to act on proposed rule changes for the distribution of market data in accordance with the applicable Exchange Act requirements.

II. Description of Proposal

Through NYSE Arca, LLC, the equities trading facility of NYSE Arca Equities, Inc., the Exchange makes available on a real-time basis ArcaBook[SM], a compilation of all limit orders resident in the NYSE Arca limit order book. In addition, the Exchange makes available real-time information relating to transactions and limit orders in debt securities that are traded through the Exchange's facilities. The Exchange makes ArcaBook and the bond transaction and limit order information (collectively, "NYSE Arca Data") available to market data vendors, broker-dealers, private network providers, and other entities by means of data feeds. Currently, the Exchange does not charge fees for the receipt and use of NYSE Arca Data.

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19 See Securities Exchange Act Release No. 50699 (November 18, 2004), 69 FR 71126 (December 8, 2004) (proposed rules addressing SRO governance and transparency); Securities Exchange Act Release No. 50700 (November 18, 2004), 69 FR 71256 (December 8, 2004) ("Concept Release Concerning Self-Regulation").

20 Section 11A(a)(1)(C)(ii) of the Exchange Act, 15 U.S.C. 78k-1(a)(1)(C)(ii).

The Exchange's proposal would establish fees for the receipt and use of NYSE Arca Data. Specifically, the Exchange proposes to establish a $750 per month access fee for access to the Exchange's data feeds that carry the NYSE Arca Data. In addition, the Exchange proposes to establish professional and non-professional device fees for the NYSE Arca Data.[21] For professional subscribers, the Exchange proposes to establish a monthly fee of $15 per device for the receipt of ArcaBook data relating to exchange-traded funds ("ETFs") and those equity securities for which reporting is governed by the CTA Plan ("CTA Plan and ETF Securities") and a monthly fee of $15 per device for the receipt of ArcaBook data relating to those equity securities, excluding ETFs, for which reporting is governed by the Nasdaq UTP Plan ("Nasdaq UTP Plan Securities").[22] For non-professional subscribers, the Exchange proposes to establish a monthly fee of $5 per device for the receipt of ArcaBook data relating to CTA Plan and ETF Securities and a monthly fee of $5 per device for the receipt of ArcaBook data relating to Nasdaq UTP Plan Securities.[23]

The Exchange also proposes a maximum monthly payment for device fees paid by any broker-dealer for non-professional subscribers that maintain brokerage accounts

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21 In differentiating between professional and non-professional subscribers, the Exchange proposes to apply the same criteria used by the Consolidated Tape Association Plan ("CTA Plan") and the Consolidated Quotation Plan ("CQ Plan") for qualification as a non-professional subscriber. The two plans, which have been approved by the Commission, are available at www.nysedata.com.

22 The "Nasdaq UTP Plan" is the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privileges Basis. The plan, which has been approved by the Commission, is available at www.utpdata.com.

23 There will be no monthly device fees for limit order and last sale price information relating to debt securities traded through the Exchange's facilities.

with the broker-dealer.[24] For 2006, the Exchange proposed a $20,000 maximum monthly payment. For the months falling in a subsequent calendar year, the maximum monthly payment will increase (but not decrease) by the percentage increase (if any) in the annual composite share volume[25] for the calendar year preceding that subsequent calendar year, subject to a maximum annual increase of five percent.

Lastly, the Exchange proposes to waive the device fees for ArcaBook data during the duration of the billable month in which a subscriber first gains access to the data.

III. Summary of Comments Received

The Commission received four comments from three commenters regarding the Proposal after it was published for comment.[26] NYSE Arca responded to the

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24 Professional subscribers may be included in the calculation of the monthly maximum amount so long as: (1) nonprofessional subscribers comprise no less than 90% of the pool of subscribers that are included in the calculation; (2) each professional subscriber that is included in the calculation is not affiliated with the broker-dealer or any of its affiliates (either as an officer, partner or employee or otherwise); and (3) each such professional subscriber maintains a brokerage account directly with the broker-dealer (that is, with the broker-dealer rather than with a correspondent firm of the broker-dealer).

25 "Composite share volume" for a calendar year refers to the aggregate number of shares in all securities that trade over NYSE Arca facilities for that calendar year.

26 Web comment from Steven C. Spencer, dated June 18, 2006 ("Spencer Letter"); letter from Markham C. Erickson, Executive Director and General Counsel, NetCoalition, to Christopher Cox, Chairman, Commission, dated August 9, 2006 ("NetCoalition I"); and letters from Gregory Babyak, Chairman, Market Data Subcommittee of the Securities Industry Association ("SIA") Technology and Regulation Committee, and Christopher Gilkerson, Chairman, SIA Technology and Regulation Committee, to Nancy Morris, Secretary, Commission, dated June 30, 2006 ("SIFMA I") and August 18, 2006 ("SIFMA II"). The SIA has merged into the Securities Industry and Financial Markets Association ("SIFMA").

comments.[27] After granting the Petition, the Commission received 25 comments from 17 commenters regarding the approval of the Proposal by delegated authority.[28] Nine

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27 Letters from Janet Angstadt, Acting General Counsel, NYSE Arca, to Nancy J. Morris, Secretary, Commission, dated July 25, 2006 ("NYSE Arca Response I"), and August 25, 2006 ("NYSE Arca Response II").

28 Letters from Christopher Gilkerson and Gregory Babyak, Co-Chairs, Market Data Subcommittee of SIFMA Technology and Regulation Committee, dated February 14, 2008 ("SIFMA VIII); Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, dated February 7, 2007 ("SIFMA VII"); Markham C. Erickson, Executive Director and General Counsel, NetCoalition, dated January 11, 2008 ("NetCoalition V"); The Honorable Paul E. Kanjorski, Chairman, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, dated December 12, 2007 ("Kanjorski Letter"); Melissa MacGregor, Vice President and Assistant General Counsel, SIFMA, dated November 7, 2007 ("SIFMA VI"); The Honorable Richard H. Baker, Member of Congress, dated October 1, 2007 ("Baker Letter"); Markham C. Erickson, Executive Director and General Counsel, NetCoalition, dated September 14, 2007 ("NetCoalition IV"); Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, dated August 1, 2007 ("SIFMA V"); Jeffrey Davis, Vice President and Deputy General Counsel, The Nasdaq Stock Market ("Nasdaq"), dated May 18, 2007 ("Nasdaq Letter"); David T. Hirschmann, Senior Vice President, Chamber of Commerce of the United States of America, dated May 3, 2007 ("Chamber of Commerce Letter"); Markham C. Erickson, Executive Director and General Counsel, NetCoalition, dated March 6, 2007 ("NetCoalition III"); Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, dated March 5, 2007 ("SIFMA IV"); Joseph Rizzello, Chief Executive Officer, National Stock Exchange ("NSX"), dated February 27, 2007 ("NSX Letter"); Keith F. Higgins, Chair, Committee on Federal Regulation of Securities, American Bar Association ("ABA"), dated February 12, 2007 ("ABA Letter"); James A. Forese, Managing Director and Head of Global Equities, Citigroup Global Markets Inc. ("Citigroup"), dated February 5, 2007 ("Citigroup Letter"); Meyer S. Frucher, Chairman and Chief Executive Officer, PHLX, dated January 31, 2007 ("PHLX Letter"); Amex, Boston Stock Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, ISE, The Nasdaq Stock Market, NYSE, NYSE Arca, and Philadelphia Stock Exchange ("PHLX") (collectively, the "Exchange Market Data Coalition"), dated January 26, 2007 ("Exchange Market Data Coalition Letter"); Oscar N. Onyema, Senior Vice President and Chief Administrative Officer, American Stock Exchange LLC ("Amex"), dated January 18, 2007 ("Amex Letter"); Sanjiv Gupta, Bloomberg, dated January 17, 2007 ("Bloomberg Letter"); Richard M. Whiting, Executive Director and General Counsel, Financial Services Roundtable, dated January 17, 2007 ("Financial Services Roundtable Letter"); Markham C. Erickson, Executive Director and General Counsel, NetCoalition, dated January 17, 2007 ("NetCoalition II"); Michael J. Simon,

commenters urged the Commission to set aside the action by delegated authority,[29] and five commenters supported the action by delegated authority.[30] One commenter expressed no views regarding the specifics of the Proposal, but urged the Commission to address market data fees as part of a more comprehensive modernization of SROs in light of recent market structure developments.[31] NYSE Arca responded to the comments submitted after the Commission granted the Petition.[32] Three commenters submitted additional comments addressing NYSE Arca's response and arguments raised by other commenters, or provided additional information.[33]

The comments submitted in connection with the Proposal and the Petition are summarized in this section. NYSE Arca's responses are summarized in section V below.

A. Commenters Opposing the Action by Delegated Authority

1. Need for a Comprehensive Review of Market Data Issues

Secretary, International Securities Exchange, LLC ("ISE"), dated January 17, 2007 ("ISE Letter"); Jeffrey T. Brown, Senior Vice President, Office of Legislative and Regulatory Affairs, Charles Schwab & Co., Inc. ("Schwab"), dated January 17, 2007 ("Schwab Letter"); and Ira Hammerman, Senior Managing Director and General Counsel, SIFMA, dated January 17, 2007 ("SIFMA III"); and letter from David Keith, Vice President, Web Products and Solutions, The Globe and Mail, to the Honorable Christopher Cox, Chairman, Commission, dated January 17, 2007 ("Globe and Mail Letter").

29 SIFMA III and IV, and Bloomberg, Chamber of Commerce, Citigroup, Financial Services Roundtable, Globe and Mail, NetCoalition, NSX, and Schwab Letters.

30 Amex, Exchange Market Data Coalition, ISE, Nasdaq, and PHLX Letters.

31 ABA Letter at 1.

32 Letter from Mary Yeager, Corporate Secretary, NYSE Arca, to the Honorable Christopher Cox, Chairman, Commission, dated February 6, 2007 ("NYSE Arca Response III").

33 Nasdaq Letter; SIFMA IV, V, and VI; NetCoalition III and IV.

Several commenters seeking a reversal of the staff's approval of the Proposal by delegated authority believed that recent regulatory and market structure developments warrant a broader review of market data fees and of the Commission's procedures for reviewing and evaluating market data proposals.[34] According to these commenters, these developments include the transformation of most U.S. securities exchanges into for-profit entities; the increasing importance of single-market depth-of-book information following decimalization and the adoption of Regulation NMS; and the absence of competitive forces that could limit the fees that an exchange may charge for its depth-of-book data. Some commenters believed that the Commission should consider not only market data fees, but also the contract terms governing the use of an exchange's market data, which may impose additional costs and include restrictions on the use of the data.[35]

In light of the significance and complexity of the issues raised, several commenters asked the Commission not only to reverse the staff's action, but also to impose a moratorium on the approval or processing of market data proposals while the Commission conducts a broader review of the issues associated with market data, including "the underlying issues of market structure, market power, transparency, and ease of dissemination and analysis of market data."[36]

2. Need for a Cost-Based Justification of Market Data Fees

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34 Citigroup Letter at 2; SIFMA III at 10, 26; SIFMA IV at 15. See also ABA Letter at 1; Bloomberg Letter at 7-8; NetCoalition I at 2; NetCoalition III at 13. Among other things, the Bloomberg and Citigroup Letters support the recommendations in SIFMA III. Bloomberg Letter at 8 n. 19; Citigroup Letter at 1.

35 Citigroup Letter at 2; SIFMA III at 23.

36 Citigroup Letter at 2. See also ABA Letter at 3; Financial Services Roundtable Letter at 1; NetCoalition III at 13; Schwab Letter at 1; SIFMA III at 26; SIFMA IV at 15.

Several commenters argued that the staff erred in approving the Proposal because NYSE Arca did not provide a cost-based justification for the Proposal's market data fees or other evidence to demonstrate that its proposed fees meet the applicable Exchange Act standards.[37] They asserted that the Exchange Act requires that an exchange's market data fees be "fair and reasonable," "not unreasonably discriminatory," and "an equitable allocation of costs,"[38] and that the Commission apply a cost-based standard in evaluating market data fees.[39] One commenter argued that market data fees "must be reasonably related to market data costs" and that the Commission should require exchanges to identify and substantiate their market data costs in their market data fee proposals.[40]

Several commenters argued that the Commission itself has recognized the need for a cost-based justification of market data fees.[41] They believed that the Commission's position in its 1999 market information concept release[42] "underscores the fundamental role that a rigorous cost-based analysis must play in reviewing market data fee filings."[43] In particular, these commenters cited the following statement from the release:

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37 Bloomberg Letter at 3; Petition at 5; SIFMA I at 6; SIFMA III at 20.

38 Schwab Letter at 4; SIFMA III at 19; SIFMA IV at 7.

39 Bloomberg Letter at 2; NetCoalition II at 3; NetCoalition III at 11; Schwab Letter at 3; SIFMA I at 6; SIFMA III at 16; SIFMA IV at 10.

40 SIFMA III at 1, 20.

41 Bloomberg Letter at 2; NetCoalition II at 3; NetCoalition III at 11; Schwab Letter at 3; SIFMA III at 20; SIFMA IV at 10.

42 Securities Exchange Act Release No. 42208 (December 9, 1999), 64 FR 70613 (December 17, 1999) ("Market Information Concept Release").

43 NetCoalition II at 3. See also Bloomberg Letter at 2; SIFMA I at 6.

> [T]he fees charged by a monopolistic provider of a service (such as the exclusive processors of market information) need to be tied to some type of cost-based standard in order to preclude excessive profits if fees are too high or underfunding or subsidization if fees are too low. The Commission therefore believes that the total amount of market information revenues should remain reasonably related to the cost of market information.[44]

Similarly, a commenter stated that the Commission acknowledged in its Concept Release Concerning Self-Regulation that the amount of market data revenues should be reasonably related to the cost of market information.[45] Another commenter, citing proceedings involving Instinet's challenge to proposed NASD market data fees,[46] argued that the Commission in that case "emphatically embraced the cost-based approach to setting market data fees . . . ," and insisted on a strict cost-based justification for the market data fees at issue.[47]

The commenters believed, further, that the costs attributable to market data should be limited to the cost of collecting, consolidating, and distributing the data,[48] and that market data fees should not be used to fund regulatory activities or to cross-subsidize an

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44 64 FR at 70627 (cited in Bloomberg Letter at 2; NetCoalition II at 3; NetCoalition III at 11 n. 47; SIFMA III at 1). One commenter maintained that the cost-based analysis requirement is based on Congressional concerns regarding the dangers of exclusive processors, in the context of either consolidated or single-market data. NetCoalition II at 3.

45 NetCoalition III at 11 n. 47.

46 Securities Exchange Act Release No. 20874 (April 17, 1984), 49 FR 17640 (April 24, 1984), aff'd sub nom. NASD, Inc. v. SEC, 802 F.2d 1415 (D.C. Cir. 1986).

47 SIFMA IV at 10.

48 Citigroup Letter at 1; SIFMA III at 21. One commenter believed that the Commission "should create standards that allow producers of market data to recover their costs and make a reasonable profit (e.g., a 10% return), but not an excessive profit." Schwab Letter at 6.

exchange's competitive operations.[49] One commenter maintained that, in the absence of cost data, the Commission cannot determine whether NYSE Arca uses market data revenues to subsidize competitive activities.[50] In particular, the commenter believed that the Commission must scrutinize the cost justification for NYSE Arca's fees to "be sure that NYSE Arca is not using its market power in the upstream data market as the exclusive processor for this data . . . to price squeeze its competitors in the downstream transaction market and to cross-subsidize its reduction in transaction fees."[51]

One commenter argued that NYSE Arca's proposed fees are not an "equitable allocation" of costs among its users and are unreasonably discriminatory because the fees are based on the number of people who view the data. Thus, a broker-dealer with many customers seeking to view market data pays considerably more for market data than an institution or algorithmic trader that pays only for the data link to its computer systems.[52]

3. <u>Exchange Act Rule 19b-4 Process</u>.

One commenter argued that the Proposal fails to satisfy the requirements of Exchange Act Rule 19b-4 and Form 19b-4, because, among other things, the Proposal does not: (1) explain why NYSE Arca must charge for data that it previously provided

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49 SIFMA III at 8; SIFMA IV at 10. The commenter believed that other costs, including member regulation and market surveillance, should be funded by listing, trading, and regulatory fees, rather than market data fees. <u>See</u> SIFMA III at 21. Another commenter maintained that funding regulatory activities through an explicit regulatory fee, rather than through market data revenues, "would be more logical and transparent . . . ." NSX Letter at 2. <u>See</u> <u>also</u> Schwab Letter at 5.

50 SIFMA IV at 10.

51 SIFMA IV at 10.

52 Schwab Letter at 4. The commenter argued that this fee structure "is a subsidization program whereby exchanges rebate revenue to their favored traders based on market data fees imposed on retail investors." <u>Id</u>.

free of charge; (2) address the change in circumstances caused by the NYSE's conversion from a member-owned, not-for-profit entity to a shareholder-owned, for-profit entity; (3) address the effect of the fee on retail investors, whom the commenter believes will be denied access to NYSE Arca's data as a result of the fees; (4) explain how making available a faster single-market data feed at a high price, while most investors must rely on slower consolidated market data products, is consistent with the mandates under the Exchange Act for equal access to and transparency in market data; and (5) include the contract terms governing access to and use of NYSE Arca's data or address the administrative costs and burdens that the contract terms impose.[53] Another commenter, citing the Petition, asserted that the Proposal fails to satisfy the requirements of Form 19b-4 because it provides no disclosure regarding the burdens on competition that could result from its proposed fees or a justification for the proposed fees.[54]

Commenters also raised more general concerns regarding the Exchange Act Rule 19b-4 rule filing process as it applies to proposed rule changes relating to market data. In light of the significant policy issues that market data proposals raise, commenters questioned whether such proposals should be eligible to be effective upon filing pursuant to Exchange Act Rule 19b-4(f)(6).[55] One commenter believed that all market data proposals should be subject to notice and comment, and that the Commission should provide a 30-day comment period for such proposals.[56] In addition, the commenter

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53 SIFMA III at 11-12.

54 Bloomberg Letter at 3. See also Petition at 6-7.

55 Baker Letter at 1-2; SIFMA III at 22; Bloomberg Letter at 6.

56 SIFMA III at 22.

cautioned that the rule filing process should not become a "rubberstamp" of an exchange's proposal.[57] One commenter suggested that the Commission narrow its delegation of authority with respect to proposed rule changes to exclude proposals that have generated significant public comment.[58]

4. Importance of Depth-of-Book Data

One commenter maintained that because single-market depth-of-book data products have significant advantages over consolidated top-of-book products in terms of both speed and the depth of interest displayed, many broker-dealers believe that it is prudent to purchase single-market depth-of-book data to satisfy their best execution and Regulation NMS order routing obligations.[59] The commenter noted that NYSE Arca has indicated in its advertising materials that its ArcaBook data feed is approximately 60 times faster than the consolidated data feeds and displays six times the liquidity within five cents of the inside quote.[60] The commenter also maintained that the NYSE has

57 SIFMA I at 2 n. 3.

58 NetCoalition III at 3-4.

59 SIFMA III at 5-6. The commenter stated that depth-of-book information has become more important because of the reduction in liquidity at the inside quote and the increase in quote volatility since decimalization, and because depth-of-book quotations are likely to become more executable following the implementation of Regulation NMS. SIFMA III at 12-13. Similarly, another commenter maintained that, through Regulation NMS, the Commission "has imposed a system that requires access to depth-of-book information." Schwab Letter at 5. Likewise, a commenter believed that market participants require depth-of-book information to trade effectively in decimalized markets. SIFMA IV at 8. See also NetCoalition III at 5.

60 SIFMA III at 14 n. 24.

linked its depth-of-book products to best execution by stating that "NYSE Arca's market data products are designed to improve trade execution."[61]

One commenter argued that the central processors that distribute consolidated data have little incentive to invest in modernizing their operations.[62] Another commenter believed that the disparity between faster and more expensive depth-of-book proprietary data feeds and the slower, less costly, and less valuable consolidated data feeds results in a "two-tiered structure with institutions having access to prices not reasonably available to small investors . . .," circumstances that the commenter believed "recreate the informational advantage that once existed on the physical floors of the open outcry markets."[63]

Another commenter believed that depth-of-book information should be considered basic information for retail investors as well as professional investors and that one goal of the National Market System should be to assure that "all investors . . . whether professional or non-professional . . . have equal access to the same quality information, at a reasonable price, and at the same time."[64] Similarly, a commenter believed that retail investors require quotations beyond the national best bid or offer to assess the quality of the executions they receive.[65]

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61 SIFMA IV at 12.

62 SIFMA III at 13.

63 Financial Services Roundtable Letter at 3. One commenter believed that market participants who choose not to purchase depth-of-book data will face the informational disadvantages that Regulation NMS seeks to eliminate. NSX Letter at 2.

64 SIFMA IV at 13.

65 NetCoalition III at 5 n. 16.

5. Lack of Competition in Market Data Pricing

Commenters argued that there are no effective competitive or market forces that limit what an exchange may charge for its depth-of-book data.[66] Although one commenter acknowledged the argument that competition in the market for liquidity and transactions could serve as a constraint on what exchanges may charge for their data products, the commenter believed that the consolidations of the NYSE with Archipelago and Nasdaq with BRUT and INET have limited this constraint.[67] The commenter also asserted that competition in the market for order execution is not the same as competition in the market for market data, and that an economic analysis must consider the market for market data from the consumer's perspective.[68] Because proprietary market data is a "sole-source product," the commenter believed that no market forces operate on the transaction between an exchange and the consumer of its data.[69] The commenter believed that the unique characteristics of the market for market data—including increased market concentration and market participants' obligation to purchase sole-source proprietary market data to trade effectively—resulted in a "classic economic market failure . . . that requires comprehensive regulatory intervention to ensure 'fair and reasonable' prices."[70] Similarly, another commenter maintained that, with respect to

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66 NetCoalition III at 9; SIFMA III at 16-17; SIFMA IV at 5.

67 SIFMA III at 17.

68 SIFMA IV at 5. See also NetCoalition III at 2.

69 SIFMA IV at 5.

70 SIFMA IV at 8. The commenter believed that Congress envisioned the Commission regulating exclusive processors in a manner similar to the way in which public utilities are regulated. SIFMA I at 5.

market data that is exclusive to an exchange, "[t]here is no way for competitive forces to produce market-driven or 'fair and reasonable' prices required by the Exchange Act . . . ."[71]

Other commenters believed that an exchange has a monopoly position as the exclusive processor of its proprietary data that "creates a serious potential for abusive pricing practices,"[72] and urged the Commission to consider the lack of competition and the inability to obtain market data from other sources.[73] One commenter asserted that "broker-dealers will . . . be forced to purchase market data at a fixed and . . . arbitrary price" until market data fees are reformed.[74]

In addition, several commenters believed that the transformation of most U.S. securities exchanges from not-for-profit membership organizations to for-profit entities has eliminated an important constraint on market data fees as the for-profit exchanges seek to maximize value for their shareholders.[75] In this regard, one commenter explained that "exchanges are beholden to their shareholders to increase revenue, and market data is

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71 NetCoalition III at 2.

72 Schwab Letter at 6. See also Spencer Letter.

73 Citigroup Letter at 1. Similarly, a commenter believed that "[u]nless checked by effective regulatory oversight . . . exchanges have both the incentives and the power to charge whatever they can for the market data over which they have exclusive control." SIFMA III at 4. The commenter also asserted that "[t]he lack of both economic market forces and comprehensive oversight of exchanges as the sole-source processors of market data . . . has allowed the exchange to simply 'name their prices' . . . ." SIFMA IV at 2.

74 NSX Letter at 2.

75 ABA Letter at 2-3; Financial Services Roundtable Letter at 2; Schwab Letter at 5; SIFMA III at 24.

the revenue stream that holds the greatest potential for doing so."[76] Other commenters argued that the advent of for-profit exchanges has eliminated the governance checks on market data pricing that operated when exchange members – broker-dealers who were obligated to purchase consolidated market data – sat on the boards of the non-profit, member-owned exchanges.[77]

6. Increase in Market Data Revenues

With respect to the increase in the NYSE Group's market data revenues following its merger with Archipelago, one commenter stated that "NYSE Group's reported market data segment revenues totaled $57.5 million in the third quarter of 2006: up 33.7% from the same three month period in 2005."[78] According to the commenter, the NYSE Group attributed its revenue growth in market data to the contribution of NYSE Arca's operations following the completion of the merger between the NYSE and Archipelago on March 7, 2006.[79] The commenter maintained that Nasdaq has experienced similar growth in its market data revenues and that the exchanges "propose to charge fees for a series of market data products that, when multiplied by the number of potential subscribers, are resulting in increased costs of doing business totaling tens of millions of dollars per year for some individual firms and hundreds of millions of dollars per year across the financial markets."[80] The commenter identified the current fees for proprietary

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76 Schwab Letter at 5. See also NetCoalition II at 4; SIFMA III at 24; SIFMA IV at 2.

77 Financial Services Roundtable Letter at 2; NetCoalition II at 4; SIFMA III at 15.

78 SIFMA III at 18-19 (citations omitted).

79 SIFMA III at 18 (citation omitted).

80 SIFMA III at 4.

and consolidated market data products and claimed that investors ultimately pay these fees.[81]

7. Recommended Solutions

To address the issues raised by market data fees, the commenters suggested several potential solutions. One commenter recommended that the Commission adopt a specialized market data form for market data rule proposals that would require a detailed justification of proposed fee changes by the SROs.[82] The commenter believed that the form should, among other things, require an exchange to substantiate its historical costs of producing market data, its current market data revenues, how and why its costs have changed and the existing revenue is no longer appropriate, how the fee would impact market participants, how the revenues would be used, and the contract terms, system specifications, and audit requirements that would be associated with the proposed fee change.[83]

The commenter also believed that the contract terms governing the use of market data should be included in market data rule filings and subject to notice and comment.[84] The commenter maintained that the contract terms are effectively non-negotiable and that the compliance costs associated with them may affect the efficiency and transparency of the markets. Another commenter asserted that exchange market data contracts limit the use and dissemination of the data provided under the contracts, potentially impairing the

81 SIFMA IV at 14 and Appendix A.

82 SIFMA III at 21-22.

83 SIFMA III at 21-22.

84 SIFMA III at 23.

flow and further analysis of the information, and impose administrative and technological burdens on firms.[85]

The commenters also suggested structural changes to address market data issues, including requiring exchanges to place their market data operations in a separate subsidiary and to make their raw market data available to third parties on the same terms as they make the data available to their market data subsidiary and to the independent central processor.[86] The commenters believed that this could encourage competition in providing market data products and services[87] and create a mechanism for free market pricing.[88]

Finally, the commenters suggested that the Commission increase the quality and depth of the required consolidated quotation information to allow retail investors to determine the prices at which their orders will be executed and to observe pricing movements in the market.[89] One commenter recommended that the Commission require exchanges to consolidate and distribute their top and depth-of-book data, and that the associated costs be paid by investors who act on the information.[90]

B. Commenters Supporting the Action by Delegated Authority

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85 Citigroup Letter at 2.

86 Bloomberg Letter at 4; Kanjorski Letter at 1; NetCoalition I at 2; Schwab Letter at 7; SIFMA III at 24-25.

87 SIFMA III at 25.

88 Schwab Letter at 7.

89 Schwab Letter 5; SIFMA III at 25-26.

90 NSX Letter at 2. Other commenters endorse this recommendation. NetCoalition III at 7, 13; SIFMA IV at 15.

Several commenters who supported the approval of the Proposal by delegated authority argued that the staff applied the correct legal standard[91] and that the broader policy questions raised by the Petition should be addressed in the context of Commission rulemaking, rather than in connection with a specific exchange market data proposal.[92]

Several commenters rejected the assertion that a cost-based standard is the correct standard for the Commission to apply in reviewing market data fee proposals.[93] In this regard, the commenters distinguished between the standards applicable to "core" market data (i.e., consolidated quotation and last sale data for U.S.-listed equities) and the standards applicable to proprietary market data products.[94] One commenter maintained that the Commission, in adopting Regulation NMS, authorized exchanges to distribute market data outside of the national market system plans, subject to the general fairness and nondiscrimination standards of Rule 603 of Regulation NMS, but "otherwise [left] to free market forces the determination of what information would be provided and at what price."[95] Another commenter, noting that the Commission specifically considered and refrained from adopting the cost-based standard that NetCoalition proposes, argued that NetCoalition's approach "would replace Regulation NMS . . . with a complex and

91 Amex Letter at 2; ISE Letter at 3; PHLX Letter at 2-3.

92 Amex Letter at 4; PHLX Letter at 8.

93 Exchange Market Data Coalition Letter at 2; ISE Letter at 3; PHLX Letter at 4.

94 Amex Letter at 1; ISE Letter at 2-3; PHLX Letter at 4-5.

95 Amex Letter at 2. The commenter noted that exchange fees also are subject to the requirements of Section 6(b)(4) of the Exchange Act. See also PHLX Letter at 7.

intrusive rate-making approach that is inconsistent with the goals of the . . . [Exchange Act] and would be more costly than beneficial."[96]

One commenter disagreed with the assertion that an exchange possesses monopoly pricing power with respect to its proprietary data products. It contended that assertions concerning an exchange's monopoly pricing power "ignore . . . market reality and market discipline. If any exchange attempts to charge excessive fees, there simply will not be buyers for such products."[97] Nasdaq noted that, as of April 30, 2007, over 420,000 professional users purchased core data, but less than 19,000 professional users purchased TotalView, Nasdaq's proprietary depth-of-book order product.[98] It concluded that "[b]roker-dealers may claim they are required to purchase TotalView, but their actions indicate otherwise."[99]

The commenters emphasized that the exchanges face significant competition in their efforts to attract order flow:

> Exchanges compete not only with one another, but also with broker-dealers that match customer orders within their own systems and also with a proliferation of alternative trading systems ("ATSs") and electronic communications networks ("ECNs") that the Commission has also

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96 Exchange Market Data Coalition Letter at 2. One commenter asserted that "[a]pplying NetCoalition's proposed strict cost-based fee analysis to every exchange market data rule filing is unworkable and . . . is not required under the Act." ISE Letter at 3. Similarly, noting that SROs must ensure that market data is not corrupted by fraud or manipulation, another commenter believed that it would be virtually impossible to identify the costs specifically associated with the production of market data versus other SRO functions. PHLX Letter at 6.

97 ISE Letter at 3. Similarly, another commenter noted that the users of data will purchase data "if it provides them value and is priced reasonably." Amex Letter at 1.

98 Nasdaq Letter at 6.

99 Nasdaq Letter at 6.

> nurtured and authorized to execute trades in any listed issue. As a result, market share of trading fluctuates among execution facilities based on their ability to service the end customer. The execution business is highly competitive and exhibits none of the characteristics of a monopoly as suggested in the NetCoalition Petition.[100]

Similarly, another commenter stated that "the market for proprietary data products is currently competitive and inherently contestable because there is fierce competition for the inputs necessary to the creation of proprietary data and strict pricing discipline for the proprietary products themselves."[101] It also noted that market data "is the totality of the information assets that each Exchange creates by attracting order flow" and emphasized that "[i]t is in each Exchange's best interest to provide proprietary information to investors to further their business objectives, and each Exchange chooses how best to do that."[102] Commenters stated that, in the absence of a regulatory requirement to provide non-core market data, it is necessary to provide a financial or other business incentive for exchanges to make such data available.[103]

IV. <u>NYSE Arca Responses to Commenters</u>

A. <u>Response to Commenters on Proposal</u>

In its responses to commenters on the Proposal, the Exchange argued that the Proposal establishes "a framework for distributing data in which all vendors and end users are permitted to receive and use the Exchange's market data on equal, non-

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100 Exchange Market Data Coalition Letter at 4.

101 Nasdaq Letter at 7.

102 <u>Id</u>. at 3, 4.

103 Amex Letter at 1; ISE Letter at 2; PHLX Letter at 7.

discriminatory terms."[104] The Exchange asserted that the proposed professional and non-professional device fees for the NYSE Arca Data were fair and reasonable because they "are far lower than those already established – and approved by the Commission – for similar products offered by other U.S. equity exchanges and stock markets."[105] In particular, the Exchange noted that the proposed $15 per month device fee for each of the ArcaBook data products is less than both the $60 per month and $70 per month device fees that the NYSE and Nasdaq, respectively, charge for comparable market data products.[106]

With respect to its proposed fees, the Exchange noted, further, that it had invested significantly in its ArcaBook products, including making technological enhancements that allowed the Exchange to expand capacity and improve processing efficiency as message traffic increased, thereby reducing the latency associated with the distribution of ArcaBook data.[107] The Exchange stated that "[i]n determining to invest the resources necessary to enhance ArcaBook technology, the Exchange contemplated that it would seek to charge for the receipt and use of ArcaBook data."[108] The Exchange also emphasized the reasonableness of its proposed fee relative to other comparable market data products, asserting, for example, that "NYSE Arca is at the inside price virtually as often as Nasdaq, yet the proposed fee for ArcaBook is merely one-fifth of the TotalView

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104 NYSE Arca Response I at 2.

105 Id.

106 NYSE Arca Response I at 2-3.

107 NYSE Arca Response II at 2.

108 Id. at 3.

fee."[109] Moreover, it stated that its decision to commence charging for ArcaBook data was based on its view that "market data charges are a particularly equitable means for funding a market's investment in technology and its operations. In contrast with transaction, membership, listing, regulatory and other SRO charges, market data charges cause all consumers of a securities market's services, including investors and market data vendors, to contribute."[110]

The Exchange stated that it proposes to use the CTA and CQ Plan contracts to govern the distribution of NYSE Arca Data and that it was not amending the terms of these existing contracts or imposing restrictions on the use or display of its data beyond those that are currently set forth in the contracts.[111] Further, the Exchange specifically noted that these contracts do not prohibit a broker-dealer from making its own data available outside of the CTA and CQ Plans.[112] Finally, the Exchange argued that by using this current structure, it believes that the administrative burdens on firms and vendors should be low.[113]

B. Response to Commenters on Petition

In its response to commenters on the Petition, the Exchange argued that recent market-based solutions have mooted the concerns expressed in the Petition regarding the

109 Id.

110 Id. at 4.

111 NYSE Arca Response I at 3.

112 Id. at n. 12 and accompanying text.

113 Id. at 5.

affordability of market data for internet portals.[114] In particular, the Exchange noted that the NYSE recently submitted a proposed rule change for a market data product that would provide unlimited real-time last sale prices to vendors for a fixed monthly fee ("NYSE Internet Proposal").[115] The Exchange stated that this NYSE Internet Proposal "would meet the needs of internet portals and add to the number of choices that are available to intermediaries and investors for their receipt of real-time prices."[116] The Exchange asserted that the NYSE Internet Proposal "provides a significant benefit to investors" since "it adds to the data-access alternatives available to them and improves the quality, timeliness and affordability of data they can receive over the internet."[117]

The Exchange also reiterated the argument that the proposed market data fees meet the statutory standards for such fees under the Exchange Act.[118] The Exchange argued that the fees represent an equitable allocation of fees and charges since they "represent the first time that [the Exchange] has established a fee that a person or entity other than an [Exchange] member or listed company must pay" and are being imposed "on those who use the facilities of [the Exchange] but do not otherwise contribute to [the Exchange's] operating costs."[119]

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114 NYSE Arca Response III at 5-6.

115 See id. at 5 (citing NYSE Internet Proposal, supra note 18).

116 NYSE Arca Response III at 5.

117 Id.

118 Id. at 11.

119 Id.

The Exchange argued that the proposed market data fees are not "unreasonably discriminatory" since "all professional subscribers are subject to the same fees and all nonprofessional subscribers are subject to the same fees."[120] The Exchange noted that the only discrimination that occurs is the "reasonable" distinction that would require professional subscribers to pay higher fees than nonprofessional subscribers.[121]

The Exchange asserted that the fees are fair and reasonable because: (1) "they compare favorably to the level of fees that other U.S. markets and the CTA and Nasdaq/UTP Plans impose for comparable products"; (2) "the quantity and quality of data NYSE Arca includes in Arca Book compares favorably to the data that other markets include in their market data products"; and (3) "the fees will enable NYSE Arca to recover the resources that NYSE Arca devoted to the technology necessary to produce Arca Book data."[122]

The Exchange also rejected the Petitioner's assertion that the Exchange acted "arbitrarily or capriciously" by using a comparison of similar market data fees in setting the level of the proposed fees.[123] The Exchange noted that in addition to studying "what other markets charge for comparable products," the Exchange also considered: (1) the needs of those entities that would likely purchase the Arca Book data; (2) the "contribution that revenues from Arca Book Fees would make toward replacing the revenues that NYSE Arca stands to lose as a result of the removal of the NQDS service

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120 Id.

121 Id.

122 Id. at 11-12.

123 Id. at 12.

from the Nasdaq/UTP Plan"; (3) "the contribution that revenues accruing from Arca Book Fees would make toward NYSE Arca's market data business"; (4) the contribution that revenues accruing from Arca Book Fees would make toward meeting the overall costs of NYSE Arca's operations"; (5) "projected losses to NYSE Arca's business model and order flow that might result from marketplace resistance to Arca Book Fees"; and (6) "the fact that Arca Book is primarily a product for market professionals, who have access to other sources of market data and who will purchase Arca Book only if they determine that the perceived benefits outweigh the cost."[124]

The Exchange also rejected the Petitioner's assertion that all proposed market data fees must be subjected to a rigorous cost-based analysis.[125] The Exchange noted that the Petitioner "is able to cite only one instance" that supports such an assertion.[126] The Exchange also noted that Petitioner "fails to mention that a significant portion of the industry" expressed opposition to a cost-based approach to analyzing market data fees in response to various Commission releases and other initiatives.[127] The Exchange argued that a cost-based analysis of market data fees is impractical because "[i]t would

124 Id. at 12-13.

125 Id. at 13.

126 Id.

127 Id. at 14-15. The Exchange referenced opposition in the industry to a cost-based analysis of market data fees expressed in connection with the Market Information Concept Release, the Concept Release Concerning Self-Regulation, the Regulation NMS initiative, and the Commission's Advisory Committee on Market Information.

inappropriately burden both the government and the industry, stifle competition and innovation, and in the end, raise costs and, potentially, fees."[128]

The Exchange also disputed Petitioner's argument that the Exchange's proposed market data fees amount to an exercise of monopoly pricing power.[129] It noted that "[m]arkets compete with one another by seeking to maximize the amount of order flow that they attract. The markets base the competition for order flow on such things as technology, customer service, transaction costs, ease of access, liquidity and transparency."[130] The Exchange noted that "[t]he Commission has prescribed top-of-the-book consolidated market data as the data required for best execution purposes" and that there is "no regulatory requirement" for brokers to receive depth-of-book or other proprietary market data products.[131] Accordingly, the Exchange asserted that no monopoly power exists, and that the marketplace determines the fees charged by the Exchange for depth-of-book market data.[132] Further, the Exchange claimed that if the market data fees were excessive, market participants "would forego Arca Book data and would choose to receive the depth-of-book service of other markets."[133] It noted that:

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128 Id. at 15 (citing NYSE Response to Market Information Concept Release (April 10, 2000) (emphasis in original).

129 Id. at 16.

130 Id. at 16. See also id. at 18 ("If too many market professionals reject Arca Book as too expensive, NYSE Arca would have to reassess the Arca Book Fees because Arca Book data provides transparency to NYSE Arca's market, transparency that plays an important role in the competition for order flow.")

131 Id. at 18.

132 Id.

133 Id.

> As a result of all of the choices and discretion that are available to brokers, the displayed depth-of-book data of one trading center does not provide a complete picture of the full market for the security. It displays only a portion of all interest in the security. A brokerage firm has potentially dozens of different information sources to choose from in determining if, where, and how to represent an order for execution.[134]

The Exchange also addressed other concerns raised by commenters in connection with the Petition. First, the Exchange indicated that is has no intention of retroactively imposing the proposed market data fees.[135] The Exchange also disputed a commenter's statement which indicated that "market data revenues of the NYSE Group (the parent company of Exchange and NYSE) for the third quarter of 2006 rose 33.7% from the year-earlier."[136] According to the Exchange, this statistic does not demonstrate "a significant increase in market data revenues during 2006" since the 2005 market data revenue from the NYSE Group used to generate this statistic did not include the Exchange's market data revenue because the Exchange was not part of the NYSE Group in 2005.[137] The Exchange notes that the combined market data revenues for the Exchange and NYSE have actually declined slightly.[138] Lastly, the Exchange rejects the commenters' contention that a significant speed variance exists between proprietary market data products and the consolidated data feed that markets make available under the CQ and Nasdaq/UTP Plans. The Exchange notes that the "variations in speed are measured in

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134 Id. at 17.

135 Id. at 20.

136 Id.

137 Id.

138 Id. at n. 50 and accompanying text. According to the Exchange, pro forma results indicate that the Exchange and NYSE received a combined $242 million in 2005, while they only received a combined $235 million in 2006.

milliseconds" and that "[f]rom a display perspective the difference is imperceptible."[139] Furthermore, the Exchange notes that the CQ Plan participants have undertaken a technology upgrade that would reduce the latency of the consolidated feed from "several hundred milliseconds to approximately 30 milliseconds."[140]

V. Discussion

The Commission finds that the Proposal is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to a national securities exchange. In particular, it is consistent with Section 6(b)(4) of the Exchange Act,[141] which requires that the rules of a national securities exchange provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other parties using its facilities, and Section 6(b)(5) of the Exchange Act,[142] which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, 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, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

The Commission also finds that the Proposal is consistent with the provisions of Section 6(b)(8) of the Exchange Act,[143] which requires that the rules of an exchange not

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139 Id. at 21.

140 Id.

141 15 U.S.C. 78f(b)(4).

142 15 U.S.C. 78f(b)(5).

143 15 U.S.C. 78f(b)(8).

impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Finally, the Commission finds that the Proposal is consistent with Rule 603(a) of Regulation NMS,[144] adopted under Section 11A(c)(1) of the Exchange Act, which requires an exclusive processor that distributes information with respect to quotations for or transactions in an NMS stock to do so on terms that are fair and reasonable and that are not unreasonably discriminatory.[145]

A. Commission Review of Proposals for Distributing Non-Core Data

The standards in Section 6 of the Exchange Act and Rule 603 of Regulation NMS do not differentiate between types of data and therefore apply to exchange proposals to distribute both core data and non-core data. Core data is the best-priced quotations and comprehensive last sale reports of all markets that the Commission, pursuant to Rule 603(b), requires a central processor to consolidate and distribute to the public pursuant to joint-SRO plans.[146] In contrast, individual exchanges and other market participants distribute non-core data voluntarily. As discussed further below, the mandatory nature of the core data disclosure regime leaves little room for competitive forces to determine

144 17 CFR 242.603(a).

145 NYSE Arca is an exclusive processor of the NYSE Arca Data under Section 3(a)(22)(B) of the Exchange Act, 15 U.S.C. 78c(a)(22)(B), which defines an exclusive processor as, among other things, an exchange that distributes information with respect to quotations or transactions on an exclusive basis on its own behalf.

146 See Rule 603(b) of Regulation NMS ("Every national securities exchange on which an NMS stock is traded and national securities association shall act jointly pursuant to one or more effective national market system plans to disseminate consolidated information, including a national best bid and national best offer, on quotations for and transactions in NMS stocks. Such plan or plans shall provide for the dissemination of all consolidated information for an individual NMS stock through a single plan processor.")

products and fees. Non-core data products and their fees are, by contrast, much more sensitive to competitive forces. For example, the Commission does not believe that broker-dealers are required to purchase depth-of-book order data, including the NYSE Arca data, to meet their duty of best execution.[147] The Commission therefore is able to use competitive forces in its determination of whether an exchange's proposal to distribute non-core data meets the standards of Section 6 and Rule 603.

The requirements for distributing core data to the public were first established in the 1970s as part of the creation of the national market system for equity securities.[148] Although Congress intended to rely on competitive forces to the greatest extent possible to shape the national market system, it also granted the Commission full rulemaking authority in the Exchange Act to achieve the goal of providing investors with a central source of consolidated market information.[149]

Pursuant to this Exchange Act authority, the Commission has required the SROs to participate in three joint-industry plans ("Plans") pursuant to which core data is distributed to the public.[150] The Plans establish three separate networks to disseminate

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147 See notes 224-226 below and accompanying text.

148 These requirements are discussed in detail in section III of the Concept Release on Market Information, 64 FR at 70618-70623.

149 H.R. Rep. No. 94-229, 94th Cong., 1st Sess. 92 (1975) ("Conference Report").

150 The three joint-industry plans, approved by the Commission, are: (1) the CTA Plan, which is operated by the Consolidated Tape Association and disseminates transaction information for securities primarily listed on an exchange other than Nasdaq; (2) the CQ Plan, which disseminates consolidated quotation information for securities primarily listed on an exchange other than Nasdaq; and (3) the Nasdaq UTP Plan, which disseminates consolidated transaction and quotation information for securities primarily listed on Nasdaq. The CTA Plan and CQ Plan are available at www.nysedata.com. The Nasdaq UTP Plan is available at www.utpdata.com.

core data for NMS stocks: (1) Network A for securities primarily listed on the NYSE; (2) Network C for securities primarily listed on Nasdaq; and (3) Network B for securities primarily listed on exchanges other than the NYSE and Nasdaq. For each security, the data includes: (1) a national best bid and offer ("NBBO") with prices, sizes, and market center identifications; (2) the best bids and offers from each SRO that include prices, sizes, and market center identifications; and (3) last sale reports from each SRO. The three Networks establish fees for this core data, which must be filed for Commission approval.[151] The Networks collect the applicable fees and, after deduction of Network expenses, distribute the remaining revenues to their individual SRO participants.

The Plans promote the wide availability of core market data.[152] For each of the more than 7000 NMS stocks, quotations and trades are continuously collected from many different trading centers and then disseminated to the public by the central processor for a Network in a consolidated stream of data. As a result, investors have access to a reliable source of information for the best prices in NMS stocks. Commission rules long have required broker-dealers and data vendors, if they provide any data to customers, to also provide core data to investors in certain contexts, such as trading and order-routing.[153] In addition, compliance with the trade-through requirements of Rule 611 of Regulation

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151 Rule 608(b)(1) of Regulation NMS, 17 CFR 242.608(b)(1).

152 The Plan provisions for distributing quotation and transaction information are discussed in detail in section II of the Concept Release on Market Information, 64 FR at 70615-70618.

153 Rule 603(c) of Regulation NMS, 17 CFR 242.603(c).

NMS[154] necessitates obtaining core quotation data because it includes all the quotations that are entitled to protection against trade-throughs.[155]

For many years, the core data distributed through the Networks overwhelmingly dominated the field of equity market data in the U.S. With the initiation of decimal trading in 2001, however, the value to market participants of non-core data, particularly depth-of-book order data, increased. An exchange's depth-of-book order data includes displayed trading interest at prices inferior to the best-priced quotations that exchanges are required to provide for distribution in the core data feeds. Prior to decimal trading, significant size accumulated at the best-priced quotes because the minimum spread between the national best bid and the national best offer was 1/16th, or 6.25 cents. When the minimum inside spread was reduced to one cent, the size displayed at the best quotes decreased substantially, while the size displayed at the various one-cent price points away from the inside quotes became a more useful tool to assess market depth.

In 2005, the Commission adopted new rules that, among other things, addressed market data.[156] Some commenters on the rule proposals recommended that the Commission eliminate or substantially modify the consolidation model for distributing core data. In addressing these comments, the Commission described both the strengths and weaknesses of the consolidation model. It emphasized the benefits of the model for

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154 17 CFR 242.611.

155 Rule 600(b)(57)(iii) of Regulation NMS, 17 CFR 242.600(b)(57)(iii) (definition of "protected bid" and "protected offer" limited to the best bids and best offers of SROs). The Commission decided not to adopt a proposal which would have protected depth-of-book quotations against trade-throughs if the market displaying such quotations voluntarily disseminated them in the consolidated quotation stream. Regulation NMS Release, 70 FR at 37529.

156 Regulation NMS Release, 70 FR at 37557-37570.

retail investors, but noted the limited opportunity for market forces to determine the level and allocation of fees for core data and the negative effects on innovation by individual markets in the provision of their data.[157]

The Commission ultimately decided that the consolidation model should be retained for core data because of the benefit it afforded to investors, namely "helping them to assess quoted prices at the time they place an order and to evaluate the best execution of their orders against such prices by obtaining data from a single source that is highly reliable and comprehensive."[158]

With respect to the distribution of non-core data, however, the Commission decided to maintain a deconsolidation model that allows greater flexibility for market forces to determine data products and fees.[159] In particular, the Commission both authorized the independent dissemination of an individual market's or broker-dealer's trade data, which previously had been prohibited by Commission rule, and streamlined the requirements for the consolidated display of core market data to customers of broker-dealers and vendors.[160] Most commenters supported this approach.[161] A few

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157 Id. at 37558.

158 Id. at 37504.

159 When describing the deconsolidation model in the context of deciding whether to propose a new model for core data, the Commission noted that "the strength of this model is the maximum flexibility it allows for competitive forces to determine data products, fees, and SRO revenues." Securities Exchange Act Release No. 49325 (February 26, 2004), 69 FR 11126, 11177 (March 9, 2004). As discussed in the text, the Commission decided to retain the consolidation model, rather than proposing a new deconsolidation model, for core data.

160 See Regulation NMS Release, 70 FR at 37566-37567 (addressing differences in distribution standards between core data and non-core data).

161 Id.

commenters, however, recommended that "the Commission should expand the consolidated display requirement to include additional information on depth-of-book quotations, stating that the NBBO alone had become less informative since decimalization."[162] Such an approach effectively would have treated an individual market's depth-of-book order data as consolidated core data and thereby eliminated the operation of competitive forces on depth-of-book order data. The Commission did not adopt this recommendation, but instead decided to:

> allow market forces, rather than regulatory requirements, to determine what, if any, additional quotations outside the NBBO are displayed to investors. Investors who need the BBOs of each SRO, as well as more comprehensive depth-of-book information, will be able to obtain such data from markets or third party vendors.[163]

Some commenters on the Proposal and the Petition recommended fundamental changes in the regulatory treatment of non-core data in general and depth-of-book quotations in particular.[164] The Commission, however, considered this issue in 2005 and continues to hold the views just described. It does not believe that circumstances have changed significantly since 2005 and will continue to apply a primarily market-based approach for assessing whether exchange proposals to distribute non-core data meet the applicable statutory standards.

The Exchange Act and its legislative history strongly support the Commission's reliance on competition, whenever possible, in meeting its regulatory responsibilities for overseeing the SROs and the national market system. Indeed, competition among

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162 Id. at 37567 (citation omitted).

163 Id. (citations omitted) (emphasis added).

164 See section IV.A.4 above.

multiple markets and market participants trading the same products is the hallmark of the national market system.[165] A national market "system" can be contrasted with a single monopoly market that overwhelmingly dominates trading its listed products. Congress repeatedly emphasized the benefits of competition among markets in protecting investors and promoting the public interest. When directing the Commission to facilitate the establishment of a national market system, for example, Congress emphasized the importance of allowing competitive forces to work:

> In 1936, this Committee pointed out that a major responsibility of the SEC in the administration of the securities laws is to "create a fair field of competition." This responsibility continues today. The bill would more clearly identify this responsibility and clarify and strengthen the SEC's authority to carry it out. The objective would be to enhance competition and to allow economic forces, interacting within a fair regulatory field, to arrive at appropriate variations in practices and services.[166]

In addition, Congress explicitly noted the importance of relying on competition in overseeing the activities of the SROs:

> S. 249 would give the SEC broad authority not only to oversee the general development of a national market system but also to insure that the ancillary programs of the self-regulatory organizations and their affiliates are consistent with the best interests of the securities industry and the investing public. . . . This is not to suggest that under S. 249 the SEC would have either the responsibility or the power to operate as an 'economic czar' for the development of a national market system. Quite the contrary, for a fundamental premise of the bill is that the initiative for the development of the facilities of a national market system must come from private interests and will depend on the vigor of competition within the securities industry as broadly defined.[167]

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165 See, e.g., Exchange Act Section 11A(a)(1)(C)(ii).

166 S. Rep. No. 94-75, 94th Cong., 1st Sess. 8 (1975) ("Senate Report").

167 Senate Report at 12.

With respect to market information, Congress again expressed its preference for the Commission to rely on competition, but noted the possibility that competition might not be sufficient in the specific context of core data – the central facilities for the required distribution of consolidated data to the public:

> It is the intent of the conferees that the national market system evolve through the interplay of competitive forces as unnecessary regulatory restrictions are removed. The conferees expect, however, that in those situations where competition may not be sufficient, such as in the creation of a composite quotation system or a consolidated transactional reporting system, the Commission will use the powers granted to it in this bill to act promptly and effectively to insure that the essential mechanisms of an integrated secondary trading system are put into effect as rapidly as possible.[168]

The Commission's approach to core data and non-core data follows this Congressional intent exactly. With respect to the systems for the required distribution of consolidated core data, the Commission retained a regulatory approach that uses joint-industry plans and a central processor designed to assure access to the best quotations and most recent last sale information that is so vital to investors. With respect to non-core data, in contrast, the Commission has maintained a market-based approach that leaves a much fuller opportunity for competitive forces to work.

This market-based approach to non-core data has two parts. The first is to ask whether the exchange was subject to significant competitive forces in setting the terms of its proposal for non-core data, including the level of any fees. If an exchange was subject to significant competitive forces in setting the terms of a proposal, the Commission will approve the proposal unless it determines that there is a substantial countervailing basis to find that the terms nevertheless fail to meet an applicable requirement of the Exchange

168 Conference Report at 92 (emphasis added).

Act or the rules thereunder. If, however, the exchange was not subject to significant competitive forces in setting the terms of a proposal for non-core data, the Commission will require the exchange to provide a substantial basis, other than competitive forces, in its proposed rule change demonstrating that the terms of the proposal are equitable, fair, reasonable, and not unreasonably discriminatory.

As discussed above, the Commission believes that, when possible, reliance on competitive forces is the most appropriate and effective means to assess whether terms for the distribution of non-core data are equitable, fair and reasonable, and not unreasonably discriminatory. If competitive forces are operative, the self-interest of the exchanges themselves will work powerfully to constrain unreasonable or unfair behavior. As discussed further below, when an exchange is subject to competitive forces in its distribution of non-core data, many market participants would be unlikely to purchase the exchange's data products if it sets fees that are inequitable, unfair, unreasonable, or unreasonably discriminatory. As a result, competitive forces generally will constrain an exchange in setting fees for non-core data because it should recognize that its own profits will suffer if it attempts to act unreasonably or unfairly. For example, an exchange's attempt to impose unreasonably or unfairly discriminatory fees on a certain category of customers would likely be counter-productive for the exchange because, in a competitive environment, such customers generally would be able respond by using alternatives to the exchange's data.[169] The Commission therefore believes that the existence of significant

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169 See, e.g., Richard Posner, Economic Analysis of Law § 9.1 (5th ed. 1998) (discussing the theory of monopolies and pricing). See also U.S. Dep't of Justice & Fed'l Trade Comm'n, Horizontal Merger Guidelines § 1.11 (1992), as revised (1997) (explaining the importance of alternative products in evaluating the presence of competition and defining markets and market power). Courts

competition provides a substantial basis for finding that the terms of an exchange's fee proposal are equitable, fair, reasonable, and not unreasonably or unfairly discriminatory.

Even when competitive forces are operative, however, the Commission will continue to review exchange proposals for distributing non-core data to assess whether there is a substantial countervailing basis for determining that a proposal is inconsistent with the Exchange Act.[170] For example, an exchange proposal that seeks to penalize market participants for trading in markets other than the proposing exchange would present a substantial countervailing basis for finding unreasonable and unfair discrimination and likely would prevent the Commission from approving an exchange proposal.[171] In the absence of such a substantial countervailing basis for finding that a proposal failed to meet the applicable statutory standards, the Commission would approve the exchange proposal as consistent with the Exchange Act and rules applicable to the exchange.

B. Review of the NYSE Arca Proposal

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frequently refer to the Department of Justice and Federal Trade Commission merger guidelines to define product markets and evaluate market power. See, e.g., FTC v. Whole Foods Market, Inc., 502 F. Supp. 2d 1 (D.D.C. 2007); FTC v. Arch Coal, Inc., 329 F. Supp. 2d 109 (D.D.C. 2004).

170 See Exchange Act Section 19(b)(2) ("The Commission shall approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of this title and the rules and regulations thereunder applicable to such organization. The Commission shall disapprove a proposed rule change of a self-regulatory organization if it does not make such finding.")

171 Cf. Regulation NMS Release, 70 FR at 37540 (in discussion of market access fees under Rule 610 of Regulation NMS, the Commission noted that "any attempt by an SRO to charge differential fees based on the non-member status of the person obtaining indirect access to quotations, such as whether it is a competing market maker, would violate the anti-discrimination standard of Rule 610.").

The terms of an exchange's proposed rule change to distribute market data for which it is an exclusive processor must, among other things, provide for an equitable allocation of reasonable fees under Section 6(b)(4), not be designed to permit unfair discrimination under Section 6(b)(5), be fair and reasonable under Rule 603(a)(1), and not be unreasonably discriminatory under Rule 603(a)(2). Because NYSE Arca is proposing to distribute non-core data, the Commission reviewed the terms of the Proposal under the market-based approach described above. The first question is whether NYSE Arca was subject to significant competitive forces in setting the terms of the Proposal.

1. <u>Competitive Forces Applicable to NYSE Arca</u>

At least two broad types of significant competitive forces applied to NYSE Arca in setting the terms of its Proposal to distribute the ArcaBook data: (1) NYSE Arca's compelling need to attract order flow from market participants; and (2) the availability to market participants of alternatives to purchasing the ArcaBook data.

a. <u>Competition for Order Flow</u>

Attracting order flow is the core competitive concern of any equity exchange – it is the "without which, not" of an exchange's competitive success. If an exchange cannot attract orders, it will not be able to execute transactions. If it cannot execute transactions, it will not generate transaction revenue. If an exchange cannot attract orders or execute transactions, it will not have market data to distribute, for a fee or otherwise, and will not earn market data revenue.[172]

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172 <u>See</u> Exchange Market Data Coalition Letter at 3 ("The end product of these efforts – the listings, the members, the trading facilities, the regulation – is market data. Market data is the totality of the information assets that each Exchange creates by attracting order flow.").

In the U.S. national market system, buyers and sellers of securities, and the broker-dealers that act as their order-routing agents, have a wide range of choices of where to route orders for execution. They include, of course, any of the nine national securities exchanges that currently trade equities, but also include a wide variety of non-exchange trading venues: (1) electronic communication networks ("ECNs") that display their quotes directly in the core data stream by participating in FINRA's Alternative Display Facility ("ADF") or displaying their quotations through an exchange; (2) alternative trading systems ("ATSs") that offer a wide variety of order execution strategies, including block crossing services for institutions that wish to trade anonymously in large size and midpoint matching services for the execution of smaller orders; and (3) securities firms that primarily trade as principal with their customer order flow.

NYSE Arca must compete with all of these different trading venues to attract order flow, and the competition is fierce. For example, in its response to the commenters, NYSE Arca notes that its share of trading in 2005 was 3.6% in Network A stocks, 23% in Network C stocks, and 30% in Network B stocks.[173] More recently during December 2007, NYSE Arca share volume was 12.5% in Network A stocks, 14.8% in Network C

173 NYSE Arca Response III at 18 n. 44. The NYSE and NYSE Arca are wholly-owned subsidiaries of NYSE Group, Inc. One commenter stated that the NYSE had "combined Arca's liquidity pool with its own," and that "the networking effect of the NYSE Group's combined pool of liquidity" had resulted in "greater market power over its pricing for market data." SIFMA IV at 8 (emphasis in original). In fact, the NYSE and NYSE Arca liquidity pools have not been combined. The two exchanges operate as separate trading centers with separate limit order books, and each distributes its depth-of-book order data separately for separate fees. In analyzing the competitive position of NYSE Arca for purposes of distributing such data, the Commission has considered NYSE Arca as a trading center separate from the NYSE.

stocks, and 29.4% in Network B stocks, adding up to 15.4% of total U.S. market volume.[174]

Given the competitive pressures that currently characterize the U.S. equity markets, no exchange can afford to take its market share percentages for granted – they can change significantly over time, either up or down.[175] Even the most dominant exchanges are subject to severe pressure in the current competitive environment. For example, the NYSE's reported market share of trading in NYSE-listed stocks declined from 79.1% in January 2005 to 41.1% in December 2007.[176] In addition, a recent non-exchange entrant to equity trading – the BATS ECN – has succeeded in capturing 5.1% of trading in NYSE-listed stocks and 7.9% of trading in Nasdaq-listed stocks.[177] Another ECN – Direct Edge – has a matched market share of 3.0% in NYSE-listed stocks and

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174 Source: ArcaVision (available at www.arcavision.com); see also NYSE Arca Response III at 18 ("NYSE Arca does not maintain a dominant share of the market in any of the three networks."); Lehman Brothers, Inc., Equity Research, "Exchanges December Volume Analysis" at 1 (Jan. 3, 2008) ("Lehman Trading Volume Analysis") (NYSE Arca's matched market share during the month of December 2007 was 12.4% in NYSE-listed stocks and 14.8% in Nasdaq-listed stocks).

175 See Exchange Market Data Coalition Letter at 4 ("Exchanges compete not only with one another, but also with broker dealers that match customer orders within their own systems and also with a proliferation of alternative trading systems ("ATSs") and electronic communications networks ("ECNs") that the Commission has also nurtured and authorized to execute trades in any listed issue. As a result, market share of trading fluctuates among execution facilities based upon their ability to service the end customer.").

176 Source: ArcaVision (available at www.arcavision.com).

177 Lehman Trading Volume Analysis at 1. The Commission recently published for comment an application by BATS Exchange, Inc. to be registered as a national securities exchange. Securities Exchange Act Release No. 57322 (Feb. 13, 2008), 73 FR 9370 (Feb. 20, 2008).

6.9% in Nasdaq-listed stocks.[178] Moreover, nearly all venues now offer trading in all U.S.-listed equities, no matter the particular exchange on which a stock is listed or on which the most trading occurs. As a result, many trading venues stand ready to provide an immediately accessible order-routing alternative for broker-dealers and investors if an exchange attempts to act unreasonably in setting the terms for its services.

Table 1 below provides a useful recent snapshot of the state of competition in the U.S. equity markets in the month of December 2007:[179]

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178 Lehman Trading Volume Analysis at 1.

179 Source: ArcaVision (available at www.arcavision.com).

Table 1 Reported Share Volume in U.S-Listed Equities during December 2007 (%)	
Trading Venue	**Market Share**
All Non-Exchange	30.2
Nasdaq	29.1
NYSE	22.6
NYSE Arca	15.4
American Stock Exchange	0.8
International Stock Exchange	0.7
National Stock Exchange	0.6
Chicago Stock Exchange	0.5
CBOE Stock Exchange	0.2
Philadelphia Stock Exchange	0.1

Perhaps the most notable item of information from Table 1 is that non-exchange trading venues collectively have a larger share of trading than any single exchange. Much of this volume is attributable to ECNs such as BATS and Direct Edge, noted above. In addition, the proliferation of non-exchange pools of liquidity has been a significant development in the U.S. equity markets.[180] Broker-dealers often check the

180 See, e.g., NYSE Arca Response III at 17 ("If the brokerage firm is unable to internalize the trade, typically, it next takes the order to dark pools, crossing networks, ECNs, alternative trading systems, or other non-traditional execution facilities to search for an execution."); http://www.advancedtrading.com/directories/darkpool (directory of more than 20 non-exchange pools of liquidity that are classified as "independent," "broker-dealer-owned," and "consortium-owned.").

liquidity available in these pools as a first choice prior to routing orders to an exchange. In sum, no exchange possesses a monopoly, regulatory or otherwise, in the execution of order flow from broker-dealers.

The market share percentages in Table 1 strongly indicate that NYSE Arca must compete vigorously for order flow to maintain its share of trading volume. As discussed below, this compelling need to attract order flow imposes significant pressure on NYSE Arca to act reasonably in setting its fees for depth-of-book order data, particularly given that the market participants that must pay such fees often will be the same market participants from whom NYSE Arca must attract order flow.[181] These market participants particularly include the large broker-dealer firms that control the handling of a large volume of customer and proprietary order flow. Given the portability of order flow from one trading venue to another, any exchange that sought to charge unreasonably high data fees would risk alienating many of the same customers on whose orders it depends for competitive survival.[182]

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181 See, e.g., Exchange Market Data Coalition Letter at 4 ("It is in the Exchange's best interest to provide proprietary information to investors to further their business objectives, and each Exchange chooses how best to do that."); Nasdaq Letter at 9 ("Like the market for electronic executions, the related market for proprietary data is also influenced by the equity investments of major financial institutions in one or more exchanges . . . . Equity investors control substantial order flow and transaction reports that are the essential ingredients of successful proprietary data products. Equity investors also can enable exchanges to develop competitive proprietary products . . . .").

182 See NYSE Arca Response III at 16 ("Markets compete with one another by seeking to maximize the amount of order flow that they attract. The markets base competition for order flow on such things as technology, customer service, transaction costs, ease of access, liquidity and transparency. In recent months, significant changes in market share, the rush to establish trade-reporting facilities for the reporting of off-exchange trades, frequent changes in transaction fees and new market data proposals have provided evidence of the intensity of the competition for order flow.").

Some commenters asserted that an exchange's distribution of depth-of-book order data is not affected by its need to attract order flow.[183] Attracting order flow and distributing market data, however, are in fact two sides of the same coin and cannot be separated.[184] Moreover, the relation between attracting order flow and distributing market data operates in both directions. An exchange's ability to attract order flow determines whether it has market data to distribute, while the exchange's distribution of market data significantly affects its ability to attract order flow.[185]

For example, orders can be divided into two broad types – those that seek to offer liquidity to the market at a particular price (non-marketable orders) and those that seek an immediate execution by taking the offered liquidity (marketable orders). The wide distribution of an exchange's market data, including depth-of-book order data, to many market participants is an important factor in attracting both types of orders. Depth-of-book order data consists of non-marketable orders that a prospective buyer or seller has chosen to display. The primary reason for a prospective buyer or seller to display its trading interest at a particular price, and thereby offer a free option to all market

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183 See section III.A.5 above.

184 See, e.g., Larry Harris, Trading and Exchanges, Market Microstructure for Practitioners 99 (2003) (noting that it would be "very difficult for innovative trading systems to compete for order flow" if the data from those trading venues were not distributed).

185 See, e.g., NYSE Arca Response III at 13 (in setting level of fees, one factor was "projected losses to NYSE Arca's business model and order flow that might result from marketplace resistance to Arca Book Fees"); Report of the Advisory Committee on Market Information: A Blueprint for Responsible Change (September 14, 2001), Section VII.B.1 (available at www.sec.gov) ("[A] market's inability to widely disseminate its prices undoubtedly will adversely impact its ability to attract limit orders and, ultimately, all order flow. This barrier to intermarket competition, in turn, could decrease liquidity and innovation in the marketplace.").

participants at that price, is to attract contra trading interest and a fast execution. The extent to which a displayed non-marketable order attracts contra interest will depend greatly on the wide distribution of the displayed order to many market participants. If only a limited number of market participants receive an exchange's depth-of-book order data, it reduces the chance of an execution for those who display non-marketable orders on that exchange. Limited distribution of displayed orders thereby reduces the ability of the exchange to attract such orders. Moreover, by failing to secure wide distribution of its displayed orders, the exchange will reduce its ability to attract marketable orders seeking to take the displayed liquidity. In other words, limited distribution of depth-of-book order data will limit an exchange's ability to attract both non-marketable and marketable orders. Consequently, an exchange generally will have strong competitive reasons to price its depth-of-book order data so that it will be distributed widely to those most likely to use it to trade.[186]

A notable example of the close connection between a trading venue's distribution of order data and its ability to attract order flow was provided by the Island ECN in 2002. To avoid the application of certain regulatory requirements, Island ceased displaying its order book to the public in three very active exchange-traded funds ("ETFs") in which it

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186 See NYSE Arca Response III at 18 ("If too many market professionals reject Arca Book as too expensive, NYSE Arca would have to reassess the Arca Book Fees because Arca Book data provides transparency to NYSE Arca's market, transparency that plays an important role in the competition for order flow."). This pressure on exchanges to distribute their order data widely is heightened for those exchanges that have converted from member-owned, not-for profit entities to shareholder-owned, for-profit companies. For-profit exchanges are more likely to place greater importance on distributing market information widely than on limiting such information for the use of their members.

enjoyed a substantial market share. After going "dark," Island's market share in the three ETFs dropped by 50%.[187]

This competitive pressure to attract order flow is likely what led NYSE Arca, and its predecessor corporation, to distribute its depth-of-book order data without charge in the past.[188] It now has made a business decision to begin charging for that data, apparently believing that it has a sufficiently attractive data product that the benefit obtained from increased data revenues will outweigh the potential harm of reduced order flow if significant numbers of data users choose not to pay the fee.[189] Commenters concede that NYSE Arca is entitled to charge a fee for its depth-of-book order data,[190] but

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187 See Terrence Hendershott and Charles. M. Jones, "Island Goes Dark: Transparency, Fragmentation, and Regulation," 18 The Review of Financial Studies (No. 3) 743, 756 (2005); see also Nasdaq Letter at 7 ("[T]he market for proprietary data products is currently competitive and inherently contestable because there is fierce competition for the inputs necessary to the creation of proprietary data and strict pricing discipline for the proprietary data products themselves."). In contrast to the Island example, and as noted in the Nasdaq Letter at 9, an element of the BATS ECN's business strategy over the last two years in gaining order flow has been to provide its order data to customers free of charge. See BATS Trading, Newsletter (July 2007) (available at http://www.batstrading.com/newsletters/0707Newsletter.pdf) ("BATS has chosen not to charge for many of the things for which our competitors charge. . . . More importantly, our market data is free. Why would a market charge its participants for the data they send to that market? Feel free to pose this same question to our competitors.").

188 Cf. NYSE Arca Response III at 4 ("Several years ago, certain [ECNs] began to make their real-time quotes available for free in order to gain visibility in the market place.").

189 NYSE Arca Response I at 4 ("[F]ees will enable the Exchange to further diversify its revenue to compete with its rivals. The Exchange believes that its business has reached the point where its customers are willing to pay for the value of the Exchange's information.").

190 See, e.g., Petition at 9; SIFMA I at 7.

claim that the fee chosen by NYSE Arca is unaffected by its need to attract order flow.[191] The Commission disagrees and notes that NYSE Arca, in setting the fee, acknowledged that it needed to balance its desire for market data revenues with the potential damage that a high fee would do to its ability to attract order flow.[192]

b. Availability of Alternatives to ArcaBook Data

In addition to the need to attract order flow, the availability of alternatives to an exchange's depth-of-book order data significantly affects the terms on which an exchange distributes such data.[193] The primary use of depth-of-book order data is to assess the depth of the market for a stock beyond that which is shown by the best-priced quotations that are distributed in core data. Institutional investors that need to trade in large size typically seek to assess market depth beyond the best prices, in contrast to retail investors who generally can expect to receive the best price or better when they trade in smaller sizes.[194]

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191 See notes 66-71 above and accompanying text.

192 NYSE Arca Response III at 13 (in setting the level of fees for ArcaBook data, NYSE Arca considered "projected losses to NYSE Arca's business model and order flow that might result from marketplace resistance to" the fees).

193 See NYSE Arca Response III at 13 (in setting fees for ArcaBook data, NYSE Arca considered "the fact that Arca Book is primarily a product for market professionals, who have access to other sources of market data and who will purchase Arca Book only if they determine that the perceived benefits outweigh the cost"); see also the authorities cited in note 170 above. In considering antitrust issues, courts have recognized the value of competition in producing lower prices. See, e.g., Leegin Creative Leather Products v. PSKS, Inc., 127 S. Ct. 2705 (2007); Atlanta Richfield Co. v. United States Petroleum Co., 495 U.S. 328 (1990); Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574 (1986); State Oil Co. v. Khan, 522 U.S. 3 (1997); Northern Pacific Railway Co. v. U.S., 356 U.S. 1 (1958).

194 The market information needs of retail investor are discussed at notes 235-248 below and accompanying text.

In setting the fees for its depth-of-book order data, an exchange must consider the extent to which sophisticated traders would choose one or more alternatives instead of purchasing the exchange's data.[195] Of course, the most basic source of information concerning the depth generally available at an exchange is the complete record of an exchange's transactions that is provided in the core data feeds. In this respect, the core data feeds that include an exchange's own transaction information are a significant alternative to the exchange's depth-of-book data product.

For more specific information concerning depth, market participants can choose among the depth-of-book order products offered by the various exchanges and ECNs.[196] A market participant is likely to be more interested in other exchange and ECN products when the exchange selling its data has a small share of trading volume, because the depth-of-book order data provided by other exchanges and ECNs will be proportionally more important in assessing market depth. As a result, smaller exchanges may well be inclined to offer their data for no charge or low fees as a means to attract order flow. Even larger exchanges, however, must consider the lower fees of other exchanges in setting the fees for the larger exchanges' data. Significant fee differentials could lead to

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195 See NYSE Arca Response III at 17 ("As a result of all of the choices and discretion that are available to brokers, the displayed depth-of-book data of one trading center does not provide a complete picture of the full market for a security. . . . A brokerage firm has potentially dozens of different information sources to choose from in determining if, where, and how to represent an order for execution.").

196 See Nasdaq Letter at 7-8 ("The large number of SROs, TRFs, and ECNs that currently produce proprietary data or are currently capable of producing it provides further pricing discipline for proprietary data products. As shown on Exhibit A, each SRO, TRF, ECN and BD is currently permitted to produce proprietary data products, and many currently do or have announced plans to do so, including Nasdaq, NYSE, NYSEArca, and BATS.").

shifts in order flow that, over time, could harm a larger exchange's competitive position and the value of its non-core data.

Market depth also can be assessed with tools other than depth-of-book order data. For example, market participants can "ping" the various markets by routing oversized marketable limit orders to access an exchange's total liquidity available at an order's limit price or better.[197] In contrast to depth-of-book order data, pinging orders have the important advantage of searching out both displayed and reserve (i.e., nondisplayed) size at all price points within an order's limit price. Reserve size can represent a substantial portion of the liquidity available at exchanges.[198] It often will be available at prices that are better than or equal to an exchange's best displayed prices, and none of this liquidity will be discernible from an exchange's depth-of-book order data. Pinging orders thereby give the sender an immediate and more complete indication of the total liquidity available at an exchange at a particular time. Moreover, sophisticated order routers are capable of maintaining historical records of an exchange's responses to pinging orders over time to gauge the extent of total liquidity that generally can be expected at an exchange. These

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197 See Regulation NMS Release, 70 FR at 37514 (discussion of pinging orders noting that they "could as aptly be labeled 'liquidity search' orders").

198 See, e.g., NYSE Arca Response III at 17 (noting that brokers "may elect to have NYSE Arca hold a portion of the order as hidden interest that NYSE Arca holds in reserve, which means that NYSE Arca will not include the undisplayed portion of the order as part of the Arca Book display"); Michael Scotti, "The Dark Likes Nasdaq," Traders Magazine (May 1, 2007) (quoting statement of Nasdaq's executive vice president that 15 to 18 percent of Nasdaq's executed liquidity is non-displayed).

records are a key element used to program smart order routing systems that implement the algorithmic trading strategies that have become so prevalent in recent years.[199]

Another alternative to depth-of-book order data products offered by exchanges is the threat of independent distribution of order data by securities firms and data vendors.[200] As noted above, one of the principal market data reforms adopted in 2005 was to authorize the independent distribution of data by individual firms. To the extent that one or more securities firms conclude that the cost of exchange depth-of-book order products is too high and appreciably exceeds the cost of aggregating and distributing such data, they are entitled to act independently and distribute their own order data, with or without a fee. Indeed, a consortium of major securities firms in Europe has undertaken such a market data project as part of the implementation of the Markets in Financial Instruments Directive ("MiFID") adopted by the European Union.[201] No securities statue or regulation prevents U.S. firms from undertaking an analogous project in the U.S. for

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199 See, e.g., www.advancedtrading.com/directories/dark-algorithms (descriptions of product offerings for "dark algorithms" that seek undisplayed liquidity at multiple trading venues); EdgeTrade, Inc., "EdgeTrade issues white paper on market fragmentation and unprecedented liquidity opportunities through smart order execution" (September 10, 2007) (available at www.edgetrade.com) ("EdgeTrade's smart order execution strategy . . . simultaneously sprays aggregated dark pools and public markets, and then continuously moves an order in line with shifting liquidity until best execution is fulfilled.").

200 See Nasdaq Letter at 3 ("Proprietary optional data may be offered by a single broker-dealer, a group of broker-dealers, a national securities exchange, or a combination of broker-dealers or exchanges, unlike consolidated data which is only available through a consortium of SROs.").

201 The project – currently named "Markit BOAT" – distributes both quotes and trades and is described at http://www.markit.com/information/boat/boat-data.html. It currently intends to charge fees of 120 euros per month per user for its quote and trade data. See Nasdaq Letter at 9 (noting the potential for firms to export Project BOAT technology to the United States).

the display of depth-of-book order data. This data could encompass orders that are executed off of the exchanges, as well as orders that are submitted to exchanges for execution. If major U.S. firms handling significant order flow participated in the project, the project could collect and distribute data that covered a large proportion of liquidity in U.S. equities.

The Commission recognizes that the depth-of-book order data for a particular exchange may offer advantages over the alternatives for assessing market depth. The relevant issue, however, is whether the availability of these alternatives imposes significant competitive restraints on an exchange in setting the terms, particularly the fees, for distributing its depth-of-book order data. For example, Nasdaq has a substantial trading share in Nasdaq-listed stocks, yet only 19,000 professional users purchase Nasdaq's depth-of-book data product and 420,000 professional users purchase core data in Nasdaq-listed stocks.[202] A reasonable conclusion to draw from this disparity in the number of professional users of consolidated core data and Nasdaq's non-core data is that the great majority of professional users either believe they do not need Nasdaq's depth-of-book order data or simply do not think it is worth $76 per month to them (approximately $3.50 per trading day) compared to other sources of information on market depth in Nasdaq-listed stocks. The fact that 95% of the professional users of core data choose not to purchase the depth-of-book order data of a major exchange strongly suggests that no exchange has monopoly pricing power for its depth-of-book order data.[203]

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202 Nasdaq Letter at 6.

203 See id. ("Empirical sales data for Nasdaq TotalView, Nasdaq's proprietary depth-of-book data, demonstrate that broker-dealers do not consider TotalView to be

In sum, there are a variety of alternative sources of information that impose significant competitive pressures on an exchange in setting fees for its depth-of-book order data. The Commission believes that the availability of these alternatives, as well as NYSE Arca's compelling need to attract order flow, imposed significant competitive pressure on NYSE Arca to act equitably, fairly, and reasonably in setting the terms of the Proposal.

c. Response to Commenters on Competition Issues

Some commenters suggested that exchanges are impervious to competitive forces in distributing their order data because Exchange Act rules require broker-dealers to provide their orders to an exchange, and that exchanges therefore enjoy a regulatory monopoly.[204] As discussed above, however, exchanges face fierce competition in their efforts to attract order flow. For the great majority of orders, Exchange Act rules do not

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required for compliance with Regulation NMS or any other regulation. . . . [O]f the 735 broker-dealer members that trade Nasdaq securities, only 20 or 2.7 percent spend more than $7,000 per month on TotalView users. Nasdaq understands that firms with more than 100 TotalView professional users generally provide TotalView to only a small fraction of their total user populations.").

204 See, e.g., Bloomberg Letter at 4; Financial Services Roundtable Letter at 1; NetCoalition III at 6. Some commenters suggested that broker-dealers were required to provide their data to exchanges for free and then buy that data back from the exchanges. NSX Letter at 1; SIFMA III at 12. A broker-dealer, however, has no need to buy back its own data, with which it is already familiar. Rather, broker-dealers need to see data submitted by other broker-dealers and market participants. This need is served by the core function of a securities exchange, which is to provide a central point for bringing buy and sell orders together, thereby enabling the resulting market data to be distributed to all market participants. See, e.g., Section 3(a)(1) of the Exchange Act, 15 U.S.C. 78c(a)(1) ("exchange" defined as, among other things, "facilities for bringing together purchasers and sellers of securities").

require that they be routed to an exchange.[205] These include all marketable orders and most non-marketable orders. With respect to certain types of non-marketable orders, two Exchange Act rules can require broker-dealers to provide such orders to an exchange in certain circumstances, but only when the broker-dealer chooses to do business on the exchange. Rule 602 of Regulation NMS[206] requires certain broker-dealers, once they have chosen to communicate quotations on an exchange, to provide their best quotations to the exchange.[207] Rule 604 of Regulation NMS[208] requires market makers and specialists to reflect their displayable customer limit orders in their quotations in certain circumstances, but provides an exception if the order is delivered for display through an exchange or FINRA, or to a non-exchange ECN that delivers the order for display through an exchange or FINRA. Most significantly, while these rules can require certain orders to be displayed through an exchange or FINRA, broker-dealers have a great deal of flexibility in deciding which exchange or FINRA. As discussed above, exchanges

205 For example, a broker-dealer commenter asserted that exchanges enjoy a "government-protected monopoly" as exclusive processors of their market information. Schwab Letter at 6; see also SIFMA IV at 7 ("Normal market forces cannot be relied upon here because of the unique structure of the market for data that the exchanges compile from their captive broker-dealer customers and then sell back to them."). As noted in Table 1 above, non-exchange trading venues now execute more volume in U.S.-listed equities than any single exchange.

206 17 CFR 242.602 (previously designated as Rule 11Ac1-1).

207 Only broker-dealers that choose to participate on an exchange as "responsible broker-dealers" are required to provide their best bid and best offer to such exchange. Rule 602(b) and Rule 600(b)(65)(i) of Regulation NMS. Broker-dealers that participate only in the over-the-counter (i.e., non-exchange) market as responsible broker-dealers are required to provide their quotations to FINRA, a not-for-profit membership organization of broker-dealers. Rule 602(b) and Rule 600(b)(65)(ii) of Regulation NMS.

208 17 CFR 242.604 (previously designated as Rule 11Ac1-4).

compete vigorously to display the non-marketable orders handled by broker-dealers. No particular exchange has a regulatory monopoly to display these orders.[209]

Some commenters asserted that exchanges act as monopolies in distributing depth-of-book order data because they are the exclusive processors of such data, as defined in Section 3(a)(22)(B) of the Exchange Act. Many businesses, however, are the exclusive sources of their own products, but this exclusivity does not mean that a business has monopoly pricing power when selling its product and is impervious to competitive pressures. The particular circumstances of the business and its product must be examined. As discussed above, the U.S. exchanges are subject to significant competitive forces in setting the terms for their depth-of-book order products, including the need to attract order flow and the availability of alternatives to their depth-of-book order products. Consequently, NYSE Arca does not have monopoly pricing power for ArcaBook data merely because it meets the statutory definition of an exclusive processor of the data.[210]

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209 One commenter asserted that "exchanges have government-granted exclusive access to market data for securities listed in their respective markets." SIFMA I at 12. In fact, a listing exchange does not have any particular privileges over other exchanges in attracting quotation and trade data in its listed stocks. Rather, other exchanges are free to trade such stocks pursuant to unlisted trading privileges, and the listing exchange must compete with those exchanges for order flow. If the listing exchange is unable to attract order flow, it will not have quotations or trades to distribute.

210 A straightforward example may help illustrate this point. Table 1 shows that there are several exchanges with a very small share of trading volume. Such an exchange would meet the statutory definition of an exclusive processor, but clearly would be unable to exert monopoly pricing power if it attempted to sell its depth-of-book order data at an unreasonably high price. Accordingly, the relevant issue is not whether an exchange falls within the statutory definition of an exclusive processor, but whether it is subject to significant competitive forces in setting the terms for distribution of its depth-of-book data.

Commenters cited a decision of the U.K. competition authorities concerning proposed acquisitions of the London Stock Exchange plc ("LSE") for the proposition that an exchange is a monopolist of its proprietary market information.[211] Their reliance on this decision is misplaced for two important reasons. First, unlike the U.S. where the core data feeds provide an essential source of information for every exchange's most valuable data – its best quoted prices and last sale information – the LSE's proprietary data is the sole source of information for trading on the LSE. As a result, market participants have few, if any, useful alternatives for LSE proprietary data. In the U.S., in contrast, the availability of an exchange's essential trading information in the core data feeds, as well as other valuable alternatives, discussed above, for assessing market depth beyond the best quoted prices, precludes the U.S. exchanges from exerting monopoly power over the distribution of their non-core data. Second, there historically has been very little effective competition among markets for order flow in the U.K. The U.K. Competition Commission, for example, found that the most important competitive constraint on the LSE was not the existence of other trading venues with significant trading volume in LSE-listed stocks, but rather "primarily, the threat that [other exchanges, including foreign exchanges such as the NYSE and Nasdaq] will expand their services and compete directly with LSE."[212] In contrast, the U.S. has a national market system for trading equities in which competition is provided not merely by the threat of

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211 NetCoalition IV at 9; SIFMA V at 8.

212 U.K. Competition Commission, A Report on the Proposed Acquisition of London Stock Exchange plc by Deutsche Borse AG or Euronext NV (November 2005), at 57 (emphasis added). The intensity of competition among markets trading the same products in Europe could increase substantially in the wake of the implementation of MiFID in November 2007.

other markets attempting to trade an exchange's listed products, but by the on-the-ground existence of multiple markets with a significant share of trading in such products. These competitors also distribute depth-of-book order products with substantial liquidity in the same stocks included in an exchange's depth-of-book product. In sum, the competitive forces facing NYSE Arca in its distribution of ArcaBook data were entirely inapplicable to the LSE in its distribution of proprietary data in 2005.

In addition, the existence of significant competitive forces applicable to NYSE Arca renders inapposite the citations of commenters to statements in Exchange Act legislative history and Commission releases regarding monopoly data distribution. Such statements were made in the context of the central processors of core data for the Networks, which in fact have monopoly pricing power for such mandated data. Central processors of core data therefore are in a very different economic and legal position than NYSE Arca as exclusive processor for its depth-of-book order data.[213]

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213 One commenter cited two papers for the claim that exchanges have government-conferred monopolies over the collection and distribution of trading data. NetCoalition IV at 9-10 (citing Wilkie Farr & Gallagher, counsel to Bloomberg L.P., "Discussion Paper: Competition, Transparency, and Equal Access to Financial Market Data" (September 24, 2002) (submitted by Bloomberg L.P. in consultation with George A. Hay and Erik R. Sirri); Erik R. Sirri, "What glory price? Institutional form and the changing nature of equity trading" (Federal Reserve Bank of Atlanta 2000 Financial Markets Conference on e-Finance, October 15-17). Dr. Sirri currently is Director of the Commission's Division of Trading and Markets. The papers were prepared when he was not a member of the Commission's staff. As discussed at length above, the commenter's claim that exchanges have a monopoly over the collection and distribution of trading data confuses core data, which Commission rules require to be collected by a central processor pursuant to the joint-industry Plans, and non-core data, which the individual exchanges must compete to attract from market participants. Indeed, the major shifts in order flow among exchanges and other trading venues in the years since the papers were written in 2000 and 2002 amply demonstrate that no exchange has a monopoly over the collection of orders displayed in the exchanges' depth-of-book data feeds. As noted above (text accompanying note

For example, commenters cited a passage from the legislative history of the 1975 amendments to the Exchange Act for the proposition that any exclusive processor must be considered a monopoly, but this passage applies only to the central processors of consolidated core data that Rule 603(b) requires to be consolidated:

> Despite the diversity of views with respect to the practical details of a national market system, all current proposals appear to assume there will be an exclusive processor or service bureau <u>to which the exchanges and the NASD will transmit data and which in turn will make transactions and quotation information available to vendors of such information</u>. Under the composite tape "plan" declared effective by the Commission, SIAC would serve as this exclusive processor. The Committee believes that if such a <u>central</u> facility is to be utilized, the importance of the manner of its regulation cannot be overestimated. . . . The Committee believes that if economics and sound regulation dictate the establishment of an exclusive <u>central</u> processor for the <u>composite</u> tape or any other element of the national market system, provision must be made to insure that this <u>central</u> processor is not under the control or domination of any particular market center. Any exclusive processor is, in effect, a public utility, and thus it must function in a manner which is absolutely neutral with respect to all market centers, all market makers, and all private firms. Although the existence of a monopolistic processing facility would not necessarily raise antitrust problems, serious antitrust questions would be posed if access to this facility and its services were not available on reasonable and nondiscriminatory terms to all in the trade or its charges were not reasonable.[214]

These Congressional concerns apply to a central processor that has no competitors in the distribution of data that must be consolidated from all the markets. They do not apply to the independent distribution of non-core data by an individual exchange that is subject to significant competitive forces.

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176), for example, the NYSE's market share in its listed stocks has declined from 79.1% in January 2005 to 41.1% in December 2007. For these reasons and those explained in the text, the two papers are outdated. Neither the NYSE, nor any other exchange, currently has a monopoly over the collection and distribution of depth-of-book order data in its listed stocks.

214 Senate Report at 11-12 (emphasis added).

Similarly, commenters cited a passage from the Commission's Market Information Concept Release for the proposition that an exchange must submit cost data to justify a proposed fee for the exchange's depth-of-book order data.[215] The Release stated that "the total amount of market information revenues should remain reasonably related to the cost of market information."[216] The Market Information Concept Release, however, was published in 1999, prior to the start of decimal trading and to the increased

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215 See section III.A.2 above. As noted in section III.A.7 above, commenters recommended a variety of market data regulatory solutions, in addition to a cost-based justification of fees. One was a regulatory mandate that exchanges place their market data operations in separate subsidiaries and provide their data to third parties on the same terms they make the data available to the subsidiary. Given its determination that NYSE Arca was subject to significant competitive forces in setting the terms of the Proposal, the Commission does not believe this regulatory mandate is necessary or appropriate. It also notes that the recommendation alone would not address the potential problem of an exchange's unreasonably high fees under the per device fee structure that is used throughout the exchange industry. For example, the proposed fees for ArcaBook data would be levied based on the number of professional and non-professional subscribers who receive the data on their devices. Regardless of whether subscribers obtained their data from an exchange subsidiary or another competing vendor, the exchange would receive the same total amount of fees based on the total number of subscribers who chose to receive the data. From the standpoint of maximizing its revenues from per device fees, the exchange likely would be indifferent to whether subscribers purchased through its subsidiary or elsewhere. It therefore would be willing to make the data available to its subsidiary for the same per device fees that it made the data available to third parties. Moreover, to the extent that an exchange would want to benefit a subsidiary that it was required to create to act as a vendor of market data, that requirement need not cause the exchange to charge lower fees. Instead, it could create conflicts of interest under which the exchange would have incentives to favor the subsidiary over other vendors in ways that might be difficult to monitor effectively. Under its proposal, NYSE Arca will make the ArcaBook data available to vendors on a non-discriminatory basis. For the same reason that NYSE Arca's proposed fees for the ArcaBook data are not unreasonably high – the competitiveness of the market for that data – other potential problems cited by commenters as arising in a non-competitive environment are not an obstacle to approval of the NYSE Arca proposal under the relevant Exchange Act provisions and rules.

216 64 FR at 70627.

usefulness of non-core data distributed outside the Networks. The Market Information Concept Release in general, and the cited statement in particular, solely addressed a central exclusive processor that has no competitors in distributing consolidated core data to the public pursuant to the Plans.[217]

Moreover, the Commission did not propose, much less adopt, a "strictly cost-of-service (or 'ratemaking') approach to its review of market information fees in every case," noting that "[s]uch an inflexible standard, although unavoidable in some contexts, can entail severe practical difficulties."[218] Rather, the Commission concluded that "Congress, consistent with its approach to the national market system in general, granted

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217 See, e.g., 64 FR at 70615 ("These [joint-SRO] plans govern all aspects of the arrangements for disseminating market information. . . . The plans also govern two of the most important rights of ownership of the information – the fees that can be charged and the distribution of revenues derived from those fees. As a consequence, no single market can be said to fully 'own' the stream of consolidated information that is made available to the public. Although markets and others may assert a proprietary interest in the information that they contribute to the stream, the practical effect of comprehensive federal regulation of market information is that proprietary interests in this information are subordinated to the Exchange Act's objectives for a national market system.")

218 64 FR at 70619. In the Market Information Concept Release, the Commission discussed the one context in which it had previously adopted a strict cost-of-service standard for market data fees – a denial of access proceeding involving the NASD and Instinet. See supra, note 42. It emphasized, however, that the scope of its decision was limited to the "particular competitive situation presented in the proceedings." 64 FR at 70622-70623. Specifically, the NASD essentially had sought to charge a retail rate for a wholesale product that would have severely curtailed the opportunity for a data vendor like Instinet to compete with the NASD in the retail market. The practical difficulties of implementing the strict cost-of-service approach were amply demonstrated by the long and difficult history of the attempt to determine the NASD's cost of producing the data. See 64 FR at 70623.

the Commission some flexibility in evaluating the fairness and reasonableness of market information fees."[219]

Some commenters suggested that depth-of-book order data has become so important since the initiation of decimal trading that broker-dealers now are effectively required to purchase the exchanges' depth-of-book data products.[220] No regulatory requirement, however, compels broker-dealers to purchase an exchange's depth-of-book order data. As discussed above, only core data is necessary for broker-dealers to comply with the consolidated display requirements of Rule 603(c) of Regulation NMS.[221] In addition, only core data is necessary to comply with the trade-through requirements of Rule 611 of Regulation NMS.[222]

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219 Id. at 70619. Commenters also pointed to Commission and staff statements about costs in the context of the entry of an exchange as a new participant in one of the Plans. NetCoalition IV at 12-14; SIFMA V at 9-10. Again, competitive forces are not operative in this context because Rule 603(b) requires an exchange to join the Plans and disseminate its best quotations and trades through a central processor in the core data feeds. A cost-based analysis is necessary in this context, not because it is universally required by the Exchange Act to determine fair and reasonable fees, but because the absence of competitive forces impels the use of a regulatory alternative.

220 See section III.A.4 above. Commenters cited a passage from the Regulation NMS Release for the proposition that exchanges could exert market power when distributing non-core data. NetCoalition III at 6; SIFMA V at 11-12. The concern mentioned in the Regulation NMS Release, however, explicitly applied only to the "best quotations and trades" of an SRO – i.e., an SRO's core data – and not to non-core data.

221 Note 153 above and accompanying text. Rule 603(c) requires broker-dealers and vendors, in certain trading and order-routing contexts, to provide a consolidated display of the national best bid and offer and the most recent last sale report. All of this information is included in the core data feeds.

222 Note 155 above and accompanying text. When it adopted Regulation NMS, the Commission declined to adopt a proposal that would have extended trade-through protection to depth-of-book quotations if the market displaying such quotations

Commenters also asserted that an exchange's depth-of-book order data may be necessary for a broker-dealer to meet its duty of best execution to its customers.[223] The Commission believes, however, that broker-dealers are not required to obtain depth-of-book order data, including the NYSE Arca data, to meet their duty of best execution. For example, a broker-dealer can satisfy this duty "to seek the most favorable terms reasonably available under the circumstances for a customer's transaction"[224] by, among other things, reviewing executions obtained from routing orders to a market. Under established principles of best execution, a broker-dealer is entitled to consider the cost and difficulty of trading in a particular market, including the costs and difficulty of assessing the liquidity available in that market, in determining whether the prices or other benefits offered by that market are reasonably available.[225] Although the Commission has urged broker-dealers to "evaluate carefully" the different options for execution, we have acknowledged that cost considerations are legitimate constraints on what a broker-

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voluntarily disseminated them in the consolidated core quotation stream. Regulation NMS Release, 70 FR at 37529.

223 See note 59 above and accompanying text.

224 See Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290, 48322 (Sept. 12, 1996) ("Order Handling Rules Release").

225 See Order Handling Rules Release, 61 FR at 48323 (acknowledging that, consistent with best execution, broker-dealers may take into account cost and feasibility of accessing markets and their price information); Regulation NMS Release, 70 FR at 37538 n. 341 (noting that the "cost and difficulty of executing an order in particular market" is a relevant factor in making a best execution determination). NYSE Arca and Nasdaq also stated their view that depth-of-book order products are not required for best execution purposes. NYSE Arca Response III at 18; Nasdaq Letter at 5-6.

dealer must do to obtain best execution.[226] In order to "evaluate carefully" execution options a broker-dealer need not purchase all available market data. The Commission does not view obtaining depth-of-book data as a necessary prerequisite to broker-dealers' satisfying the duty of best execution.[227]

2. Terms of the Proposal

As discussed in the preceding section, NYSE Arca was subject to significant competitive forces in setting the terms of the Proposal. The Commission therefore will approve the Proposal in the absence of a substantial countervailing basis to find that its terms nevertheless fail to meet an applicable requirement of the Exchange Act or the

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226 Order Execution Obligations, Proposing Release, Securities Exchange Act Release No. 36310 (Sept. 29, 1995), 60 FR 52792 at 52794 (Oct. 10, 1995) ("While not all markets and trading systems are equally accessible to large and small broker-dealers, and not all order handling technologies are equally affordable to all broker-dealers, when efficient and cost-effective systems are readily accessible, broker-dealers must evaluate carefully whether they can be used in fulfilling their duty of best execution.").

227 Some broker-dealers may conclude that, as a business matter to attract customers and generate commissions, they should obtain depth-of-book order data from one or more exchanges to inform their order-routing and pricing decisions. As with any other business decision, if the costs of obtaining the market data outweigh the benefits, broker-dealers will not buy it. This will put pressure on the exchange selling the data to lower the price that it charges. If, however, such firms believed that an exchange's depth-of-book order product is overpriced for certain business purposes, they could limit their use of the product to other contexts, such as "black-box" order routing systems and a block trading desk, where the depth-of-book data feed is most directly used to assess market depth. The firm would not display the data widely throughout the firm as a means to minimize the fees that must be paid for the data. This limited use of the data would drastically reduce the revenues that an exchange might have sought to obtain by charging a high fee and therefore be self-defeating for the exchange. In sum, exchanges will be subject to competitive pressures to price their depth-of-book order data in a way that will promote wider distribution and greater total revenues.

rules thereunder.[228] An analysis of the Proposal and of the views of commenters does not provide such a basis.

First, the proposed fees for ArcaBook data will apply equally to all professional subscribers and equally to all non-professional subscribers (subject only to the maximum monthly payment for device fees paid by any broker-dealer for non-professional subscribers). The fees therefore do not unreasonably discriminate among types of subscribers, such as by favoring participants in the NYSE Arca market or penalizing participants in other markets.

Second, the proposed fees for the ArcaBook data are substantially less than those charged by other exchanges for depth-of-book order data. For example, the NYSE charges a $60 per month terminal fee for depth-of-book order data in NYSE-listed stocks. Similarly, Nasdaq charges a $76 per month device fee for professional subscribers to depth-of-book order data on all NMS stocks. By comparison, the NYSE Arca fee is 75% less than the NYSE fee for data in NYSE-listed stocks, and more than 60% less than the Nasdaq fee for data in all NMS stocks. It is reasonable to conclude that competitive pressures led NYSE Arca to set a substantially lower fee for its depth-of-book order data than the fees charged by other markets. If, in contrast, NYSE Arca were a monopoly data provider impervious to competitive pressures, there would be little reason for it to set significantly lower fees than other exchanges.[229]

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228 The Exchange Act requirements are addressed in the text accompanying notes 142-172 above.

229 See Table 1, note 179 above and accompanying text.

Third, NYSE Arca projects that the total revenues generated by the fee for ArcaBook data initially will amount to less than $8 million per year,[230] and that its market data revenue as a percentage of total revenue is likely to remain close to the 2005 figure, which was approximately 17%.[231] Viewed in the context of NYSE Arca's overall funding, therefore, the fees for ArcaBook data are projected to represent a small portion of NYSE Arca's market data revenues and an even smaller portion of NYSE Arca's total revenues (using NYSE Arca's $8 million estimate, the fees will amount to less than 12.9% of NYSE Arca's 2005 market data revenues and less than 1.6% of NYSE Arca's 2005 total revenues). In addition, NYSE Arca generated approximately $415.4 million in revenue from equity securities transaction fees in 2005.[232] These transaction fees are paid by those who voluntarily choose to submit orders to NYSE Arca for execution. The fees

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230 NYSE Arca Response III at 12 n. 28. The reasonableness of this projection is supported by referring to the number of data users that have subscribed to Nasdaq's proprietary depth-of-book product for Nasdaq-listed stocks. Nasdaq reports 19,000 professional users and 12,000 non-professional users as of April 30, 2007. Nasdaq Letter at 6. If the same number of users purchased ArcaBook data for all stocks, the total revenue for NYSE Arca would be $8,280,000 per year. As noted in Table 1, NYSE Arca has a smaller market share than Nasdaq and therefore may not attract as many subscribers to its depth-of-book product. On the other hand, NYSE Arca is charging substantially less for its data and may attract more users. In the final analysis, market forces will determine the actual revenues generated by NYSE Arca's pricing decision.

231 NYSE Arca Response III at 12 nn. 28-29. One commenter noted that the market data revenues of the NYSE Group, which includes both NYSE and NYSE Arca, had grown by 33.7% from the third quarter of 2005 to the third quarter of 2006. <u>See</u> section IV.A.6 above. Although correct, this figure does not demonstrate any growth in market data revenues because the 2005 figure only included the market data revenues of NYSE, while the 2006 figure included the market data revenues of both the NYSE and NYSE Arca. Using an "apples-to-apples" comparison that includes both exchanges for both time periods, their combined market data revenues declined slightly from 2005 to 2006. NYSE Arca Response III at 20.

232 NYSE Group, Inc., Form 10-K for period ending December 31, 2005 (filed March 31, 2006), at 19.

therefore are subject to intense competitive pressure because of NYSE Arca's need to attract order flow. In comparison, the $8 million in projected annual fees for ArcaBook data do not appear to be inequitable, unfair, or unreasonable.

One commenter, although agreeing that exchange transaction fees are subject to intense competitive pressure, asserted that such "intermarket competition does not constrain the exchanges' pricing of market data, but it actually creates an incentive for the exchanges to increase their prices for data."[233] If, however, NYSE Arca were truly able to exercise monopoly power in pricing its non-core data, it likely would not choose a fee that generates only a small fraction of the transaction fees that admittedly are subject to fierce competitive forces. As discussed above, NYSE Arca was indeed subject to significant competitive forces in pricing the ArcaBook data.

Several commenters expressed concern that the Proposal would adversely affect market transparency.[234] They noted that NYSE Arca previously had distributed the ArcaBook data without charge and asserted that the new fees could substantially limit the availability of the data. The Petition, for example, stated that "the cumulative impact of [the Proposal] and other pending and recently approved market data proposals threaten to place critical data, which should be available to the general public, altogether beyond the reach of the average retail investor."[235]

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233 SIFMA V at 14-15.

234 Financial Services Roundtable Letter at 3; Schwab Letter at 5.

235 Petition at 3.

Assuring the wide availability of quotation and trade information is a primary objective of the national market system.[236] With respect to non-professional users, and particularly individual retail investors, the Commission long has sought to assure that retail investors have ready access to the data they need to participate effectively in the equity markets. Indeed, the Commission's 1999 review of market information was prompted by a concern that retail investors should have ready access to affordable market data through their on-line accounts with broker-dealers. The Concept Release on Market Information noted that, in the course of the 1999 review, the Networks had reduced by up to 80% the fees for non-professional subscribers to obtain core data with the best-priced quotations and most recent last sale prices.[237] It also emphasized the importance of such affordable data for retail investors:

> One of the most important functions that the Commission can perform for retail investors is to ensure that they have access to the information they need to protect and further their own interests. Communications technology now has progressed to the point that broad access to real-time market information should be an affordable option for most retail investors, as it long has been for professional investors. This information could greatly expand the ability of retail investors to monitor and control their own securities transactions, including the quality of execution of their transactions by broker-dealers. The Commission intends to assure that market information fees applicable to retail investors do not restrict their access to market information, in terms of both number of subscribers and quality of service. In addition, such fees must not be unreasonably discriminatory when compared with the fees charged to professional users of market information.[238]

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236 Section 11A(a)(1)(C)(iii) of the Exchange Act.

237 Market Information Concept Release, 64 FR at 70614. Since 1999, the Network data fees applicable to retail investors have either remained the same or been further reduced. Currently, nonprofessional investors can obtain unlimited amounts of core data for no more than $1 per month each for Network A, B, and C stocks. See SIFMA III, Appendix A.

238 Market Information Concept Release, 64 FR at 70614.

The Commission appreciates the efforts of the Petitioner and other commenters in advocating the particular needs of users of advertiser-supported Internet Web sites, a great many of whom are likely to be individual retail investors. The Commission believes that the exchanges and other entities that distribute securities market information will find business-justified ways to attend to the needs of individual investors and, as markets evolve, develop innovative products that meet the needs of these users and are affordable in light of the users' economic circumstances. In this respect, it recognizes the exchange proposals to distribute new types of data products specifically designed to meet the needs of Internet users for reference data on equity prices.[239]

The Commission does not believe, however, that the Proposal will significantly detract from transparency in the equity markets. Of course, any increase in fees can lower the marginal demand for a product. To assess an effect on transparency, however, the relevant question is whether the fees for a particular product deter a significant number of market participants from obtaining the market data they need because the fees are not affordable given their economic circumstances.[240] Market transparency does not require that the same products be made available to all users on the same terms and conditions. Such a one-size-fits-all approach would ignore the important differences among data users in terms of both their needs and their economic circumstances. Most

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239 See NYSE Internet Proposal and Nasdaq Reference Data Proposal, note 18 above.

240 See Market Information Concept Release, 64 FR at 70630 ("[T]he relevant Exchange Act question is whether the fees for particular classes of subscribers, given their economic circumstances and their need for and use of real-time information, are at a sufficiently high level that a significant number of users are deterred from obtaining the information or that the quality of their information services is reduced.")

importantly, such an approach would fail to address the particular needs of individual retail investors.

With respect to professional data users (i.e., those who earn their living through the markets), the Commission believes that competitive forces, combined with the heightened ability of professional users to advance their own interests, will produce an appropriate level of availability of non-core data. With respect to non-professional users, as well, the Commission believes that the ArcaBook fees will not materially affect their access to the information they need to participate effectively in the equity markets.[241] The ArcaBook data likely is both too narrow and too broad to meet the needs of most retail investors. It likely is too narrow for most retail investors when they make their trading and order-routing decisions. The best prices quoted for a stock in the ArcaBook data reflect only the NYSE Arca market. Other markets may be offering substantially better prices. It is for this reason that Rule 603(c) of Regulation NMS requires broker-dealers and vendors to provide their customers with a consolidated display of core data in the context of trading and order-routing decisions. A consolidated display includes the national best bid and offer for a stock, as well as the most recent last sale for such stock reported at any market. This consolidated display thereby gives retail investors a valuable tool for ascertaining the best prices for a stock.

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241 See NYSE Arca Response III at 18 ("The overwhelming majority of retail investors are unaffected by the inter-market competition over proprietary depth-of-book products. For them, the consolidated top-of-book data that the markets make available under the NMS Plans provides adequate information on which they can base trading decisions.").

Two commenters stated that the average retail order is 1000 or more shares and is larger than the size typically reflected in the consolidated quotation in core data.[242] This issue was raised, however, when the Commission was formulating its approach to non-core data in 2005. It noted that the average execution price for small market orders (the order type typically used by retail investors) is very close to, if not better than, the NBBO.[243] In addition, a study by the Commission's Office of Economic Analysis of quoting in 2003 in 3,429 Nasdaq stocks found that the average displayed depth of quotations at the NBBO was 1,833 shares – greater than the size of the average order cited by commenters.[244]

Some commenters suggested that the core data provided by the Networks disadvantaged retail investors because it was not distributed as fast as the depth-of-book order data obtained directly from an exchange.[245] The central processors of core data must first obtain data from each SRO and then consolidate it into a single data feed for distribution to the public. While exchanges are prohibited from providing their data to direct recipients any sooner than they provide it to the Network central processor,[246] the additional step of transmitting data to the central processor inevitably means that a direct

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242 Schwab Letter at 1-2; SIFMA IV at 14.

243 Regulation NMS Release, 70 FR at 37567. Most retail investors receive order executions at prices equal to or better than the NBBO that is disseminated in core data. See also Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Adoption of Regulation NMS, 70 FR 37636 (estimating that between 98% and 99% of all trades did not trade through better-priced bids or offers).

244 70 FR at 37511 n. 108.

245 Schwab Letter at 4; SIFMA III at 6 n. 11.

246 Regulation NMS Release, 70 FR at 37567.

data feed can be distributed faster to users than the Network data feed. The size of this time latency, however, is extremely small in absolute terms. For example, a technology upgrade by the central processor for Network A and Network B has reduced the latency of the core data feed to approximately 3/100ths of a second.[247] The Commission does not believe that such a small latency under current market conditions disadvantages retail investors in their use of core data, but rather would be most likely relevant only to the most sophisticated and active professional traders with state-of-the-art systems.

Moreover, outside of trading contexts, the ArcaBook data will be far broader than individual investors typically need. The ArcaBook data encompasses all quotations for a stock at many prices that are well away from the current best prices. For retail investors that are not trading but simply need a useful reference price to track the value of their portfolio and monitor the market, the enormous volume of data regarding trading interest outside the best prices is not needed.[248]

Some commenters asserted that the Proposal failed to satisfy the requirements of Exchange Act Rule 19b-4 and Form 19b-4.[249] Form 19b-4 requires, among other things, that SROs provide a statement of the purpose of the proposed rule change and its basis under the Exchange Act. The statement must be sufficiently detailed and specific to support a finding that the proposed rule change meets the requirements of the Exchange

247 NYSE Arca Response III at 21. The upgrade was completed in April 2007. See Securities Industry Automation Corporation, Notice to CTA Recipients, "Reminder Notice – CQS Unix Activation – New Source IP Addresses" (April 27, 2007) (available at www.nysedata.com).

248 See NYSE Arca Response II at 2 ("during the first ten months of 2005 the number of messages processed by the Exchanged greatly increased from approximately 9,800 MPS [messages per second] to 14,100 MPS").

249 See section III.A.3 above.

Act, including that the proposed rule change does not unduly burden competition or efficiency, does not conflict with the securities laws, and is not inconsistent with the public interest or the protection of investors. The NYSE Arca Proposal met these requirements. Among other things, the Proposal noted that the proposed fees compared favorably to the fees that other competing markets charge for similar products, including those of other exchanges that previously had been approved by the Commission.[250]

One commenter argued that NYSE Arca should have addressed a number of specific points that it raised in opposition to the Proposal, such as including a statement of costs to produce the ArcaBook data.[251] The purpose of Form 19b-4, however, is to elicit information necessary for the public to provide meaningful comment on the proposed rule change and for the Commission to determine whether the proposed rule change is consistent with the requirements of the Exchange Act and the rules thereunder.[252] The Proposal met these objectives. Although Form 19b-4 requires that a proposed rule change be accurate, consistent, and complete, including the information necessary for the Commission's review, the Form does not require SROs to anticipate and respond in advance to each of the points that commenters may raise in opposition to a proposed rule change. With this Order, the Commission has determined that the points raised by the commenter do not provide a basis to decline to approve the Proposal.

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250 See Proposal, 71 FR at 33499.

251 SIFMA III at 11-12.

252 Section B of the General Instructions for Form 19b-4.

Finally, commenters raised concerns regarding the contract terms that will govern the distribution of ArcaBook data.[253] In particular, one notes that NYSE Arca has not filed its vendor distribution agreement with the Commission for public notice and comment and Commission approval.[254]

NYSE Arca has stated, however, that it plans to use the vendor and subscriber agreements used by CTA and CQ Plan Participants (the "CTA/CQ Vendor and Subscriber Agreements") to govern the distribution of NYSE Arca Data. According to the Exchange, the CTA/CQ Vendor and Subscriber Agreements "are drafted as generic one-size-fits all agreements and explicitly apply to the receipt and use of certain market data that individual exchanges make available in the same way that they apply to data made available under the CTA and CQ Plans," and the contracts need not be amended to cause them to govern the receipt and use of the Exchange's data.[255] The Exchange maintains that because "the terms and conditions of the CTA/CQ contracts <u>do</u> <u>not</u> change in any way with the addition of the Exchange's market data . . . there are no changes for the industry or Commission to review."[256]

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253 <u>See</u> section III.A.7 above.

254 SIFMA I at 7. In this regard, the commenter states that, procedurally, the Exchange "is amending and adding to the CTA vendor agreement without first submitting its contractual changes through the CTA's processes, which are subject to industry input through the new Advisory Committee mandated by Regulation NMS." SIFMA I at 8.

255 NYSE Arca Response I at 3.

256 NYSE Arca Response I at 3 (emphasis in original).

The Commission believes that the Exchange may use the CTA/CQ Vendor and Subscriber Agreements to govern the distribution of NYSE Arca Data.[257] It notes that the NYSE used the CTA Vendor Agreement to govern the distribution of its OpenBook and Liquidity Quote market data products.[258] Moreover, the Exchange represents that, following consultations with vendors and end-users, and in response to client demand:

> [The Exchange] chose to fold itself into an existing contract and administration system rather than to burden clients with another set of market data agreements and another market data reporting system, both of which would require clients to commit additional legal and technical resources to support the Exchange's data products.[259]

In addition, the Exchange has represented that it is "not imposing restrictions on the use or display of its data beyond those set forth" in the existing CTA/CQ Vendor and

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257 The Commission is not approving the CTA/CQ Vendor and Subscriber Agreements, which the CTA and CQ Plan Participants filed with the Commission as amendments to the CTA and CQ Plans that were effective on filing with the Commission pursuant to Rule 608(b)(3)(iii) of Regulation NMS (previously designated as Exchange Act Rule 11Aa3-2(c)(3)(iii)). See, e.g., Securities Exchange Act Release No. 28407 (September 6, 1990), 55 FR 37276 (September 10, 1990) (File No. 4-2811) (notice of filing and immediate effectiveness of amendments to the CTA Plan and the CQ Plan). Rule 608(b)(3)(iii) of Regulation NMS (previously designated as Exchange Act Rule 11Aa3-2(c)(3)(iii)) allows a proposed amendment to a national market system plan to be put into effect upon filing with the Commission if the plan sponsors designate the proposed amendment as involving solely technical or ministerial matters.

258 Securities Exchange Act Release Nos. 53585 (March 31, 2006), 71 FR 17934 (April 7, 2006) (order approving File Nos. SR-NYSE-2004-43 and NYSE-2005-32) (relating to OpenBook); and 51438 (March 28, 2005), 70 FR 17137 (April 4, 2005) (order approving File No. SR-NYSE-2004-32) (relating to Liquidity Quote). For the both the OpenBook and Liquidity Quote products, the NYSE attached to the CTA Vendor Agreement an Exhibit C containing additional terms governing the distribution of those products, which the Commission specifically approved. NYSE Arca is not including additional contract terms in the Proposal.

259 NYSE Arca Response I at 4.

Subscriber Agreements.[260] The Commission therefore does not believe that the Exchange is amending or adding to such agreements.

A commenter also stated that the Exchange has not recognized the rights of a broker or dealer, established in Regulation NMS, to distribute its order information, subject to the condition that it does so on terms that are fair and reasonable and not unreasonably discriminatory.[261] In response, the Exchange states that the CTA/CQ Vendor and Subscriber Agreements do not prohibit a broker-dealer member of an SRO participant in a Plan from making available to the public information relating to the orders and transaction reports that it provides to the SRO participant.[262] Accordingly, the Commission believes that the Exchange has acknowledged the rights of a broker or dealer to distribute its market information, subject to the requirements of Rule 603(a) of Regulation NMS.

A commenter also stated that the Exchange has failed to consider the administrative burdens that the proposal would impose, including the need for broker-dealers to develop system controls to track ArcaBook access and usage.[263] In response, the Exchange represents that it has communicated with its customers to ensure system readiness and is using "a long-standing, well-known, broadly-used administrative system" to minimize the amount of development effort required to meet the

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260 NYSE Arca Response I at 3.

261 SIFMA I at 7.

262 NYSE Arca Response I at 4.

263 SIFMA I at 8.

administrative requirements associated with the proposal.[264] Accordingly, the Commission believes that NYSE Arca has reasonably addressed the administrative requirements associated with the Proposal.

VI. Conclusion

It is therefore ordered that the earlier action taken by delegated authority, Securities Exchange Act Release No. 54597 (October 12, 2006) 71 FR 62029 (October 20, 2006), is set aside and, pursuant to Section 19(b)(2) of the Exchange Act, the Proposal (SR-NYSEArca-2006-21) is approved.

By the Commission.

264 NYSE Arca Response I at 4-5.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 57933 / June 5, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2836 / June 5, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13059

In the Matter of	:	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934**
Faro Technologies, Inc.	:	
Respondent.	:	

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Faro Technologies, Inc. ("Faro" or "Respondent").

II.

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

Document 5 of 48

III.

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

A. SUMMARY

This matter involves Faro's violations of the anti-bribery, books and records, and internal controls provisions of the Foreign Corrupt Practices Act ("FCPA") through over twenty improper payments made to Chinese government officials by Faro's wholly-owned Chinese subsidiary, Faro Shanghai Co., Ltd. ("Faro-China"). From 2004 through 2006, Faro-China paid a total of $444,492 in bribes to employees of numerous Chinese state-owned companies in order to obtain sales contracts. The improper payments, which were authorized by a Faro executive, generated approximately $4.5 million in sales, from which Faro realized a net profit of $1,411,306. None of these improper payments were accurately reflected in Faro's books and records. Additionally, Faro's system of internal accounting controls failed to prevent or detect the payments.

B. RESPONDENT

1. **Faro Technologies, Inc.** is a software development and manufacturing company with its headquarters in Lake Mary, Florida. Faro conducts operations in a number of foreign jurisdictions, including China. Faro operates in China through its wholly-owned subsidiary, Faro Shanghai Co., Ltd. Faro's common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act, and is listed on the NASDAQ.

C. FACTS

1. Faro Hired a Country Sales Manager for Faro-China, Despite His Request to "Do Business the Chinese Way"

In early 2003, Faro established Faro-China to sell its products in China. Previously, Faro relied on a Chinese distributor to sell Faro products to Chinese customers. Shortly after establishing Faro-China, Faro promoted its Vice-President of Sales for the Asia-Pacific region to the post of Director of Asia-Pacific Sales ("Sales Director"). In this capacity, the Sales Director had oversight responsibility for sales at Faro-China, as well as other Faro subsidiaries and distributors in the region.

The Sales Director recommended a former employee of Faro's Chinese distributor for the new Country Sales Manager position ("Country Manager") at Faro-China, and in May 2003, Faro offered that individual an employment contract. After receiving the proposed employment contract, the Country Manager communicated to three Faro officers, including the Sales Director, requesting permission to "do business [on behalf of Faro] the Chinese way." After receiving that request, the Sales Director explained to the

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

other two Faro officers that the Country Manager was requesting permission to pay kickbacks or other things of value to potential customers in order to obtain sales contracts with those customers.

After learning of the Country Manager's request to do business "the Chinese way," certain Faro officers sought a legal opinion from Faro's Chinese counsel as to whether such payments to customers violated Chinese law. Members of Faro management, including the Sales Director, learned that such payments to customers likely violated China's anti-bribery laws, particularly where Faro-China's customers were Chinese state-owned companies. After receiving this legal advice that noted the prevalence of state-owned companies in China, the same Faro officers orally directed both the Sales Director and the Country Manager not to make any such payments.

2. Faro, through its Sales Director, Authorized Improper Payments to Chinese State-Owned Customers in Exchange for Sales Contracts

Soon after beginning Faro-China's operations, the Sales Director authorized the Country Manager to make illegal cash payments, termed "referral fees," to employees of Chinese state-owned companies in order to obtain contracts. For example, in a November 2004 e-mail to the Sales Director, the Country Manager requested permission to give a $13,300 payment to an employee of a state-owned company. In the same e-mail, the Country Manager reiterated that "to have a good relationship with customers in China" you have to give them "money." The Country Manager explained that taking customers to dinner or giving them travel opportunities was not enough to promote a good relationship with the potential customer in China. Instead, employees of companies, including state-owned companies, wanted cash in order "to cooperate with [Faro] and help [Faro] get the order." The Sales Director responded to the Country Manager by e-mail, saying that he has "always understood" that this is how business was done in China, and approving the improper payment.

Throughout 2004 and 2005, the Sales Director approved additional corrupt payments to employees of state-owned or state-controlled businesses in China in order to obtain sales contracts. The Sales Director never instructed the Country Manager to cease the payments. Instead, the Sales Director merely expressed concern that they would be caught making the payments. In the same November 2004 e-mail, the Sales Director stated that the 20-30% "referral fee" is "a lot of money in China and someone will notice that one day and we may all be in trouble." The Sales Director instructed the Country Manager to "be careful" when making the improper payments, but to make the improper payments when he "really needed to do it."

3. The Sales Director Instructed·Faro-China Staff to Alter Accounts and Conceal the True Nature of the Improper Payments and Approved the Use of Third-Party Intermediaries to Avoid Detection

The Sales Director further instructed Faro-China's staff to alter account entries in order to delete the actual recipient of the improper payments. In an April 2004 e-mail, the Sales Director instructed Faro-China staff: "please do not use the words 'customer referral fee' but only 'referral fee'" when describing the improper payments in the company's books and records. In the same e-mail, the Sales Director explained that the reason for his instruction was that he "did not want to end up in jail" as a result of "this bribery."

In February 2005, a new Faro officer e-mailed a news article to all international business units describing the prosecution of another U.S. company for payment of bribes in China, and stated that the article highlighted the fact that Faro must take precautions to "observe U.S. law" in their dealings in China. The Faro officer specifically forwarded the e-mail to the Sales Director and instructed him to have it translated for Faro-China's staff. After reading the translated e-mail, the Country Manager e-mailed the Sales Director and requested authorization to continue making the improper payments, albeit through third-party intermediaries or "distributors." In a February 16, 2005 e-mail response, the Sales Director approved the Country Manager's proposed use of an intermediary to funnel payments to customers, including state-owned customers, in order "to avoid exposure." Faro-China funneled cash payments through these intermediaries for nearly one year, from early 2005 until early 2006.

The bribes continued until early 2006. In total, from 2004 through 2006, Faro made $444,492 in improper corrupt payments to Chinese state-owned customers through Faro-China in order to obtain and retain contracts from which it realized a net profit of $1,411,306. Faro lacked a system of internal accounting controls sufficient to provide reasonable assurances that the transactions were executed in accordance with management's authorization, and the corrupt payments were improperly recorded as legitimate "selling expenses" in Faro's books and records. During the period of the improper payments described above, Faro provided no training or education to any of its employees, agents, or subsidiaries regarding the requirements of the FCPA. Faro also failed to establish a program to monitor its employees, agents, and subsidiaries for compliance with the FCPA.

D. VIOLATIONS

The FCPA, enacted in 1977, added Section 30A of the Exchange Act to prohibit issuers, and certain other persons including agents of issuers, from, among other things, making improper payments to foreign officials for the purpose of influencing their decisions in order to obtain or retain business. The FCPA also added Exchange Act Section 13(b)(2)(A) to require public companies to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer. The FCPA also added Exchange Act Section 13(b)(2)(B) to require such companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that: (i) transactions are executed in accordance with management's general or specific authorization; and (ii) transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and to maintain accountability for assets.

The Sales Director, a Faro executive, explicitly directed and authorized the illegal payments made through Faro-China. Throughout the relevant period, employees of the Chinese state-owned companies were foreign officials within the meaning of the FCPA. Accordingly, Faro violated the anti-bribery provisions of Section 30A of the Exchange Act.

Moreover, in connection with these improper payments to Chinese government officials, Faro failed to make and keep accurate books, records, and accounts as required by Section 13(b)(2)(A) of the Exchange Act. Further, as evidenced by the extent and duration of improper payments to Chinese government officials, and the improper recording of these payments in its subsidiary's books and records, Faro failed to devise and maintain an effective system of internal controls sufficient to prevent violations of the FCPA, as required by Section 13(b)(2)(B) of the Exchange Act. As a result of the conduct described above, Faro violated Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act.

<u>Faro's Remedial Efforts and Cooperation</u>

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent and cooperation afforded the Commission staff.

IV.

Respondent Faro Technologies, Inc. has undertaken to:

1. Retain, through Faro's Board of Directors, within 60 days after the entry of this order, an independent consultant ("Independent Consultant"), not unacceptable to the staff of the Commission for a period of two (2) years to review and evaluate Faro's internal controls, record-keeping, and financial reporting policies and procedures as they relate to its compliance with the anti-bribery, books and records, and internal accounting controls of the FCPA, codified at Sections 30A, 13(b)(2)(A), 13(b)(2)(B) of the Exchange Act. Faro shall cooperate fully with the Independent Consultant and shall provide the Independent Consultant with access to its files, books, records, and personnel as reasonably requested for review;

2. Require that the Independent Consultant issue a report, within one hundred twenty (120) days after being retained, summarizing the review and recommending policies and procedures reasonably designed to ensure compliance with the federal securities laws as they related to the FCPA. Simultaneously with providing

that report to Faro's Board of Directors, the Independent Consultant shall transmit a copy to Charles E. Cain, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F Street, N.E., Washington, DC 20549;

3. Adopt all recommendations in the report of the Independent Consultant; provided, however, that within sixty (60) days after the Independent Consultant serves that report, Faro shall advise the Independent Consultant and the Commission in writing of any recommendations that it considers to be unduly burdensome, impractical, or costly. With respect to any recommendations that Faro considers unduly burdensome, impractical, or costly, Faro 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. As to any recommendation on which Faro and the Independent Consultant do not agree, such parties shall attempt in good faith to reach an agreement within sixty days after Faro serves the written advice. In the event that Faro and the Independent Consultant are unable to agree on an alternative proposal, Faro will by abide by the determinations of the Independent Consultant;

4. Require the Independent Consultant to undertake a review, which shall be completed within one year of the entry of this order, of Faro's policies and procedures regarding compliance with the federal securities laws as they related to the FCPA. During the review of Faro's compliance program, the Independent Consultant shall (i) certify that Faro's policies and procedures are appropriately designed to accomplish their goals, (ii) monitor Faro's implementation and compliance with the policies and procedures, and (iii) report on the Independent Consultant's findings as to the effectiveness of the policies and procedures to Faro's Audit Committee. Should the Independent Consultant, during this period, determine that there is a reasonable likelihood that corrupt payments have been offered, promised, paid, or authorized by any Faro entity, including agents, consultants, and joint ventures, shareholders acting on Faro's behalf, and contractors and sub-contractors working directly or indirectly for Faro, the Consultant shall promptly report such payments to Faro's Audit Committee, and Faro shall then be obligated to promptly report the same to the staff of the Commission at the address listed above. Further, the Independent Consultant shall disclose to the staff of the Commission in the event that Faro, or its officers, employees, agents, consultants, and joint ventures, or shareholders acting on Faro's behalf, or contractors and sub-contractors working directly or indirectly for Faro, refuse to provide information necessary for the performance of the Independent Consultant's responsibilities. Faro agrees that it will not take any action to retaliate against the Independent Consultant for such disclosures. During the period, Faro shall immediately disclose to the staff of the Commission, at the address listed above, any information of which it learns that suggests there is a reasonable likelihood that corrupt payments were offered, promised, paid, or authorized by any Faro entity, including agents, consultants, and joint ventures, or shareholders acting on Faro's behalf, or contractors and sub-contractors working directly or indirectly for Faro; and

5. Require the Independent Consultant to enter into an agreement with Faro which provides that for the period of engagement and for a period of two years from completion of the engagement, the Independent Consultant shall not enter into any

employment, consultant, attorney-client, auditing or other professional relationship with Faro, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the Independent Consultant will require that any firm with which she/he is affiliated or of which she/he is a member, and any person engaged to assist the Independent Consultant in performance of her/his duties under this Order shall not, without prior written consent of the Securities and Exchange Commission's Division of Enforcement, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Faro, or any of its present of former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

6. These undertakings shall be binding upon any acquirer or successor in interest to Faro or substantially all of Faro's assets and liabilities or business. For good cause shown, the Commission's staff may extend any of the procedural dates set forth above.

V.

Accordingly, IT IS HEREBY ORDERED, pursuant to Section 21C of the Exchange Act, that:

(i) Respondent Faro will cease and desist from committing or causing any violations and any future violations of Exchange Act Sections 30A, 13(b)(2)(A), and 13(b)(2)(B);

(ii) Respondent shall comply with the undertakings enumerated in Section IV above;

(iii) IT IS FURTHER ORDERED that Respondent shall, within ten days of the entry of this Order, pay disgorgement of $1,411,306 and prejudgment interest of $439,637.32 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 Faro Technologies, Inc. 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 Christopher Conte, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., N.E., Washington, D.C. 20549.

By the Commission.

Florence E. Harmon
Acting Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 57931 / June 5, 2008

INVESTMENT ADVISERS ACT OF 1940
Release No. 2741 / June 5, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13058

In the Matter of JAMES G. MARQUEZ, 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 James G. Marquez ("Marquez" or "Respondent").

II.

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

Document 6 of 48.

III.

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

1. Marquez, age 59, is a resident of Cos Cob, Connecticut. From 1996 through October 2001, Marquez was a portfolio manager and principal of Bayou Management, LLC ("Bayou Management"), the investment adviser[1] to a hedge fund known as Bayou Fund, LLC ("Bayou Fund"). During that time, Marquez acted as a principal, agent, and control person of, and investment adviser to, the Bayou Fund, and also was associated with and acted as a control person of Bayou Securities, LLC ("Bayou Securities"), a broker-dealer affiliated with Bayou Fund and Bayou Management and registered with the Commission pursuant to Section 15(b) of the Exchange Act.

2. On May 28, 2008, a judgment was entered by consent against Respondent, in the United States District Court for the Southern District of New York, permanently restraining and enjoining him from future violations of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, in the civil action entitled Securities and Exchange Commission v. James G. Marquez, Civil Action Number 08-CIV-4773 (S.D.N.Y. filed May 22, 2008).

3. The Commission's complaint in that action alleges that from 1996 through October 2001, in order to retain Bayou Fund's investors and attract further investments, Respondent and his partners systematically concealed Bayou Fund's mounting trading losses by misrepresenting the fund's performance in monthly correspondence to investors. The complaint further alleges that Respondent and his partners created a sham accounting firm to issue and certify falsified "independent" yearly audits of the Bayou Fund's performance and attracted several million dollars in investments by issuing fictitious account statements, periodic newsletters, and falsified year-end "independent" financial statements. The complaint further alleges that in October 2001, Marquez resigned and attempted to dissociate himself from Bayou Management but did not disclose the ongoing fraud or take any steps to halt it. The complaint further alleged that Marquez's partners continued the scheme and attracted increasing amounts of investor capital before the fraud was revealed in 2005.

IV.

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

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1 Bayou Management was not registered with the Commission as an investment adviser. Section 203(b)(3) of the Advisers Act exempts from the registration provisions of the Advisers Act investment advisers that have fewer than fifteen clients and do not hold themselves out to the public as advisers (and do not manage a registered investment company).

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

Any reapplication for association by Respondent Marquez 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.

Florence E. Harmon
Acting Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8928 / June 6, 2008

SECURITIES EXCHANGE ACT OF 1934
Release No. 57934 / June 6, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13060

In the Matter of **EKN Financial Services, Inc.** **f/k/a Ehrenkrantz King** **Nussbaum, Inc.,** **and** **Anthony Ottimo,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, AND SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, AS TO EKN FINANCIAL SERVICES, INC. F/K/A EHRENKRANTZ KING NUSSBAUM, INC., AND ANTHONY OTTIMO**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), and Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against EKN Financial Services, Inc., f/k/a Ehrenkrantz King Nussbaum, Inc. ("Ehrenkrantz" or the "firm") and Anthony Ottimo ("Ottimo") (collectively, "Respondents").

Document 7 of 48

II.

In anticipation of the institution of these proceedings, Respondents have submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions 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 EKN Financial Services, Inc., f/k/a Ehrenkrantz King Nussbaum, Inc., and Anthony Ottimo ("Order"), as set forth below.

III.

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

Respondents

1. Ehrenkrantz, a registered broker-dealer headquartered in Garden City, New York, is approximately 45 percent owned by Ottimo, the firm's chief executive officer.

2. Ottimo, 68 and a resident of Plainview, New York, is the chief executive officer of Ehrenkrantz, and also a registered representative of the firm. He holds Series 4, 7, 24 and 63 licenses.

Overview

3. These proceedings arise out of deceptive practices engaged in by Ehrenkrantz and a person associated with Ehrenkrantz ("the associated person") between January 2003 and November 2003. During that period, Ehrenkrantz, through the associated person, defrauded mutual funds and their shareholders by engaging in deceptive practices designed to mislead the funds and conceal from the funds that four of Ehrenkrantz customers each controlled numerous accounts, which they used to exceed limits on exchanges imposed by the funds. Ottimo failed reasonably to supervise the associated person with a view to preventing the violations.

4. The associated person, although nominally an independent contractor, performed the functions of a registered representative with respect to the accounts at

[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.

issue, and was therefore an associated person of Ehrenkrantz and a person subject to the supervision of Ottimo. The associated person was not registered or approved in accordance with the rules of any national securities exchange or association of which Ehrenkrantz was a member.

Account Cloning

5. Ehrenkrantz and the associated person employed a variety of deceptive acts and practices, including using multiple account numbers, multiple codes used to identify registered representatives purportedly servicing the accounts ("representative codes"), and codes used to identify the branch offices where the accounts were located ("office codes"), to conceal from the funds that multiple accounts were under common control and to thereby avoid the funds' restrictions on market timing and exchanges between funds in a given fund family. Among other things, Ehrenkrantz and the associated person opened accounts for the four customers using codes of representatives who were not involved in servicing the accounts and office codes of Ehrenkrantz branches which were not involved in servicing the accounts.

6. Multiple account numbers allowed the customers to use new accounts to continue their market timing activities after existing accounts had been restricted based upon market timing or exchanges in excess of fund policies, because the mutual funds were misled into believing that the transactions did not originate from the same customers. Multiple registered representative codes concealed the identities of the Ehrenkrantz registered representatives from mutual funds so that the funds could not identify a specific Ehrenkrantz representative as facilitating market timing and restrict further transactions effected by the registered representative associated with that representative code. Finally, multiple branch codes concealed the identity of the Ehrenkrantz Garden City, New York branch as the originating branch of the transactions.

7. The associated person was aware that mutual funds were reviewing trades by accounts with common representative codes or branch codes to detect patterns of market timing activity.

8. Ehrenkrantz earned approximately $62,000 in ill-gotten gains from the accounts controlled by the four customers as the result of this scheme.

Violations

9. As a result of the conduct described above, the associated person and Ehrenkrantz willfully violated Section 17(a) of the Securities Act, which prohibits fraud in the offer and sale of securities, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in connection with the purchase or sale of securities, and Ehrenkrantz willfully violated and the associated person willfully aided and abetted violations of Section 15(c)(1) of the Exchange Act, which prohibits a broker-dealer from using interstate facilities or the mails to effect or induce transactions in

securities "by means of any manipulative, deceptive, or other fraudulent device or contrivance." In addition, Ehrenkrantz willfully violated and the associated person willfully aided and abetted, and Ottimo caused, the violations of, Section 15(b)(7) of the Exchange Act and Rule 15b7-1 thereunder, which prohibits broker-dealers from effecting transactions in securities unless all persons associated with the firm who are involved in effecting the securities transactions, are registered or approved in accordance with the rules of any national securities exchange or association of which the broker-dealer is a member.

Failure to Supervise

10. Section 15(b)(4)(E) of the Exchange Act requires broker-dealers reasonably to supervise persons subject to their supervision, with a view toward preventing violations of the federal securities laws. See e.g., Dean Witter Reynolds, Inc., Exchange Act Rel. No. 46578 (October 1, 2002). The Commission has emphasized that the "responsibility of broker-dealers to supervise their employees by means of effective, established procedures is a critical component in the federal investor protection scheme regulating the securities markets." Id. Section 15(b)(4)(E) of the Exchange Act provides for the imposition of a sanction against a broker or dealer who "has failed reasonably to supervise, with a view to preventing violations of the securities laws, another person who commits such a violation, if such other person is subject to his supervision." Section 15(b)(6)(A)(i) parallels Section 15(b)(4)(E) and provides for the imposition of sanctions against persons associated with a broker or dealer.

11. From January 2003 through November 2003, Ottimo failed reasonably to supervise the associated person, with a view to preventing the associated person's violations of the federal securities laws. Specifically, Ottimo was aware that the associated person was using multiple accounts for certain customers; that those customers were engaged in market timing; that, in connection with the accounts, Ehrenkrantz was listing codes identifying registered representatives of Ehrenkrantz who were not servicing those accounts; and that at least some funds had stopped exchanges in accounts of the relevant customers by preventing exchanges in accounts by representatives listed as servicing those accounts; and failed to follow up and investigate these red flags.

Undertakings

Respondent has undertaken as follows:

12. Ongoing Cooperation by Ehrenkrantz. Ehrenkrantz undertakes to cooperate fully with the Commission in any and all investigations, litigations or other proceedings relating to or arising from the matters described in this Order. In connection with such cooperation, Ehrenkrantz has undertaken:

A. To produce, without service of a notice or subpoena, any and all documents and other information reasonably requested by the Commission's staff;

B. To use its best efforts to cause its employees to be interviewed by the Commission's staff at such times as the staff reasonably may direct;

C. To use its best efforts to cause its employees to appear and testify truthfully and completely without service of a notice or subpoena in such investigations, depositions, hearings or trials as may be requested by the Commission's staff; and

D. That in connection with any testimony of Ehrenkrantz to be conducted at deposition, hearing or trial pursuant to a notice or subpoena, Ehrenkrantz:

i. Agrees that any such notice or subpoena for Ehrenkrantz's appearance and testimony may be served by regular mail on its counsel, Robert Bursky, Esq., or any successor identified by Ehrenkrantz; and

ii. Agrees that any such notice or subpoena for Ehrenkrantz's appearance and testimony in an action pending in a United States District Court may be served, and may require testimony, beyond the territorial limits imposed by the Federal Rules of Civil Procedure.

13. Independent Compliance Consultant. Ehrenkrantz undertakes to, within 30 days of the entry of this Order plus, hire an independent compliance consultant ("Consultant"), not unacceptable to the Commission staff, to review and evaluate the effectiveness of Ehrenkrantz's supervisory and compliance systems, policies and procedures designed to detect and prevent violations of the federal securities laws concerning: (1) review of incoming and outgoing correspondence, including electronic correspondence such as e-mail; (2) mutual fund market timing activity; (3) supervision of branch offices; and (4) registration of associated persons as required by the rules of any national securities exchange or association of which Ehrenkrantz is a member. In connection with the hiring of the Consultant, Ehrenkrantz undertakes the following:

A. The Consultant's expenses shall be borne exclusively by Ehrenkrantz. Ehrenkrantz shall cooperate fully with the Consultant and shall provide the Consultant with access to its files, books, records, and personnel as reasonably requested for the review. Ehrenkrantz shall cause the review to begin no later than 60 days after the issuance of this Order.

B. At the conclusion of the review, which in no event shall be more than 120 days of the entry of this Order, Ehrenkrantz shall cause the Consultant to submit to Ehrenkrantz and to the Commission's staff a written Initial Report. The Initial Report shall describe the review performed and the conclusions reached, and will include any recommendations deemed necessary to make the policies, procedures, and system of supervision and compliance adequate.

C. Within 30 days of receipt of the Initial Report, Ehrenkrantz shall in writing respond to the Initial Report. In such response, Ehrenkrantz shall advise the Consultant and the Commission's staff of the recommendations from the Initial Report that it has determined to accept and the recommendations that it considers to be unduly burdensome. With respect to any recommendation that Ehrenkrantz deems unduly burdensome, Ehrenkrantz may propose an alternative policy, procedure or system designed to achieve the same objective or purpose.

D. Ehrenkrantz and the Consultant shall attempt in good faith to reach agreement within 180 days of the date of the entry of this Order with respect to any recommendation that Ehrenkrantz deems unduly burdensome. If the Consultant and Ehrenkrantz are unable to agree on an alternative proposal, Ehrenkrantz shall abide by the recommendation of the Consultant.

E. Within 200 days of the date of the entry of this Order, Ehrenkrantz shall, in writing, advise the Consultant and the Commission's staff of the recommendations and proposals that it is adopting.

F. Ehrenkrantz shall cause the Consultant to complete the aforementioned review and submit a written Final Report to Ehrenkrantz and to the Commission's staff within 230 days of the date of the entry of this Order. The Final Report shall recite the efforts the Consultant undertook to review Ehrenkrantz's supervisory and compliance policies, procedures, and systems as set forth in paragraph 13; set forth its conclusions and recommendations; and describe how Ehrenkrantz is implementing those recommendations.

G. Ehrenkrantz shall take all necessary and appropriate steps to adopt and implement all recommendations contained in the Consultant's Final Report.

H. No later than one year after the date of the Consultant's Final Report, Ehrenkrantz shall cause the Consultant to conduct a follow-up review of Ehrenkrantz's efforts to implement the recommendations contained in the Final Report, and Ehrenkrantz shall cause the Consultant to submit a follow-up report to the Commission's staff. The follow-up report shall set forth the details of Ehrenkrantz's efforts to implement the recommendations contained in the Final Report, and shall state whether Ehrenkrantz has fully complied with the recommendations in the Final Report.

I. For good cause shown, and upon receipt of a timely application from the Consultant or Ehrenkrantz, the Commission's staff may extend any of the procedural dates set forth above.

J. To ensure the independence of the Consultant, Ehrenkrantz: (a) shall not have the authority to terminate the Consultant without the prior written approval of the Commission's staff; (b) shall compensate the Consultant, and persons engaged to assist the Consultant, for services rendered pursuant to this Order at their reasonable and customary rates; (c) shall not be in and shall not have an attorney-client relationship with the Consultant and shall not seek to invoke the attorney-client or any other privilege or doctrine to prevent the Consultant from transmitting any information, reports, or documents to the Commission staff; and (d) during the period of engagement and for a period of two years after the engagement, shall not enter into any employment, customer, consultant, attorney-client, auditing, or other professional relationship with the Consultant.

K. Ehrenkrantz shall cause the Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with Ehrenkrantz, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Consultant in performance of his/her duties under this Order shall not, without prior written consent of the Atlanta Regional Office Commission staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Ehrenkrantz, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

IV.

On the basis of the foregoing, Respondents hereby consent to the entry of an Order by the Commission imposing the following remedial sanctions pursuant to Section 8A of the Securities Act and Sections 15(b) and 21C of the Exchange Act:

A. Ehrenkrantz shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Sections 10(b), 15(c)(1) and 15(b)(7) of the Exchange Act and Rules 10b-5 and 15b7-1 thereunder;

B. Ottimo shall cease and desist from causing any violations and any future violations of Section 15(b)(7) of the Exchange Act and Rule 15b7-1 thereunder.

C. Ehrenkrantz is hereby censured;

D. Ottimo shall be, and hereby is, barred from association in a supervisory capacity with any broker or dealer.

E. Ehrenkrantz shall pay disgorgement of $31,000 and prejudgment interest of $10,024 to the Securities and Exchange Commission. Respondent Ehrenkrantz shall also pay a civil money penalty in the amount of $25,000 to the Securities and Exchange Commission. Respondent Ehrenkrantz shall satisfy the disgorgement and prejudgment interest obligation by paying $10,000 within ten (10) business days of the entry of this Order and the remainder in installments according to the following schedule: (1) $10,000 within 90 days of the entry of this Order plus interest pursuant to SEC Rule of Practice 600; and (2) $21,024 within 180 days of the entry of this Order plus interest pursuant to SEC Rule of Practice 600. Respondent Ehrenkrantz shall satisfy the civil penalty obligation by paying (1) $15,000 within 270 days of the entry of this Order; and (2)

$10,000 within 360 days of the entry of this Order. If Respondent Ehrenkrantz fails to make any payment by the date agreed and/or in the amount agreed according to the schedule set forth above, the entire amount of disgorgement and prejudgment interest, and civil penalties plus any interest accrued on the disgorgement pursuant to SEC Rule of Practice 600, and interest accrued on the penalties pursuant to 31 U.S.C. § 3717, minus amounts paid, shall become due and payable immediately without further application.

All payments shall be made by certified check, bank cashier's check, or United States postal money order payable to the Securities and Exchange Commission. The payment shall be delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, Virginia 22312, Mail Stop 0-3, and shall be accompanied by a letter identifying Respondent Ehrenkrantz as a respondent in this action; setting forth the title and civil action number of this action and the name of this Court; and specifying that payment is made pursuant to this Order, a copy of which cover letter and money order or check shall be sent to Ronald L. Crawford, Senior Associate Regional Administrator, Securities and Exchange Commission, 3475 Lenox Rd., N.E., Suite 1000, Atlanta, GA 30326-1232. Respondent Ehrenkrantz shall pay post-judgment interest on any delinquent amounts pursuant to 28 USC § 1961.

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

F. Ottimo shall, within ten days of the entry of this Order, pay disgorgement of $31,000 and prejudgment interest of $10,024 to the Securities and Exchange Commission. Respondent Ottimo shall also pay a civil money penalty in the amount of $25,000 to the Securities and Exchange Commission. Ottimo shall satisfy the civil penalty obligation by paying (1) $10,000 within 90 days of the entry of this Order; and (2) $15,000 within 270 days of the entry of this Order. If Respondent Ottimo fails to make any payment by the date agreed and/or in the amount agreed according to the schedule set forth above, the entire amount of disgorgement and prejudgment interest, and civil penalties plus any interest accrued on the disgorgement pursuant to SEC Rule of Practice 600, and interest accrued on the penalties pursuant to 31 U.S.C. § 3717, minus amounts paid, shall become due and payable immediately without further application. 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, Alexandria, VA 22312, Mail Stop 0-3; and (D) submitted under cover letter that identifies Ottimo 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 Ronald L. Crawford, Senior Associate Regional Administrator, Securities and Exchange Commission, 3475 Lenox Rd., N.E., Suite 1000, Atlanta, GA 30326-1232.

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

G. Ehrenkrantz shall comply with the undertaking specified in Paragraph 13 above.

By the Commission.

Florence E. Harmon
Acting Secretary

By: J. Lynn Taylor
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 230, 232, 239, 270, and 274

[Release Nos. 33-8929, 34-57942, 39-2457, IC-28298; File Number S7-12-08]

RIN 3235-AK13

INTERACTIVE DATA FOR MUTUAL FUND RISK/RETURN SUMMARY

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: We are proposing rules requiring mutual funds to provide risk/return summary information in a form that would improve its usefulness to investors. Under the proposed rules, risk/return summary information could be downloaded directly into spreadsheets, analyzed in a variety of ways using commercial off-the-shelf software, and used within investment models in other software formats. Mutual funds would provide the risk/return summary section of their prospectuses to the Commission and on their Web sites in interactive data format using the eXtensible Business Reporting Language ("XBRL"). The interactive data would be provided as an exhibit to registration statements. The proposed rules are intended not only to make risk/return summary information easier for investors to analyze, but also to assist in automating regulatory filings and business information processing. Interactive data has the potential to increase the speed, accuracy, and usability of mutual fund disclosure, and eventually reduce costs. We are also proposing to permit investment companies to submit portfolio holdings information in our interactive data voluntary program without being required to submit other financial information.

DATES: Comments should be submitted on or before August 1, 2008.

Document 8 of 48

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

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml);
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-12-08 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 Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-12-08. 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 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: Alberto H. Zapata, Senior Counsel, or Tara R. Buckley, Branch Chief, Office of Disclosure Regulation, Division of

Investment Management, at (202) 551-6784, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5720.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") is proposing amendments to Rule 485[1] under the Securities Act of 1933 ("Securities Act"), Rules 11,[2] 202,[3] and 401[4] of Regulation S-T[5], Rule 8b-33[6] under the Investment Company Act of 1940 ("Investment Company Act"), and Form N-1A[7] under the Securities Act and the Investment Company Act. We are also proposing amendments to proposed Rule 405 of Regulation S-T.[8]

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1 17 CFR 230.485.

2 17 CFR 232.11.

3 17 CFR 232.202.

4 17 CFR 232.401.

5 17 CFR 232.10 et seq.

6 17 CFR 270.8b-33.

7 17 CFR 239.15A and 274.11A.

8 See Securities Act Release No. 8924 (May 30, 2008) [73 FR 32794 (June 10, 2008)] ("Interactive Data Proposing Release").

Table of Contents

I. INTRODUCTION AND BACKGROUND

A. Introduction

Over the last several decades, developments in technology and electronic data communication have significantly decreased the time and cost of filing disclosure documents with us. Technological developments also have facilitated greater transparency in the form of easier access to, and analysis of, financial reporting and disclosures. Most notably, in 1993 we began to require electronic filing on our Electronic Data Gathering, Analysis and Retrieval System ("EDGAR").[9] Since then, widespread use of the Internet has vastly decreased the time and expense of accessing disclosure filed with us.

We continue to update our filing standards and systems as technologies improve. These developments assist us in our goal to promote efficient and transparent capital markets. For example, since 2003 we have required electronic filing of certain ownership reports filed on Forms 3,[10] 4,[11] and 5[12] in a format that provides interactive data, and recently we adopted similar rules governing the filing of Form D.[13] In addition, recently we have encouraged, and in some cases required, open-end management investment

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9 In 1993, we began to require domestic issuers to file most documents electronically. Securities Act Release No. 6977 (Feb. 23, 1993) [58 FR 14628 (Mar. 18, 1993)]. Electronic filing began with a pilot program in 1984. Securities Act Release No. 6539 (June 27, 1984) [49 FR 28044 (July 10, 1984)].

10 17 CFR 249.103 and 274.202.

11 17 CFR 249.104 and 274.203.

12 17 CFR 249.105.

13 17 CFR 239.500.

companies ("mutual funds")[14] and public reporting companies to provide disclosures and communicate with investors using the Internet.[15] Now, as part of our continuing efforts to assist filers as well as investors who use Commission disclosures, we propose to require that mutual fund risk/return summary information be provided in a format that makes the information interactive.

Our proposal builds on our voluntary filer program, started in 2005,[16] that allowed us to evaluate the merits of interactive data. The voluntary program allows companies to submit financial statements on a supplemental basis in interactive format as exhibits to specified filings under the Securities Exchange Act of 1934 ("Exchange Act") and the Investment Company Act.[17] Over 75 companies have participated in the voluntary program. These companies span a wide range of industries and company characteristics, and have a total market capitalization of over $2 trillion. Companies that participate in the program still are required to file their financial statements in American Standard Code for Information Interchange ("ASCII") or HyperText Markup Language ("HTML").[18]

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14 An open-end management investment company is an investment company, other than a unit investment trust or face-amount certificate company, that offers for sale or has outstanding any redeemable security of which it is the issuer. See Sections 4 and 5(a)(1) of the Investment Company Act [15 U.S.C. 80a-4 and 80a-5(a)(1)].

15 See, e.g., Exchange Act Release No. 57172 (Jan. 18, 2008) [73 FR 4450 (Jan. 25, 2008)]; Securities Act Release No. 8861 (Nov. 21, 2007) [72 FR 67790 (Nov. 30, 2007)] ("Summary Prospectus Proposing Release"); Exchange Act Release No. 56135 (July 26, 2007) [72 FR 42222 (Aug. 1, 2007)]; Exchange Act Release No. 55146 (Jan. 22, 2007) [72 FR 4148 (Jan. 29, 2007)]; Securities Act Release No. 8591 (July 19, 2005) [70 FR 44722 (Aug. 3, 2005)].

16 Securities Act Release No. 8529 (Feb. 3, 2005) [70 FR 6556 (Feb. 8, 2005)] ("Voluntary Program Adopting Release").

17 15 U.S.C. 80a-1 et seq.

18 HTML is a standardized language commonly used to present text and other information on Web sites.

In 2007, we extended the program to enable mutual funds voluntarily to submit in interactive data format supplemental information contained in the risk/return summary section of their prospectuses.[19] The risk/return summary contains key information about a fund's investment objectives and strategies, costs, risks, and past performance.[20] Approximately 20 mutual funds from a wide variety of fund families have submitted risk/return summary information in interactive format.

In a recently issued release, we proposed to require companies, other than investment companies that are registered under the Investment Company Act, business development companies,[21] and other entities that report under the Exchange Act and prepare their financial statements in accordance with Article 6 of Regulation S-X, to submit financial information to the Commission in interactive data format.[22] In this release, we propose to extend similar requirements to mutual fund risk/return summary information.

The submission of mutual fund risk/return summary information based on interactive data would create new ways for investors, analysts, and others to retrieve and use the information. For example, users of risk/return summary information could download cost and performance information directly into spreadsheets, analyze it using commercial off-the-shelf software, or use it within investment models in other software

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19 Securities Act Release No. 8823 (July 11, 2007) [72 FR 39290 (July 17, 2007)] ("Risk/Return Voluntary Program Adopting Release").

20 Items 2 and 3 of Form N-1A.

21 Business development companies are a category of closed-end investment companies that are not required to register under the Investment Company Act. 15 U.S.C. § 80a-2(a)(48).

22 See Interactive Data Proposing Release, supra note 8.

formats. Through interactive data, what is currently static, text-based information can be dynamically searched and analyzed, facilitating the comparison of mutual fund cost, performance, and other information across multiple classes of the same fund and across the more than 8,000 funds currently available.[23]

Interactive data also could provide a significant opportunity to automate regulatory filings and business information processing, with the potential to increase the speed, accuracy, and usability of mutual fund disclosure. Such automation could eventually reduce costs. A mutual fund that uses a standardized interactive data format at earlier stages of its reporting cycle could reduce the need for repetitive data entry and, therefore, the likelihood of human error. In this way, interactive data may improve the quality of information while reducing its cost.

Also, to the extent investors currently are required to pay for access to mutual fund risk/return summary information that has been extracted and reformatted into an interactive data format by third-party sources, the availability of interactive data in Commission filings could allow investors to avoid additional costs associated with third-party sources.

We believe that requiring mutual funds to file the risk/return summary section of their prospectuses using interactive data format would enable investors, analysts, and the Commission staff to capture and analyze that information more quickly and at less cost than is possible using the same information provided in a static format. Any investor with a computer would have the ability to acquire and download interactive data that have generally been available only to intermediaries and third-party analysts. The

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[23] Investment Company Institute, 2008 Investment Company Fact Book, at 15 (2008), available at: http://www.icifactbook.org/pdf/2007_factbook.pdf (as of year-end 2007, there were 8,752 mutual funds).

proposed interactive data requirements would not change what is currently disclosed, but would add a requirement to include risk/return summary information in a new format as an exhibit. Thus the proposal to require that filers provide risk/return summary information using interactive data will not alter the disclosure or formatting standards of mutual fund prospectuses, which would continue to be available as they are today for those who prefer to view the traditional text-based document.

Throughout this release, we solicit comment on many issues concerning the use of interactive data, including specifically whether mutual fund risk/return summary information in interactive data format should be required as exhibits to Securities Act registration statements filed with us. We are seeking comment from investors, mutual funds, financial intermediaries, analysts, accountants, and any other parties or individuals who may be affected by the use of interactive disclosure in Commission filings, and any other members of the public.

B. Current Filing Technology and Interactive Data

Companies filing electronically are required to file their registration statements and periodic reports in ASCII or HTML format.[24] Also, to a limited degree, our electronic filing system uses other formats for internal processing and document-type identification. For example, our system uses eXtensible Markup Language ("XML") to process reports of beneficial ownership of equity securities on Forms 3, 4, and 5 under

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24 Rule 301 of Regulation S-T [17 CFR 232.301] requires electronic filings to comply with the EDGAR Filer Manual, and Section 5.2 of the EDGAR Filer Manual requires that electronic filings be in ASCII or HTML format. Rule 104 of Regulation S-T [17 CFR 232.104] permits filers to submit voluntarily as an adjunct to their official filings in ASCII or HTML unofficial PDF copies of filed documents. Unless otherwise stated, we refer to filings in ASCII or HTML as traditional format filings.

Section 16(a) of the Exchange Act.[25]

Electronic formats such as HTML, XML, and XBRL are open standards[26] that define or "tag" data using standard definitions. The tags establish a consistent structure of identity and context. This consistent structure can be.recognized and processed by a variety of different software applications. In the case of HTML, the standardized tags enable Web browsers to present Web sites' embedded text and information in predictable format. In the case of XBRL, software applications, such as databases, financial reporting systems, and spreadsheets, recognize and process tagged information.

XBRL was derived from the XML standard. It was developed and continues to be supported by XBRL International, a collaborative consortium of approximately 550 organizations representing many elements of the financial reporting community worldwide in more than 20 jurisdictions, national and regional. XBRL U.S., the international organization's U.S. jurisdiction representative, is a non-profit organization that includes companies, public accounting firms, software developers, filing agents, data aggregators, stock exchanges, regulators, financial services companies, and industry associations.[27]

Risk/return summary information in interactive format requires a standard list of tags. These tags are similar to definitions in an ordinary dictionary, and they cover a variety of concepts that can be read and understood by software applications. For the

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25 15 U.S.C. 78p(a).

26 The term "open standard" is generally applied to technological specifications that are widely available to the public, royalty-free, at minimal or no cost.

27 XBRL U.S. supports efforts to promote interactive financial and business data specific to the U.S.

risk/return summary, a mutual fund would use the list of tags for risk/return summary information developed by the Investment Company Institute ("ICI").[28] This list of tags contains descriptive labels, authoritative references to Commission regulations where applicable, and other elements, all of which provide the contextual information necessary for interactive data[29] to be recognized and processed by software.[30]

To apply data tags to risk/return summary information, a preparer uses

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28 Unless stated otherwise, when we refer to the "list of tags for risk/return summary information" we mean the interactive data taxonomy developed by the ICI, including any modifications. We anticipate entering into a contract to update the architecture of the taxonomy developed by the ICI and conform the taxonomy to any changes in the risk/return summary that we adopt pursuant to a pending rule proposal. See Summary Prospectus Proposing Release, supra note 15.

The ICI is a national association of the U.S. investment company industry. The taxonomy developed by the ICI received acknowledgement from XBRL International in June 2007 and is used by mutual funds participating in the Commission's voluntary program. The taxonomy is available on XBRL International's Web site at: http://www.xbrl.org/Taxonomy/ici/ici-rr-summarydocument-20070516-acknowledged.htm.

29 The proposed rules would define the interactive data necessary to create human-readable disclosure as the "interactive data file," which would be required with every interactive data submission. See Interactive Data Proposing Release, supra note 8 (proposing new definitions under 17 CFR 232.11). The EDGAR Filer Manual would identify any necessary supporting files.

30 For example, contextual information would identify the entity to which it relates, usually by using the filer's CIK number. A hypothetical filer converting its traditional electronic disclosure of total annual fund operating expenses of 0.73% would have to create interactive data that identify what the 0.73% represents, total annual fund operating expenses, and that the number is a percentage. The contextual information would include other information as necessary; for example, the date of the prospectus to which it relates and the series and class to which it applies.

A mutual fund may issue multiple "series" of shares, each of which is preferred over all other series in respect of assets specifically allocated to that series. Rule 18f-2 under the Investment Company Act [17 CFR 270.18f-2]. Each series is, in effect, a separate investment portfolio.

A mutual fund may issue more than one class of shares that represent interests in the same portfolio of securities with each class, among other things, having a different arrangement for shareholder services or the distribution of securities, or both. Rule 18f-3 under the Investment Company Act [17 CFR 270.18f-3].

commercially available software that guides the preparer in mapping information in the risk/return summary, such as line item costs in a mutual fund's fee table, to the appropriate tags in the standard list. This involves locating an element in the list of tags that represents the particular disclosure that is to be tagged. Occasionally, because mutual funds have some flexibility in preparing the risk/return summary, particularly the narrative portions, it is possible that a mutual fund may wish to use a non-standard disclosure that is not included in the standard list of tags. In this situation, a fund would create a company-specific element, called an extension.

A mutual fund may choose to tag its own risk/return summary using commercially available software, or it may choose instead to outsource the tagging process. In the event a mutual fund relies upon a service provider to tag the fund's risk/return summary, the mutual fund would want to carefully review the tagging done by the service provider in order to make sure that the tagged risk/return summary information is accurate and consistent with the information the mutual fund presents in its traditional format filing.

Because mutual fund risk/return summary information in interactive data format, referred to as the interactive data file, is intended to be processed by software applications, the unprocessed interactive data is not readable. Thus, viewers are necessary to convert the interactive data file to human readable format. Some viewers are similar to Web browsers used to read HTML files.

The Commission's Web site currently provides links to four viewers that allow the public to easily read mutual fund and other company disclosures submitted using interactive data.[31] One of these viewers allows users to view and compare mutual fund risk/return summary information, including investment objectives and strategies, risks, costs, and performance, that is submitted in interactive data format.[32] These viewers demonstrate the capability of downloading interactive data into software such as Microsoft Excel as well as into other applications that are widely available on the Internet. In addition, we are aware of other applications under development that may provide additional and advanced functionality.

C. The Commission's Multiyear Evaluation of Interactive Data and Overview of Proposed Rules

In 2004, we began assessing the benefits of interactive data and its potential for improving the timeliness and accuracy of financial disclosure and analysis of Commission filings.[33] As part of this evaluation, we adopted rules in 2005 permitting filers, on a voluntary basis, to provide financial disclosure in interactive data format as an exhibit to certain filings on our electronic filing system. After more than two years of increasing participation, over 75 companies have chosen to provide interactive data financial reporting.[34]

In 2007, we extended the program to enable mutual funds voluntarily to submit

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31 See viewers available at http://www.sec.gov/xbrl.

32 A mutual fund information viewer for the voluntary program is available at: http://a.viewerprototype1.com/viewer.

33 See SEC Announces Initiative to Assess Benefits of Tagged Data in Commission Filings, Securities and Exchange Commission Press Release, July 22, 2004, available at: http://www.sec.gov/news/press/2004-97.htm.

34 A viewer for this interactive data is available at: http://www.sec.gov/spotlight/xbrl/xbrlwebapp.shtml. This viewer, one of several funded by the Commission to demonstrate interactive data, maintains a running total of companies and filers submitting data as part of the voluntary program. As of April 17, 2008, 78 companies had submitted 350 interactive data reports.

risk/return summary information in interactive data format. To date, approximately 20 mutual funds have chosen to provide interactive data risk/return summaries.[35]

During this time, we have kept informed of technology advances and other interactive data developments. We note that several U.S. and foreign regulators have begun to incorporate interactive data into their financial reporting systems. The Federal Deposit Insurance Corporation ("FDIC"), the Federal Reserve, and the Office of the Comptroller of the Currency ("OCC") require the use of XBRL.[36] As of 2006, approximately 8,200 U.S. financial institutions were using XBRL to submit quarterly reports to banking regulators.[37] Countries that have required or instituted voluntary or pilot programs for XBRL financial reporting include Australia, Belgium, Canada, China, Denmark, France, Germany, Ireland, Israel, Japan, Korea, Luxembourg, the Netherlands, New Zealand, Norway, Singapore, Spain, Sweden, Thailand, and the United Kingdom.[38]

We also have kept informed of relevant advances and developments by hosting roundtables on the topic of interactive data reporting,[39] creating the Commission's Office

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[35] The mutual fund information viewer contains all mutual fund submissions under the voluntary program. As of May 1, 2008, 21 mutual funds had submitted 33 interactive data reports.

[36] Since 2005, the FDIC, Federal Reserve, and the OCC have required the insured institutions that they oversee to file their quarterly Consolidated Reports of Condition and Income (called "Call Reports") in interactive data format using XBRL. Call Reports, which include data about an institution's balance sheet and income statement, are used by these federal agencies to assess the financial health and risk profile of the financial institution.

[37] See Improved Business Process Through XBRL: A Use Case for Business Reporting, available at http://www.xbrl.org/us/us/FFIEC%20White%20Paper%2002Feb2006.pdf.

[38] See XBRL International Progress Report (November 2007), available at http://www.xbrl.org/ProgressReports/2007_11_XBRL_Progress_Report.pdf.

[39] See materials available at http://www.sec.gov/spotlight/xbrl/xbrl-meetings.shtml.

of Interactive Disclosure,[40] and meeting with international securities regulators to discuss, among other items, timetables for implementation of interactive data initiatives for financial reporting.[41] Also, staff of the Commission have attended meetings of the Advisory Committee on Improvements to Financial Reporting ("CIFiR") in which the committee discussed proposals for financial reporting using interactive data.[42] We also have reviewed written statements and public comments received by CIFiR on its XBRL developed proposal.[43]

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40 See SEC Announces New Unit to Lead Global Move to Interactive Data, Securities and Exchange Commission Press Release, October 9, 2007, available at: http://www.sec.gov/news/press/2007/2007-213.htm.

41 See Chairman Cox, Overseas Counterparts Meet to Discuss Interactive Data Timetable, Securities and Exchange Commission Press Release, November 9, 2007, available at: http://www.sec.gov/news/press/2007/2007-227.htm.

42 The Commission established CIFiR to examine the U.S. financial reporting system, with the goals of reducing unnecessary complexity and making information more useful and understandable for investors. See SEC Establishes Advisory Committee to Make U.S. Financial Reporting System More User-Friendly for Investors, Securities and Exchange Commission Press Release, June 27, 2007, available at http://www.sec.gov/news/press/2007/2007-123.htm.

CIFiR conducted an open meeting on March 14, 2008, in which it heard reactions from an invited panel of participants to CIFiR's developed proposal regarding required filing of financial information using interactive data. An archived Webcast of the meeting is available at http://sec.gov/about/offices/oca/cifir.shtml. The March 14, 2008 panelists presented their views and engaged with CIFiR members regarding issues relating to requiring interactive data tagged financial statements, including tag list and technological developments, implications for large and small public companies, needs of investors, necessity of assurance and verification of such tagged financial statements, and legal implications arising from such tagging. Also, CIFiR has provided to the Commission an interim progress report that contains a developed proposal that the Commission, over the long term, require the filing of financial information using interactive data once specified conditions are satisfied. See Progress Report of the Advisory Committee on Improvements to the Financial Reporting to the United States Securities and Exchange Commission (Feb. 14, 2008) ("Progress Report"), available at http://www.sec.gov/about/offices/oca/acifr/acifr-pr-021408-final.pdf.

43 The XBRL developed proposal appears in chapter 4 of the Progress Report. Written statements of panelists at the March 14, 2008 meeting and public comments received on the Progress Report are available at http://sec.gov/comments/265-24/265-24.shtml.

Building on our experience monitoring the voluntary program and our participation in the other initiatives described above, we are now proposing rules to require mutual funds to provide risk/return summary information using interactive data as an exhibit to their registration statements filed on Form N-1A.[44] Interactive data would be required to be provided on a mutual fund's Web site[45] and with the fund's Securities Act registration statements and post-effective amendments thereto.[46] We believe this has the potential to provide advantages for the investing public by making risk/return summary information more accessible, timely, inexpensive, and easier to analyze.

By enabling mutual funds to further automate their disclosure processes, interactive data may eventually help funds improve the speed at which they generate information, while reducing the cost of filing and potentially increasing the accuracy of the data. For example, with standardized interactive data tags, registration statements may require less time for information gathering and review. Also, standardized interactive data tagging may enhance the ability of a fund's in-house professionals to identify and correct errors in the fund's registration statements filed in traditional electronic format. Mutual funds also may gain benefits not directly related to risk/return summary information disclosures. For example, mutual fund families that use interactive data may be able to compile information more quickly and potentially more reliably both

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44 Form N-1A is the form used by mutual funds to register under the Investment Company Act and to offer securities under the Securities Act.

45 The proposed Web site posting requirement would apply only to the extent a mutual fund already maintains a Web site.

46 Interactive data would be required as an exhibit to a Securities Act registration statement or post-effective amendment thereto that contains risk/return summary information. Interactive data would not be required as an exhibit to a post-effective amendment that does not contain risk/return summary information.

for internal purposes and for communications with financial intermediaries, third party information providers, and the public. However, we recognize that at the outset, mutual funds would most likely prepare their interactive data as an additional step after their prospectuses have been prepared.

The principal elements of the proposal are as follows:

- Mutual funds would provide to the Commission a new exhibit with their risk/return summary information in interactive data format, beginning with initial registration statements, and post-effective amendments that are annual updates to effective registration statements, that become effective after December 31, 2009.[47]
- Mutual funds providing risk/return summary information in interactive data format would be required to use the most recent list of tags released by XBRL U.S. as required by the EDGAR Filer Manual. Mutual funds also would be required to tag a limited number of document and entity identifier elements, such as the form type and the fund's name. As with interactive data for the risk/return summary, these document and entity identifier elements would be formatted using the appropriate list of tags as required by the EDGAR Filer Manual.[48]
- A mutual fund required to provide risk/return summary information in interactive data format to the Commission also would be required to post that information in

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[47] The proposed schedule is premised on the rules being adopted this fall in time for mutual funds to implement this schedule, and could be adjusted depending on when the Commission adopts any final rules.

[48] The appropriate list of tags for document and entity identifier elements would be a list released by XBRL U.S. and would be required to be used by all issuers required to submit interactive data.

interactive data format on its Web site on the earlier of the date that the interactive data is submitted to the Commission or is required to be submitted to the Commission.

- The proposed rules would not alter the requirements to provide risk/return summary information with the traditional format filings.[49]
- Risk/return summary information in interactive data format would be provided as exhibits identified in General Instruction C.3.(g) of Form N-1A.
- Viewable interactive data as displayed through software available on the Commission's Web site, and to the extent identical in all material respects to the corresponding portion of the traditional format filing, would be subject to all the same liability provisions of the federal securities laws as the corresponding data in the traditional format filing.
- Data in the interactive data file submitted to us generally would be subject to the federal securities laws in a manner similar to that of the voluntary program and, as a result, would be
    - deemed not filed for purposes of specified liability provisions; and
    - protected from liability for failure to comply with the proposed tagging and related requirements if the interactive data file either
        - met the requirements; or
        - failed to meet those requirements, but the failure occurred despite

49 When we extended the voluntary program to the mutual fund risk/return summary, we stated in the adopting release that the interactive data submission would be supplemental to filings and not replace the required traditional electronic format of the information it contains. We also said that volunteers would be required to continue to file their traditional electronic filings. See Part II.A. of the Risk/Return Voluntary Program Adopting Release, supra note 19, 72 FR at 39292.

the mutual fund's good faith and reasonable effort, and the mutual fund corrected the failure as soon as reasonably practicable after becoming aware of it.

- The proposed rules would require the risk/return summary information and document and entity identifier elements to be tagged according to Regulation S-T and the EDGAR Filer Manual.[50]
- Each interactive data submission would be required to be filed as a post-effective amendment under Rule 485(b) under the Securities Act[51] and would be required to be filed after effectiveness of the related filing, but no later than 15 business days after the effective date of the related filing.
- If a mutual fund does not submit or post interactive data as required, the fund's ability to file post-effective amendments to its registration statement under Rule 485(b) under the Securities Act would be automatically suspended until the fund submits and posts the interactive data as required.
- We anticipate that the voluntary program would be modified, if the proposed rules are adopted, to exclude participation by mutual funds with respect to risk/return summary information but continue to permit investment companies to participate with respect to financial statement information. As a result, the voluntary program would continue for the financial statements of investment

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50 Proposed Rule 405 of Regulation S-T would directly set forth the basic tagging requirements and indirectly set forth the rest of the tagging requirements through the requirement to comply with the EDGAR Filer Manual. Consistent with proposed Rule 405, the Filer Manual would contain the technical tagging requirements. See Interactive Data Proposing Release, supra note 8 (proposing Rule 405 of Regulation S-T).

51 Rule 485(b) under the Securities Act provides for immediate effectiveness of amendments to registration statements that make certain non-material and other changes.

companies that are registered under the Investment Company Act, business development companies, and other entities that report under the Exchange Act and prepare their financial statements in accordance with Article 6 of Regulation S-X.

- Registered investment companies, business development companies, and other entities that report under the Exchange Act and prepare their financial statements in accordance with Article 6 of Regulation S-X would be permitted to submit exhibits under the voluntary program containing a tagged schedule of portfolio holdings without having to submit other financial information in interactive data format.

II. DISCUSSION OF THE PROPOSED AMENDMENTS

A. Submission of Risk/Return Summary Information Using Interactive Data

The ICI's risk/return summary list of tags received acknowledgement from XBRL International in June 2007.[52] The Commission anticipates entering into a contract to update the architecture of the list of tags and conform the list of tags to any changes in the

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52 The list of tags is available on XBRL International's Web site at: http://www.xbrl.org/Taxonomy/ici/ici-rr-summarydocument-20070516-acknowledged.htm.

There are two levels of XBRL taxonomy recognition: (1) "acknowledgement" is formal recognition that a taxonomy complies with XBRL specifications, including testing by a defined set of validation tools; and (2) "approval" is a formal recognition requiring more detailed quality assurance and testing, including compliance with official XBRL guidelines for the type of taxonomy under review, creation of a number of instance documents, and an open review period after acknowledgement. For more information regarding the XBRL taxonomy recognition process, see "Taxonomy Recognition Process" on the XBRL International Web site available at: http://www.xbrl.org/TaxonomyRecognition/.

risk/return summary that we adopt pursuant to a pending rule proposal.[53]

Interactive data risk/return summary information using the list of tags for risk/return summary information has been submitted voluntarily to us by approximately 20 mutual funds. In recent years, there has been a growing development of software products for users of interactive data, as well as of applications to assist companies, including mutual funds, to tag their disclosures using interactive data.[54] The growing number of software applications available to preparers and consumers is helping make interactive data increasingly useful to both retail and institutional investors, as well as to other participants in the U.S. and global capital markets. On this basis, we believe interactive data, and in particular the XBRL standard, have become widespread and that the list of tags for risk/return summary information is now sufficiently advanced to require that mutual funds provide their risk/return summary information in interactive data format.

As discussed in more detail below, our proposed rules would require all mutual funds to submit interactive data with any registration statement or post-effective amendment on Form N-1A that includes or amends risk/return summary information.[55] We anticipate that the first required submissions would be for initial registration statements and post-effective amendments that are annual updates to effective registration

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53 See Summary Prospectus Proposing Release, supra note 15.

54 See SEC's Office of Interactive Disclosure Urges Public Comment as Interactive Data Moves Closer to Reality for Investors, Securities and Exchange Commission Press Release, Dec. 5, 2007, available at: http://www.sec.gov/news/press/2007/2007-253.htm. A list of interactive data products and service providers is available at: http://xbrl.us/Vendors/Pages/default-expand.aspx.

55 See proposed General Instruction C.3.(g) to Form N-1A.

statements and that become effective after December 31, 2009.

We are proposing that mutual funds be required to provide the same risk/return summary information in interactive data format that mutual funds have been providing in the voluntary program.[56] In addition, funds would be required to provide document and entity identifier tags, such as the form type and the fund's name. As was the case in the voluntary program, the proposed requirement for interactive data reporting is intended to be disclosure neutral. We do not intend the rules to result in mutual funds providing more, less, or different disclosure for a given disclosure item depending upon the format, whether ASCII, HTML, or XBRL.

We propose to continue requiring the existing electronic formats now used in filings because we believe it is necessary to monitor the usefulness of interactive data reporting to investors and the cost and ease of providing interactive data before attempting further integration of the interactive data format. However, the proposed rules would treat viewable interactive data as displayed through software available on the Commission's Web site, and interactive data generally,[57] as part of the official filing, instead of a supplement as is the case in the voluntary program. Further evaluation will be useful with respect to the availability of inexpensive, sophisticated interactive data viewers. Currently there are many software providers and financial printers that are developing interactive data viewers. We anticipate that these will become widely available and increasingly useful to investors.

We expect that the open standard feature of XBRL format will facilitate the

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[56] See proposed General Instruction C.3.(g) to Form N-1A.

[57] As further discussed below in Part II.F, interactive data generally would be deemed not filed for purposes of specified liability provisions.

development of applications, and software, and that some of these applications may be made available to the public for free or at a relatively low cost. The expected continued improvement in this software would give the public increasingly useful ways to view and analyze mutual fund risk/return summary information. After evaluating the use of the new interactive data technologies, software, and list of tags, we may consider proposing rules to eliminate the filing of risk/return summary information in ASCII or HTML format. Or we may consider proposing rules to require a filing format that integrates ASCII or HTML with XBRL.

We believe XBRL is the appropriate interactive data format with which to supplement ASCII and HTML. Our experience with the voluntary program and feedback from company, audit, and software communities point to XBRL as the appropriate open standard for the purposes of this rule. As a derivative of the XML standard, XBRL data would be compatible with a wide range of open source and proprietary XBRL software applications. As discussed above, many XBRL-related products exist for analysts, investors, filers, and others to more easily create and compare disclosures; still others are in development, and that process would likely be hastened by mutual fund disclosure using interactive data. Comments on our 2004 concept release and proposed rules in 2004 and 2007 generally supported interactive data and XBRL in particular.[58] Several

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[58] Securities Act Release No. 8497 (Sept. 27, 2004) [69 FR 59111 (Oct. 1, 2004)] ("Concept Release"); Securities Act Release No 8496 (Oct. 1, 2004) [69 FR 59094 (Oct. 1, 2004)]; Securities Act Release No. 8781 (Feb. 6, 2007) [72 FR 6676 (Feb. 12, 2007)]. See, e.g., letter from Deloitte & Touche LLP (Nov. 11, 2004) regarding the Voluntary Program Adopting Release, supra note 16; and letter from PR Newswire Association LLC (Nov. 11, 2004) regarding the Concept Release; and letters from Charles S. Hoffman (Feb. 10, 2007); ICI (Mar. 14, 2007); NewRiver, Inc. (Mar. 14, 2007); PricewaterhouseCoopers LLP (Mar. 14, 2007); and Ayal Rosenthal (Mar. 6, 2007) regarding extending the voluntary program to allow funds to submit tagged risk/return summaries.

other factors support our views regarding XBRL's broad and growing acceptance, internationally as well as in the U.S. For example, as noted above, in addition to the use of XBRL by other U.S. agencies,[59] several foreign securities regulators have adopted voluntary or required XBRL financial reporting.[60] We understand that several U.S. public and private companies use XBRL in connection with financial reporting or analysis.

Request for Comment:

- Should we adopt rules that require each mutual fund's risk/return summary information to be provided in interactive data format? What are the principal factors that should be considered in making this decision? Is it useful to users of risk/return summary information to continue to have, in addition to interactive data, duplicate, human-readable risk/return summary information in ASCII or HTML format?
- What opportunities exist to improve the display of risk/return summary information prepared using interactive data? How should these affect any continued requirement to file ASCII- or HTML-formatted risk/return summary information? For example, if the technology is sufficiently developed, should we

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We also note that financial statement participants in the voluntary program provided positive feedback with respect to possible mandatory XBRL. For example, the vast majority of voluntary program participants that submitted responses and views to a questionnaire answered in the affirmative to the question "Based on your experience to date, do you think it would be advisable for the Commission to continue to explore the feasibility and desirability of the use of interactive data on a more widespread and, possibly, mandated basis?" See question V.f in the Interactive Data Voluntary Program Questionnaire available at http://www.sec.gov/cgi-bin/XBRL_Questionnaire.

59 See note 36 above. Also we note CIFiR's support of XBRL as referenced above in Part I.C.

60 For example, such countries include Canada, China, Israel, Japan, Korea, and Thailand.

propose rules to encourage or require a format that embeds interactive data tags in HTML so that risk/return summary information can be viewed in a browser? How should these affect any continued requirement to file ASCII- or HTML-formatted risk/return summary information? What obstacles exist to making such improvements in the display of XBRL information?

- Is it appropriate to require mutual funds to provide interactive data using XBRL? Alternatively, in place of such a requirement, should the Commission instead wait to see whether interactive data disclosure by mutual funds is voluntarily adopted? Without a requirement, would the development of products for producing and using interactive data from mutual funds meet the needs of investors, third party information providers, and others who seek interactive data? Would a large percentage of mutual funds provide interactive data voluntarily, and following the same standard, if not required to do so?
- If we do not adopt the proposed rules and instead wait to see whether mutual funds on their own expand their use of interactive data, would such data be less comparable among mutual funds? Is there a "network effect," such that interactive data would not be useful unless many or all mutual funds provide their risk/return summary information using interactive data? Would the development of software for retail investors to obtain and make use of such data be slowed without a requirement that mutual funds provide interactive data?
- What advantages are there to investors having the mutual-fund responsible for preparing risk/return summary information in interactive data format, as opposed to a model in which third parties independently prepare the information in

interactive format and charge a fee for it?

- Do commenters agree that compared to filings using ASCII and HTML, interactive data would require less manually-transferred data? If so, do commenters believe that the proposed rules would result in less human error and therefore contribute to reduced costs?
- If we require interactive data disclosure and the proposed rules result in more effective and efficient disclosure with reduced human error and cost, would fees charged by financial printers or other service providers be likely reduced to reflect such lower costs?
- If we adopt rules requiring interactive data disclosure of risk/return summary information, is the XBRL standard the one that we should use? Are any other standards becoming more widely used or otherwise superior to XBRL? What would the advantages of any such other standards be over XBRL?
- Is the XBRL format for interactive data sufficiently developed to require its use at this time? If not, what indicators should we use to determine when it has become sufficiently developed to require its use?
- Are vendors likely to develop and make commercially available software applications or Internet products that will be able to deliver the functionality of interactive data to retail investors?
- How important is it that many different types of viewers with varying levels of sophistication and functionality be available to investors? In addition to the free viewer provided on the SEC Web site, are there likely to be other such products available at low or no cost?

- If we require risk/return summary information in interactive data format, what are the principal challenges facing the eventual integration of such reporting with the current filing formats, ASCII and HTML, so that filing in all three formats would no longer be necessary?

B. Compliance Date

The proposed rules would require all mutual funds to submit interactive data with any registration statement or post-effective amendment on Form N-1A that includes or amends risk/return summary information.[61] If the rules are adopted by this fall, we anticipate that the first required submissions would be for initial registration statements and post-effective amendments that are annual updates to effective registration statements[62] and that become effective after December 31, 2009. We are sensitive to concerns that undue expense and burden should not accompany the adoption of required interactive data reporting. We therefore propose limitations on liability applicable to the interactive data file, as well as a 15-business day period for making interactive data submissions after effectiveness of the related filing.[63]

Mutual funds under the proposed rules would be required to convert their risk/return summary information into an interactive data file using the list of tags for

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61 See proposed General Instruction C.3.(g) to Form N-1A.

62 Section 10(a)(3) of the Securities Act [15 U.S.C. 77j(a)(3)] generally requires that when a prospectus is used more than nine months after the effective date of the registration statement, the information in the prospectus must be as of a date not more than sixteen months prior to such use. The effect of this provision is to require mutual funds to update their prospectuses annually to reflect current cost, performance, and other financial information. A mutual fund updates its registration statement by filing a post-effective amendment to the registration statement.

63 We discuss more fully at Part II.F liability related to required submissions of interactive data in general and the continuation of some of the limitations on liability used in the voluntary program in particular.

risk/return summary information, as approved for use by the Commission.[64] The submission also would be required to include any supporting files as prescribed by the EDGAR Filer Manual. Interactive data would be required for the entirety of the risk/return summary information, including information for all series and all classes.[65]

As noted above, we anticipate deferring the requirement for submission of risk/return summary information in interactive data format for all mutual funds until after December 31, 2009. We also anticipate that the voluntary program, with its limitations on liability, will remain available to mutual funds until December 31, 2009, for purposes of submitting risk/return summary information in interactive data format. We believe that this period of almost two years from now will give mutual funds, including those that have not previously participated in the voluntary program, adequate opportunity to test interactive data submissions so that they may be fully prepared to file risk/return summary information in interactive data format after December 31, 2009.

Our multiyear experience with interactive data has helped us understand the extent to which a mutual fund would incur additional costs to create and submit its existing disclosures in interactive data format. Based on that experience, we believe that the process of converting a mutual fund's existing ASCII or HTML risk/return summary information into interactive data would not impose a significant burden or cost. Mutual funds could choose to tag their risk/return summary information using available software without using outside services or consultants; alternatively, they could rely on financial printers, consultants, and software companies for assistance, although they would retain

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64 See Interactive Data Proposing Release, supra note 8 (proposing amendments to Rule 11 of Regulation S-T and proposing new Rule 405(a)) and proposed amendments to proposed Rule 405(a).

65 Proposed General Instruction C.3.(g) of Form N-1A.

ultimate responsibility for both their risk/return summary information and their tagged data. As discussed in more detail in the cost-benefit analysis below,[66] we believe that the modest first-year costs for a mutual fund would decrease in subsequent periods. We also believe that these costs would be justified by interactive data's benefits.

We expect that most mutual funds that are part of smaller fund families, which generally are disproportionately affected by regulatory costs, also would be able to provide their risk/return summary information in interactive data format without undue effort or expense. While interactive data reporting involves changes in reporting procedures mostly in the initial reporting periods, we expect that these changes would provide efficiencies in future periods. As a result, there may be potential net savings to the mutual fund, particularly if interactive data become integrated into the mutual fund's disclosure process. While we recognize that requiring interactive data risk/return summary information would likely result in start-up expenses for smaller mutual fund families, we expect that both software and third-party services will be available to help meet the needs of smaller mutual fund families. We also intend that the delayed compliance date for all mutual funds would permit mutual funds that are part of smaller fund families to learn from the experience of funds that have participated in the voluntary program and to participate in the voluntary program themselves during the almost two-year period prior to December 31, 2009. The delayed compliance date would also give mutual funds that are part of smaller fund families a significant period of time across which to spread first-year data tagging costs.

We believe that adopting a delayed compliance date of December 31, 2009,

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66 See Part V.

would establish an appropriate and measured timeline, which we would be able to monitor and, if necessary, reconsider during the continuation of the voluntary program.

Request for Comment:

- Is the proposed schedule for implementation of interactive data tagging appropriate?
- Should we advance the first required interactive data submission to be for filings that become effective after June 30, 2009, or some other date, rather than December 31, 2009? Should we delay the first required interactive data submissions until, for example, 2011, 2012, or later? What benefits would there be to advancing or delaying implementation of the proposed rules? How much lead time do mutual funds need to familiarize themselves with interactive data and the process of mapping risk/return summary information using the list of tags for risk/return summary information?
- Should there be a phase-in to provide mutual funds with more time to become familiar with the list of tags for risk/return summary information and to encourage potential vendors of interactive data products and services to invest in the development and marketing of such products? If so, what should the phase-in dates be and what funds should be included in each phase? Should we differentiate funds based on net assets of the fund, the fund family, or on some other basis? Should we, for example, provide a more delayed compliance date for mutual funds that are small entities for purposes of the Regulatory Flexibility Act, i.e., funds that, together with other investment companies in the same group of related investment companies, have net assets of $50 million or less as of the end

of their most recent fiscal year? If we provide a more delayed compliance date for smaller fund families, how should we define such a category?

- Is the proposed timing sufficient for mutual funds to familiarize themselves with interactive data and the process of mapping risk/return summary information using the list of tags for risk/return summary information? Is it sufficient for funds that are part of smaller fund families, e.g., funds that are small entities for purposes of the Regulatory Flexibility Act?
- Should there be a longer lag than proposed for mutual funds that are part of smaller fund families, e.g., funds that are small entities for purposes of the Regulatory Flexibility Act, to allow them to allocate the necessary resources and meet the proposed requirements?
- Should mutual funds that are part of smaller fund families, e.g., funds that are small entities for purposes of the Regulatory Flexibility Act, be subject to the proposed rules at all? Should compliance with the proposed rules be solely voluntary for those funds?
- Will the rule proposal and the anticipated December 31, 2009 compliance date sufficiently encourage potential vendors of interactive data products and services to invest in the development and marketing of such products? If not, what changes should we make to encourage developments in the markets for filer and investor products related to mutual fund interactive data?

C. Documents and Information Covered by the Proposed Rules

The proposed rules would require interactive data tagging of a mutual fund's risk/return summary information, which is currently provided in response to Items 2 and

3 of Form N-1A.[67] In November 2007, the Commission proposed to amend Form N-1A.[68] The amendments, if adopted as proposed, would result in the risk/return summary information being contained in Items 2, 3, and 4 of Form N-1A. If the Commission adopts that proposal, we intend to apply any tagging rules we adopt to the items of amended Form N-1A that contain the information that is currently contained in Items 2 and 3.

As with the voluntary program, the proposed rules would require mutual funds to provide the interactive data in an exhibit.[69] Interactive data would be required for all information in the risk/return summary, including information for each series and class included in a mutual fund's prospectus.[70] The proposed rules would not, however, require interactive data submissions for parts of Form N-1A other than the risk/return summary information.

As with the voluntary program, the proposed rules would require that the information contained in the risk/return summary section in the traditional format filing

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67 See proposed Rule 405(b)(2); General Instruction C.3.(g) to Form N-1A. We are also proposing technical amendments to proposed Rule 405 that reflect this proposed requirement.

As previously noted, proposed Rule 405 of Regulation S-T would directly set forth the basic tagging requirements and indirectly set forth the rest of the tagging requirements through the requirement to comply with the EDGAR Filer Manual. Consistent with proposed Rule 405, the EDGAR Filer Manual would contain the detailed tagging requirements.

68 See Summary Prospectus Proposing Release, supra note 15, 72 FR at 67817.

69 See proposed General Instruction C.3.(g) to Form N-1A; proposed Rule 405(a). The Interactive Data File must be named "EX-101" as specified in the EDGAR Filer Manual.

70 See proposed General Instruction C.3.(g) to Form N-1A.

on Form N-1A be the same as in the interactive data format.[71] Further, the interactive data would have to be submitted in a manner that would permit the information for each series and any class-specific information, such as expenses and performance, to be separately identified by series and class.[72] However, information that is not class-specific, such as investment objectives, would not be required to be separately identified by class.

To clarify the intent of the rules, we propose to include an instruction to proposed Rule 405 of Regulation S-T stating that the rules require a disclosure format, but do not change substantive disclosure requirements.[73] The rules also would state clearly that the information in interactive data format should not be more or less than the information in the ASCII or HTML part of the Form N-1A filing.[74]

The proposed rules would not eliminate or alter existing filing requirements that risk/return summary information be filed in traditional format. We believe investors and other users may wish to use these electronic formats to obtain an electronic or printed copy of the entire registration statement, either in addition to or instead of disclosure formatted using interactive data. In addition, we propose to no longer require or permit the cautionary disclosure that is used in the voluntary program for required interactive data, which states that investors should not rely on the interactive data information in making investment decisions. We believe that such language would be inconsistent with

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71 Proposed Rule 405(b)(2).

72 Proposed General Instruction C.3.(g) to Form N-1A.

73 See Interactive Data Proposing Release, supra note 8 (proposing Preliminary Note 2 to proposed Rule 405).

74 Proposed Rule 405(b)(2).

the proposal that interactive data be part of the related registration statement.

We are proposing to require a mutual fund to submit interactive data for the risk/return summary information that is contained in any filing on Form N-1A that includes or amends information provided in response to Items 2 and/or 3.[75] This would include initial registration statements and any post-effective amendment that makes changes to the risk/return summary information.[76]

Request for Comment:

- Has the interactive information available through the voluntary program been useful? Should we require that more or less information be tagged? For example, should the entire risk/return summary section of Form N-1A, including the investment objective and strategies, risks, costs, and performance information, be required to be tagged in interactive data format? Should we apply tagging requirements to both narrative information, such as investment objectives, and numerical information, such as costs?
- Would investors and other users of risk/return summary information find tagged risk/return information useful for analytical purposes? Is tagged risk/return summary information that is narrative, rather than numerical, useful as an analytical tool?
- Would the availability of interactive data-formatted risk/return summary

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75 Proposed General Instruction C.3.(g) to Form N-1A.

76 Revised interactive data would be required with respect to post-effective amendments that make changes to the risk/return summary information so that the risk/return summary information would be the same in both the traditional format filing and the interactive data file. If the risk/return summary information is not revised in connection with a post-effective amendment, the exhibit index would indicate that the interactive data file was already provided.

information possibly cause competitive pressures on mutual funds to choose to make more disclosures than are required by Commission regulations? Alternatively, might the availability of tagged data possibly cause mutual funds to choose to curtail such disclosures? What types of disclosures would those be?

- Once interactive data are provided with a Form N-1A filing, should we limit the requirement to provide interactive data for amendments to only the amendments that reflect substantive changes from or additions to the risk/return summary information? What would the benefits and burdens be of revising interactive data that previously was provided in connection with a registration statement on Form N-1A to reflect changes?
- Do the standards we propose for tagging provide clear enough guidance for preparers so that we can expect to achieve consistency among filers?
- Should we require that mutual funds tag their document and entity[77] information? Would this information be useful in interactive data format?
- Should we provide an opportunity for mutual funds to submit voluntarily in interactive data format information other than that which they would be required to submit as interactive data? If so, should we permit such interactive data format information to be subject to provisions governing the proposed required filing of interactive data? Should we instead permit such interactive data format information to be submitted under the voluntary program?
- If we adopt the recently proposed amendments to Form N-1A,[78] should we

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77 See supra note 48.

78 See Summary Prospectus Proposing Release, supra note 15.

require interactive data format information for the risk/return summary? Should we require interactive data format information for any additional information contained in the proposed summary section of the prospectus? Should the information in the proposed summary prospectus be tagged? If so, should all of the information required in the summary prospectus be tagged? If not, what information in the summary prospectus should be tagged? Should only the risk/return information in the summary prospectus be tagged?

- When we proposed the summary prospectus, we proposed that mutual funds choosing to use a summary prospectus be required to provide the summary prospectus, the statutory prospectus, and the statement of additional information on the Internet with links that would allow persons to move back and forth among the documents.[79] If we were to require information in the prospectus and/or the summary prospectus to be submitted in interactive data format, should we adopt as proposed or modify the proposed linking requirements?[80]
- Should the proposed rules eliminate the requirement that the risk/return summary information be submitted in traditional format, in addition to interactive data format? Should cautionary language from the voluntary program be eliminated or modified and, if not, why not?
- Should the proposed rules apply to a prospectus filed under Securities Act Rule

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79 See Summary Prospectus Proposing Release, supra note 15, 72 FR at 67802-03.

80 See Summary Prospectus Proposing Release, supra note 15, 72 FR at 67803 and 67816 (Proposed Rule 498(f)(2)(ii) and (iii) under the Securities Act would require persons accessing documents on the Internet to be able to move back and forth between certain specified sections of the documents.).

497?[81] If we require interactive data with filings that do not currently include exhibits, such as prospectus supplements, should we require that the interactive data be provided as schedules or exhibits?

D. Filing Period

Form N-1A filings, which contain mutual fund registration statements (or amendments thereto), are often subject to revision prior to effectiveness. For this reason, the proposed rules would not permit the submission of an interactive data exhibit that is related to a registration statement or a post-effective amendment that is not yet effective. More specifically, the proposed rules would provide that an interactive data exhibit to a Form N-1A filing, whether the filing is an initial registration statement or a post-effective amendment thereto, must be submitted as a post-effective amendment to the registration statement to which the interactive data relates. Under the proposal, the amendment, including the interactive data, must be submitted after the related filing becomes effective, but not later than 15 business days after the effective date of the related filing.[82] Our proposal that the interactive data exhibit be filed within 15 business days is intended both to provide funds with adequate time to prepare the exhibit and to make the interactive data available promptly. An exhibit containing interactive data format risk/return summary information could be submitted under Rule 485(b) of the Securities Act, which provides for immediate effectiveness of amendments that make non-material changes, and would only need to contain the new exhibit, a facing page, a signature page,

[81] 17 CFR 230.497. Currently, Rule 497 prospectuses do not have a provision for exhibits, so additional EDGAR programming would be needed.

[82] Proposed General Instruction C.3.(g) of Form N-1A. This proposal differs from the voluntary program which does not impose a time limit for the filing of interactive data.

a cover letter explaining the nature of the amendment, and a revised exhibit index.

Request for Comment:

- Should we require interactive data information to be submitted before effectiveness of the related filing, e.g., at the same time that the related filing is made? Or should we, as proposed, require interactive data information to be provided only after the related filing becomes effective? If so, is 15 business days after the effective date of the related filing an appropriate time period for filing the interactive data? Should the time period be shorter or longer, e.g., 1 day, 5 days, 10 days, 20 days, 30 days? Would it be feasible and desirable to require interactive data to be submitted on the effective date of the related filing, either for filings that become effective automatically and/or for filings that are declared effective by the Commission staff? How would different requirements regarding the time of filing affect the usefulness of the interactive data, the ability of funds to file accurate interactive data, and the burdens of filing the data?

E. Web Site Posting of Interactive Data

We believe interactive data, consistent with our proposed rules, should be easily accessible for all investors and other market participants. As such disclosure becomes more widely available, advances in interactive data software, online viewers, search engines, and other Web tools may in turn facilitate access and usability of the data. Encouraging widespread accessibility to mutual funds' risk/return summary information furthers our mission to promote fair, orderly, and efficient markets, and facilitates capital formation. We believe Web site availability of the interactive data would encourage its widespread dissemination, thereby contributing to lower access costs for users. We therefore propose that each mutual fund be required to provide the same interactive data on its Web site, if it has one, that would be required to be provided to the Commission.[83] The interactive data on a fund's Web site would be required by the end of the business day on the earlier of the date that the interactive data is submitted to the Commission or is required to be submitted to the Commission.[84]

We believe access to the interactive data on fund Web sites would enable search engines and other data aggregators to more quickly and cheaply aggregate the data and make them available to investors because the data would be available directly from the mutual fund, instead of through third-party sources that may charge a fee. To help further our goals of decreasing user cost and increasing availability, we do not propose to allow mutual funds to comply with the Web posting requirement by including a hyperlink to the documents available electronically on the Commission's Web site.

We believe this requirement would be consistent with the increasing role that mutual fund Web sites perform in supplementing the information filed electronically with the Commission by delivering risk/return summary information and other disclosure directly to investors. For example, we recently proposed amendments that would permit a person to satisfy its mutual fund prospectus delivery obligations under the Securities

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83 See proposed General Instruction C.3.(g) to Form N-1A.

84 See Interactive Data Proposing Release, supra note 8 (proposing Rule 405(f)); proposed Rule 405(a). Proposed Rule 405(a) requires posting to a "corporate" Web site. For mutual funds, this would require posting to the fund's Web site.

The day the interactive data is submitted electronically to the Commission may not be the business day on which it was deemed officially filed. For example, a filing submitted after 5:30 p.m. generally is not deemed officially filed until the following business day. Under the proposed rules, the Web posting would be required to be posted at any time on the same day that the interactive data exhibit to a Form N-1A filing is deemed officially filed or required to be filed, whichever is earlier.

Act by sending or giving the key information directly to investors in the form of a summary prospectus and providing the statutory prospectus on an Internet Web site.[85] We also note that mutual funds may satisfy certain disclosure obligations by posting required disclosures on their Web sites.[86] In addition, many mutual funds provide on their Web sites access to their prospectuses, statements of additional information, and other Commission filings.[87] This proposal would expand such Web site posting by requiring mutual funds with Web sites to post their interactive data as well.

Request for Comment:

- Should we adopt rules that require each mutual fund to post interactive data from its risk/return summary on its Web site, if it has one?
- What advantages, if any, would dual Internet and EDGAR availability have for individual investors, other users, search engines, software developers, and others involved in the extraction and processing of risk/return summary data? Would it be helpful if our Web site provided the option to download the interactive data submission from our Web site or the mutual fund's Web site? Would it add a

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85 See Summary Prospectus Proposing Release, supra note 15, 72 FR at 67798-99.

86 See, e.g., Securities Act Release No. 8458 (Aug. 23, 2004) [69 FR 52788 (Aug. 27, 2004)] (disclosure regarding portfolio managers); Securities Act Release No. 8408 (April 16, 2004) [69 FR 22300 (April 23, 2004)] (disclosure regarding market timing and selective disclosure of portfolio holdings); Securities Act Release No. 8393 (Feb. 27, 2004) [69 FR 11244 (Mar. 9, 2004)] (shareholder reports and quarterly portfolio disclosure); Securities Act Release No. 8188 (Jan. 31, 2003) [68 FR 6564 (Feb. 7, 2003)] (disclosure of proxy voting policies and records); Exchange Act Release No. 47262 (Jan. 27, 2003) [68 FR 5348 (Feb. 3, 2003)] (disclosure of code of ethics).

87 Mutual funds filing registration statements are required to disclose whether or not they make available free of charge on or through their Web site, if they have one, their statement of additional information and shareholder reports. Funds that do not make their reports available in that manner also must disclose the reasons that they do not. See Item 1(b)(1) of Form N-1A.

significant burden if a mutual fund were required to submit with its interactive data the URL that would link specifically to that interactive data as posted on the mutual fund's Web site or, alternatively, link to a part of the mutual fund's Web site from which there would be easy access to the interactive data as posted there? What would facilitate the realization of any advantages of Web site posting, for example, the use of a standardized URL for interactive data? Would a standardized URL add significant cost to posting?

- Instead of requiring Web site posting, should we require that mutual funds disclose in their prospectuses, registration statements, shareholder reports, or elsewhere whether or not they provide free access to their interactive data on their Web sites and, if not, why not?
- What impact would be realized by mutual funds that do not currently provide Web sites? Would the proposed rules affect whether mutual funds create or maintain Web sites?
- Would Web site posting decrease the time and cost required for aggregators of mutual fund disclosure, individual investors, and other users to access disclosure formatted using interactive data?
- If we require Web site posting of interactive data, as proposed, should we also require that the Web site include language stating that the entire registration statement also is available for free at the Commission's Web site?

F. Accuracy and Reliability of Interactive Data

1. Voluntary Program

To help ensure the accuracy of interactive data in the voluntary program, the data has undergone validation upon receipt by our electronic filing system separate from the normal validation of the traditional format filing.[88] Potential liability also helps ensure the accuracy and reliability of the data. Although the voluntary program has provided limited protections from liability under the federal securities laws,[89] interactive data in the voluntary program are subject to the anti-fraud provisions of the federal securities laws. The voluntary program also encourages participants' efforts to create accurate and reliable interactive data that is the same as the corresponding disclosure in the traditional electronic format filing by providing that a participant is not liable for information in its interactive data that reflects the same information that appears in the corresponding portion of the traditional format filing, to the extent that the information in the corresponding portion of the traditional format filing was not materially false or misleading. To further encourage reasonable efforts to provide accurate interactive data, the voluntary program treats interactive data that do not reflect the same information as the official version as reflecting the official version if the volunteer meets several conditions. The volunteer must have made a good faith and reasonable attempt to reflect the same information as appears in the traditional format filing and, as soon as reasonably practicable after becoming aware of any difference, the volunteer must amend the interactive data to cause them to reflect the same information.[90]

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88 If the traditional format filing meets its validation criteria, but any interactive data fail their own validation criteria, all interactive data are removed and the traditional format filing is accepted and disseminated without the interactive data file.

89 Rule 402 of Regulation S-T provides these liability protections.

90 17 CFR 232.402(b).

2. Use of Technology to Detect Errors

Complete, accurate, and reliable prospectus and other disclosures are essential to investors and the proper functioning of the securities markets. Our proposed requirement to submit interactive data with mutual fund registration statements is designed to provide investors with new tools to obtain, review, and analyze information from mutual funds more efficiently and effectively. To satisfy these goals, interactive data must meet investor expectations of reliability and accuracy. Many factors, including mutual fund policies and procedures buttressed by incentives provided by the application of technology by the Commission, market forces, and the liability provisions of the federal securities laws, help further those goals.

Building on the validation criteria referenced above for interactive data in the voluntary program, we plan to use validation software to check interactive data for compliance with many of the applicable technical requirements and to help the Commission identify data that may be problematic. For example, we expect the validation software to

- check if required conventions (such as the use of angle brackets to separate data) are applied properly for standard and, in particular, non-standard special labels and tags;
- identify, count, and provide the staff with easy access to non-standard special labels and tags;[91]

[91] For example, if a mutual fund uses the words "redemption fees" as the caption for a value data tagged as "exchange fees," the software could flag the filing and bring it to the staff's attention.

- identify the use of practices, including some the XBRL U.S. Preparers Guide contains, that enhance usability;[92]
- facilitate comparison of interactive data with disclosure in the corresponding traditional format data in the official filing;
- check for mathematical errors; and
- analyze the way that mutual funds explain how particular facts relate to one another.[93]

The availability of interactive data to the staff may also enhance its review of mutual fund filings. After the FDIC required submission of interactive data, it reported that its analysts were able to increase the number of banks they reviewed by 10% to 33%, and that the number of bank reports that failed to fully meet filing requirements fell from 30% to 0%. These bank reports require information that is more structured and less varied than the information we would require. As a result, the FDIC's efficiency gains from the use of interactive data likely would be greater than ours.

We believe analysts, individual investors, and others outside the Commission that use the interactive data submitted to us also will make use of software and other tools to evaluate the interactive data and, as a result, market forces will encourage mutual funds to provide interactive data that accurately reflects the corresponding traditional format data in the traditional format filing. For example, the use of non-standard labels or tags (extensions) could introduce errors, but we expect the open source and public nature of

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92 The XBRL U.S. Preparers Guide, available from the XBRL U.S. Web site, would provide guidance to facilitate preparing information in the interactive data format that we propose to require.

93 The technology used to show these relationships is known as a "linkbase."

interactive data and the list of tags for risk/return summary information would enable software easily to detect and identify any modifications or additions to the approved list of tags. We believe such software and other technology will be widely available for free or at reasonable cost. Investors, analysts, and other users therefore would be able to identify the existence and evaluate the validity of any such modifications or additions. We also anticipate that mutual funds preparing their interactive data and investors, analysts, and other users would use such devices to search for and detect any changes made to the standard list of tags. Because analysts and other users would rapidly discover mistakes or alterations not consistent with the desired use of interactive data, mutual funds would have a powerful incentive to prepare such data with care and promptly to correct any errors.

With this proposal, we seek the rapid adoption and use of interactive data without imposing unnecessary cost and expense on mutual funds. We therefore propose that the interactive data itself provided to us generally would be subject to a liability regime under the federal securities laws similar to that governing the voluntary program. We also propose that viewable interactive data[94] as displayed through software available on the Commission's Web site, as described above and further discussed below, would be subject to the same liability under the federal securities laws as the corresponding portions of the traditional format filing.[95]

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94 Proposed Rule 11 of Regulation S-T would define viewable interactive data as "Interactive Data in Viewable Form." See Interactive Data Proposing Release, supra note 8 (proposing Rule 11 of Regulation S-T). We are proposing technical amendments to include references to risk/return summary information in the definition.

95 Proposed Rule 406 of Regulation S-T would set forth the liability applicable to interactive data and viewable interactive data that is displayed through software available on the Commission's Web site. Proposed Rule 406 also would clarify that disclosures in

Interactive data would be subject to the following liability-related provisions:

- deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 and 12 of the Securities Act;
- deemed not filed for purposes of Section 18 of the Exchange Act and Section 34(b) of the Investment Company Act;
- not otherwise subject to the liabilities of these sections;
- subject to other liability under these Acts for the substantive content of the risk/return summary disclosures (as distinct from compliance with proposed Rule 405) in the same way and to the same extent as the corresponding information in the related traditional format official filing.[96] The content of the risk/return summary disclosures refers, for example, to the investment objectives and strategies, costs, risks, and past performance. The Rule 405 requirements generally refer to the process of tagging and formatting the content of the risk/return summary for the interactive data file;
- deemed filed for purposes of (and, as a result, benefit from) Rule 103 of Regulation S-T;[97] and

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the traditional format part of an official filing on Form N-1A that contains the information corresponding to the interactive data remain subject to the federal securities laws as in the past and that nothing in proposed Rule 405 of Regulation S-T (setting forth content, format, and other requirements related to interactive data) or proposed Rule 406 would affect the liability otherwise applicable to the traditional format data. We are not proposing to modify proposed Rule 406 as set forth in our recently issued release. See Interactive Data Proposing Release, supra note 8 (proposing Rule 406 of Regulation S-T).

96 Proposed Rule 11 of Regulation S-T would define "Related Official Filing." See Interactive Data Proposing Release, supra note 8 (proposing amendments to Rule 11 of Regulation S-T). We are proposing technical amendments to the definition.

97 The viewed data would be deemed filed for purposes of Rule 103 of Regulation S-T [17 CFR 232.103] and, as a result, in general, the mutual fund would not be subject to

- protected from liability under these Acts for failure to comply with the requirements of proposed Rule 405 if the interactive data either:
    - o met the requirements of proposed Rule 405 of Regulation S-T; or
    - o failed to meet those requirements but the failure occurred despite the mutual fund's good faith and reasonable effort and the mutual fund corrected the failure as soon as reasonably practicable after becoming aware of it.

None of the proposed liability-related provisions for interactive data submitted to the Commission, however, would affect the application of the anti-fraud provisions under the federal securities laws, whether the interactive data is submitted to the Commission or posted on a fund's Web site.

Rule 405 is being proposed, in part, under the Commission's authority to specify information required to be submitted to the Commission in registration statements. To encourage accurate filing of interactive data without fear of making good faith errors, the Commission is proposing Rule 406.[98] Although not expressly addressed in proposed Rule 406, the Commission would have the authority to enforce compliance with proposed Rule 405 because it has the authority to enforce compliance with any of its rules.

We believe these liability-related provisions strike an appropriate balance between avoiding unnecessary cost and expense and encouraging accuracy in light of the nature of the interactive data to which they apply and the additional accuracy incentives that may be provided by our validation software and market forces.

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liability for electronic transmission errors beyond its control if the mutual fund corrects the problem through an amendment as soon as reasonably practicable after the fund becomes aware of the problem.

98 See Interactive Data Proposing Release, supra note 8 (proposing Rule 406).

Other aspects of the proposal would supplement the Commission's objective of supplying reliable and accurate information to investors. First, the risk/return summary information and other disclosures in the traditional format related official filing to which the interactive data relate would continue to be subject to the usual liability provisions of the federal securities laws. For example, the traditional format related official filing would continue to be subject to Section 10(b) and Rule 10b-5[99] of the Exchange Act and, in the appropriate circumstance, to Section 11 of the Securities Act.

Second, we propose that the usual liability provisions of the federal securities laws also would apply to human-readable interactive data that is identical in all material respects to the corresponding data in the traditional format filing[100] as displayed by a viewer that the Commission provides. Under these circumstances, for example, a Form N-1A's viewable interactive data would be deemed filed and subject to Section 11 of the Securities Act and Section 34(b) of the Investment Company Act, consistent with the liability applicable to the corresponding part of the traditional format Form N-1A. In that regard, such viewable interactive data disclosure therefore would have exactly the same potential liability as the corresponding portions of the traditional format filing. We believe applying liability for such viewable interactive data displayed through software on the Commission's Web site would further investors' interests in filers providing accurate interactive data under our proposal.

We expect that each mutual fund would be in the best position to determine the appropriate manner in which to assure the accuracy of the interactive data it would be

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99 17 CFR 240.10b-5.

100 The human-readable interactive data would be identical to the corresponding data in the traditional format filing if the mutual fund complied with the interactive data tagging requirements of proposed Rule 405.

required to submit and the viewable interactive data that would result. We also expect that software providers and other private sector third parties would help develop procedures and tools to help in that regard. As an adjunct to those private sector efforts, we plan to make available to mutual funds, on an optional basis, the opportunity to help assure accuracy by making a test submission with the Commission or using software we provide to create viewable interactive data.

A mutual fund would have the opportunity to submit an interactive data exhibit as part of a test submission just as a filer can make test submissions today.[101] The validation system would process the test submission with an interactive data exhibit similar to the way it processes test submissions today. If it found an error, it would advise the filer of the nature of the error and as to whether the error was major or minor. As occurs in the voluntary program, a major error in an interactive data exhibit that was part of a live filing would cause the exhibit to be held in suspense in the electronic filing system while the rest of the filing would be accepted and disseminated if there were no major errors outside of the interactive data exhibit. If that were to happen, the filer would need to revise the interactive data exhibit to eliminate the major error and submit the exhibit as an amendment to the filing to which it is intended to appear as an exhibit. A minor error in an interactive data exhibit that was part of a live filing would not prevent the interactive data exhibit from being accepted and disseminated together with the rest of the filing if there were no major errors in the rest of the filing. We believe it would be appropriate to accept and disseminate a filing without the interactive data exhibit submitted with it if only the exhibit has a major error, in order to disseminate at least as much information at

101 The EDGAR Filer Manual addresses test submissions primarily at Section 6.6.5 of Volume II.

least as timely as would have been disseminated were there no interactive data requirement.

We are not proposing that mutual funds be required to involve third parties such as auditors or consultants in the creation of the interactive data provided as an exhibit to a mutual fund's Form N-1A filing, including assurance. We are taking this approach after considering various factors, including:

- the availability of a comprehensive list of tags for risk/return summary information from which appropriate tags can be selected, thus reducing a mutual fund's need to develop new elements;
- the availability of user-friendly software with which to create the interactive data file;
- the delayed compliance date, prior to which mutual funds may become familiar with the tagging of risk/return summary information;
- the availability of interactive data technology specifications, and of other XBRL U.S. and XBRL International resources for preparers of tagged data;
- the advances in rendering/presentation software and validation tools for use by preparers of tagged data that can identify the existence of certain tagging errors;
- the expectation that preparers of tagged data will take the initiative to develop sufficient internal review procedures to promote accurate and consistent tagging; and
- the mutual fund's and preparer's liability for the accuracy of the traditional format version of the risk/return summary information that will also be

provided using the interactive data format.

Request for Comment:

- Do the proposed rules strike an appropriate balance to promote the availability of reliable interactive data without imposing undue additional costs and burdens? If not, what balance of liability will best encourage mutual funds to prepare reliable interactive data without subjecting them to undue fear of mis-tagging? How does the "extensibility" of interactive data, i.e., a mutual fund's ability to customize the standard list of tags to correspond more closely to the fund's particular risk/return summary information, affect your answer?
- What are the risks to investors under the proposed liability rules? Will investors still find the interactive data sufficiently reliable to use it?
- Should interactive data be subject to liability if a mutual fund does not tag its risk/return summary information in a manner consistent with the standards approved by the Commission, irrespective of the mutual fund's good faith effort? If the answer is yes, what should the mutual fund's liability be for such errors, and should liability attach even if the mistake is inadvertent? What if the error is the result of negligent tagging practices, but there was no affirmative intent to mislead?
- If interactive data are subject to liability as proposed, is it necessary or appropriate for viewable interactive data to be subject to liability as and to the extent proposed or otherwise? Should the answer depend on the degree of liability to which the interactive data are subject? Should viewable interactive data be subject to liability in a manner or to an extent different than as proposed?

- Should any or all interactive data be deemed filed for purposes of Section 34(b) of the Investment Company Act and, if so, should it be regardless of compliance with proposed Rule 405 or a filer's good faith and reasonable efforts to comply?
- Should the liability for interactive data be exactly the same as it is for XBRL-Related Documents under the voluntary program?
- Would software be commercially available and reasonably accessible to all required interactive data filers, investors, and analysts that would make detection of tagging errors, such as the use of inappropriate tags or improper extensions, easy and cost-effective? If so, would such monitoring by investors and analysts likely discourage the improper use of extensions or negligent conduct in the tagging process?
- Would the use of software to search for and detect any differences between a mutual fund's interactive data and the Commission-approved interactive data tags and other attributes depend on the degree of investor interest or analysis by third party information providers?
- Should a rule expressly state that the Commission retains the authority to enforce compliance with proposed Rule 405?
- Should we require the involvement of auditors, consultants, or other third parties in the tagging of data? If assurance should be required, what should be its scope, and should any such requirement be phased in?
- Should we phase in increasing levels of liability over time? Are the proposed limitations on liability necessary and appropriate at the outset, for example, the first year that a mutual fund is subject to the interactive data requirement, but

inappropriate at a later time? Should we require that interactive data be subject to more liability later?

- Should the validation software, as contemplated, cause an interactive data exhibit with a major error to be held in suspense in the electronic filing system while the rest of the filing would be accepted and disseminated if there were no major errors outside of the interactive data exhibit? In that case, should the validation software hold the entire filing in suspense or reject or accept the entire filing or interactive data exhibit?

G. Required Items

1. Data Tags

To comply with the proposed rules, mutual funds would be required to tag their risk/return summary information using the most recent list of tags for mutual fund risk/return summaries, as released by XBRL U.S. and required by the EDGAR Filer Manual. The ICI's risk/return summary list of tags received acknowledgement from XBRL International in June 2007. The Commission anticipates entering into a contract to update the architecture of the list of tags and conform the list of tags to any changes in the risk/return summary that we adopt pursuant to a pending rule proposal.[102]

Updates to the list of tags for risk/return summary reporting may be posted and available for downloading from time to time to reflect changes in the risk/return summary requirements, refinements to the list of tags, or for other reasons. To provide mutual funds sufficient time to become familiar with any such updates, we anticipate giving advance notice before requiring use of an updated list of tags. Based on experience to

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[102] See Summary Prospectus Proposing Release, supra note 15.

date with the list of tags for risk/return summaries, we believe that, with the enhancements to the list of tags that XBRL U.S. will be developing, the list of tags will be sufficiently developed to support the interactive data disclosure requirements in the proposed rules.

One of the principal benefits of interactive data is its extensibility—that is, the ability to add to the standard list of tags in order to accommodate unique circumstances in a mutual fund's particular disclosures. The use of customized tags, however, may also serve to reduce the ability of users to compare similar information across mutual funds. In order to promote comparability across funds, our proposed rules would limit the use of extensions to circumstances where the appropriate element does not exist in the standard list of tags.[103] We also are proposing that wherever possible, preparers change the label for an element that exists in the standard list of tags, instead of creating a new customized tag.[104]

Under Item 401(c) of Regulation S-T, voluntary filers' interactive data elements must reflect the same information as the corresponding traditional format elements. Further, no data element can be "changed, deleted or summarized" in the interactive data file.[105] We do not propose to change this equivalency standard for risk/return summary information provided in interactive data format as required by the proposed rules.[106]

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103 Proposed Rule 405(c)(1)(iii)(B) as proposed in Interactive Data Proposing Release, supra note 8.

104 Proposed Rule 405(c)(1)(iii)(A) as proposed in Interactive Data Proposing Release, supra note 8.

105 Proposed Rule 405(c)(2) as proposed in Interactive Data Proposing Release, supra note 8.

106 Id.

Request for Comment:

- Is our focus on comparability appropriate? Instead of stressing ease of risk/return summary comparability, should our rules permit greater use of customized data tags?
- Should we codify any other principles to encourage comparability without unduly reducing the extensibility of interactive data?

2. Regulation S-T and the EDGAR Filer Manual

We propose to require that mutual funds provide interactive data in the form of exhibits to the related registration statement on Form N-1A.[107] Interactive data would be required to comply with our Regulation S-T[108] and the EDGAR Filer Manual. The EDGAR Filer Manual is available on our Web site. It includes technical information for making electronic filings to the Commission. Volume II of this manual includes guidance on the preparation, submission, and validation of interactive data submitted under the voluntary program. Before adoption of our proposed rules, we plan to update our manual with additional instructions for filers of interactive data.

In addition to both Regulation S-T, which would include the rules we are proposing, and the instructions in our EDGAR Filer Manual, filers may access other sources for guidance in tagging their financial information. These include the XBRL U.S. Preparers Guide; user guidance accompanying tagging software; and financial printers and other service providers. New software and other forms of third-party support

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107 The requirement to submit interactive data as an exhibit would appear in proposed General Instruction C.3.(g) of Form N-1A.

108 Proposed Rule 405 of Regulation S-T would directly set forth the basic tagging and posting requirements for the XBRL data and require compliance with the EDGAR Filer Manûal. Consistent with proposed Rule 405, the EDGAR Filer Manual would contain the detailed tagging requirements.

for tagging risk/return summary information using interactive data are also becoming available.

Request for Comment:

- What specific guidance should be provided in Regulation S-T for interactive data filers?
- Does the XBRL U.S. Preparers Guide provide useful guidance to promote consistent tagging among various mutual funds?
- Is the user guidance accompanying tagging software, and the guidance available from financial printers and other service providers, helpful for filers to tag their risk/return summary information? What other sources of guidance might prove useful?

H. Consequences of Non-Compliance and Hardship Exemption

We propose that if a filer does not provide the required interactive data submission, or post the interactive data on its Web site, by the required due date, the filer's ability to file post-effective amendments under Rule 485(b), which provides for immediate effectiveness of amendments that make non-material and other changes, would be automatically suspended.[109] The suspension would become effective at the time that the filer fails to meet the requirement to submit or post interactive data and would terminate as soon as the filer has submitted and posted that data. The suspension would apply to post-effective amendments filed after the suspension becomes effective, but would not apply to post-effective amendments that were filed before the suspension

[109] Proposed Rule 485(c)(3).

became effective. The suspension would not apply to post-effective amendments filed solely for purposes of submitting interactive data, which would enable a filer to cure its failure to submit interactive data by filing an amendment under Rule 485(b). We believe that precluding the use of immediate effectiveness of post-effective amendments during any period of failure to comply would appropriately direct attention to the proposed interactive data requirement without permanently suspending a mutual fund's ability to file post-effective amendments under Rule 485(b) once the fund has remedied the failure.

If the proposed rules are adopted, we anticipate that we would not interpret Rule 303,[110] which restricts the ability of registered investment companies to incorporate by reference into an electronic filing documents that have not been filed in electronic format, to apply to the failure to file Interactive Data Files. Thus, as long as the traditional format electronic filing has been made as required, the failure to file a required Interactive Data File would not affect a mutual fund's ability to incorporate by reference the mutual fund's prospectus. For example, if we were to adopt as proposed our proposed rules regarding a summary prospectus for mutual funds, we anticipate that a mutual fund could incorporate by reference its statutory prospectus into its summary prospectus as permitted by those proposed rules, notwithstanding the fund's failure to file required interactive data.[111]

Consistent with the treatment of other applicable reporting obligations, we propose to provide a continuing hardship exemption for the inability to timely electronically submit interactive data. Rule 202 of Regulation S-T provides for

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110 Rule 303 of Regulation S-T.

111 See Summary Prospectus Proposing Release, supra note 15.

continuing hardship exemptions.[112]

Rule 202 permits a filer to apply in writing for a continuing hardship exemption if information otherwise required to be submitted in electronic format cannot be so filed without undue burden or expense. If the staff, through authority delegated from the Commission, grants the request, the filer must file the information in paper by the applicable due date and file a confirming electronic copy if and when specified in the grant of the request.

We propose to revise Rule 202 to provide that a grant of a continuing hardship exemption for interactive data would not require a paper submission.[113] If the filer did not electronically submit the interactive data by the end of the period for which the exemption was granted, the filer's ability to file post-effective amendments under Rule 485(b) would be suspended until it did electronically submit the interactive data.[114] Similarly, we propose to revise Rule 202 to provide an essentially mirror-image exemption from the proposed requirement for a mutual fund that has a Web site to post the interactive data on its Web site.[115]

Request for Comment:

- Are the consequences for failure to comply with the interactive data submission

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112 Rule 201 of Regulation S-T provides for temporary hardship exemptions. We are not proposing a temporary hardship exemption because our proposal would provide a mutual fund with a 15-business day period for submitting the interactive data file for a related Form N-1A filing.

113 See Proposed Rule 202 as proposed in Interactive Data Proposing Release, supra note 8.

114 Proposed amendment to Note 4 to Rule 202 as proposed in Interactive Data Proposing Release, supra note 8; Proposed Rule 485(c)(3).

115 Id.

requirements appropriate?

- Should we suspend the ability of a mutual fund to file post-effective amendments under Rule 485(b) if it does not comply with the proposed rules? Should the proposed rules provide similar treatment whether the failure to comply relates to interactive data submission or to Web site posting? Should the suspension apply to the particular fund that failed to comply, all series of a registrant that failed to comply, or all funds of a complex that failed to comply?
- Should the proposed rules treat a mutual fund's compliance with interactive data requirements as an express condition to the mutual fund's related registration statement or post-effective amendment becoming effective?
- Should the failure to file or post interactive data as required restrict a mutual fund's ability to incorporate by reference the fund's statutory prospectus, including under our proposed rules relating to a mutual fund summary prospectus?
- Does our proposed rule strike the correct balance of positive and negative consequences when a mutual fund meets its requirements to provide traditional format documents but fails to provide interactive data?
- Do commenters believe that the proposed revisions to the continuing hardship exemption would be sufficient to cover unanticipated technical difficulties associated with interactive data? If insufficient, why would they be insufficient and how should the hardship exemption be tailored to address technical difficulties associated with interactive data?
- Should we provide a temporary hardship exemption? If so, would six business

days be an appropriate period for the temporary hardship exemption to apply?[116] If not, would a shorter or longer period be appropriate, and why?

I. Changes to the Voluntary Program

If we adopt rules requiring mutual funds to submit risk/return information in interactive data format, we intend that mutual funds would no longer be able to submit risk/return summary information in interactive data format through the voluntary program after the compliance date for the mandatory rules. We are proposing to amend Rule 8b-33 to remove risk/return summary information as a category of information permitted to be submitted under the voluntary program. In addition, we are proposing technical amendments to other rules to reflect this.[117]

Further, in order to encourage participation in the voluntary program for tagging investment company financial information, we are proposing amendments to enable investment companies that are registered under the Investment Company Act, business development companies, and other entities that report under the Exchange Act and prepare their financial statements in accordance with Article 6 of Regulation S-X to submit exhibits containing a tagged schedule of portfolio holdings without having to submit other financial information in interactive data format.[118] As with the current

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116 See Proposed Rule 201 as proposed in Interactive Data Proposing Release, supra note 8 (proposing a six-business day temporary hardship exemption for financial statement filers).

117 See proposed Rule 401(a); proposed Rule 401(d)(1)(i); proposed Rule 401(d)(2)(i). We are also proposing to delete current Rule 401(b)(1)(iv), which provides the option to file risk/return summary information under the voluntary program, and to replace it with the option to file the portfolio holdings schedule on a stand-alone basis described below.

118 Proposed Rule 401(b)(1)(iv) (designating Schedule I - Investments in securities of unaffiliated issuers as mandatory content under the voluntary program). If rules requiring interactive data financial information are adopted, we anticipate that the voluntary program would be modified to permit participation only by registered investment

voluntary program, volunteers could participate, without pre-approval, merely by submitting a tagged Schedule I - Investments in Securities of Unaffiliated Issuers ("Schedule I").[119] To facilitate this, the Commission anticipates entering into a contract to develop a list of tags that could be used to tag portfolio holdings.

Currently, the interactive data furnished under the voluntary program must consist of at least one item from a list of enumerated mandatory content ("Mandatory Content"), including financial statements, earnings information, and, for registered management investment companies, financial highlights or condensed financial information and risk/return summary information set forth in Items 2 and 3 of Form N-1A.[120] We are adding Schedule I information as a separate item of Mandatory Content that participants can submit in order to give volunteers greater flexibility in tagging fund data.

Investors, financial intermediaries, and third party information providers, among others, use the portfolio holdings data contained in Schedule I to make decisions concerning the purchase and continued holding of funds and for other purposes. Portfolio holdings data promises to be even more useful to these various stakeholders if this data is interactive. In addition, allowing volunteers to submit tagged portfolio holdings information without having to submit other financial information in interactive data format would increase the range of options for participation in the voluntary program and encourage increased participation.

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companies, business development companies, and other entities that report under the Exchange Act and prepare their financial statements in accordance with Article 6 of Regulation S-X. See Interactive Data Proposing Release, supra note 8 (proposed Rule 401(a)).

119 Rule 12-12 of Regulation S-X [17 CFR 210.12-12].

120 Rule 401(b)(1) of Regulation S-T [17 CFR 232.401(b)(1)].

Under the current voluntary program, any official filing with which tagged exhibits are submitted must disclose that the financial information is "unaudited" or "unreviewed," as applicable and that the purpose of submitting the tagged exhibits is to test the related format and technology and, as a result, investors should not rely on the exhibits in making investment decisions.[121] We believe that this cautionary disclosure should also be tagged and included within each interactive data exhibit, in order to help alert investors and other users that the exhibits should not be relied on in making investment decisions. Accordingly, we are proposing that this disclosure be required in the exhibits submitted pursuant to the voluntary program as a tagged data element,[122] consistent with how the cautionary disclosure is presented in risk/return summary exhibits under the current voluntary program.

Request for Comment:

- Is allowing the tagging of fund data contained in Schedule I separately from other investment company financial information an appropriate next step in the voluntary program for investment companies? Is there other investment company information that should be included in the voluntary program?
- What effect would tagged data have on investors', analysts', and other users' ability to analyze investment company portfolio holdings? Are there any potential problems related to providing investment company portfolio holdings in interactive data format? For example, could this facilitate the front-running of

121 Rule 401(d)(1)(ii) of Regulation S-T [17 CFR 232.401(d)(1)(ii)].

122 See proposed Rule 401(d)(2).

investment company portfolio transactions or other behavior that could harm investors?

- Is the tagging of fund data contained in Schedule I useful on a stand-alone basis? Should we instead require a fund that submits tagged data for Schedule I to also provide tagged data for Schedules II through V,[123] as Schedules I through V are often presented together in fund financial statements? Should we allow funds to tag any or all of Schedules I through V in the voluntary program without tagging other financial information? Are there particular Schedules, or particular combinations of Schedules, that should be permitted to be tagged in the voluntary program without tagging other financial information?
- How would allowing volunteers to submit an interactive data exhibit consisting of Schedule I information on a stand-alone basis affect participation in the voluntary program? Does the tagging of Schedule I information separately from other investment company financial information present any technical concerns that would affect participation in the voluntary program?
- Should we require cautionary disclosure in the tagged schedule of portfolio holdings as a tagged data element?
- Is additional or different language necessary for cautionary disclosure?
- Has development of a list of tags for portfolio holdings advanced sufficiently to permit tagging of Schedule I on a stand-alone basis? If not, what further steps are needed?

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123 Schedule II – Investments – other than securities, Rule 12-13 of Regulation S-X [17 CFR 210.12-13]; Schedule III – Investments in and advances to affiliates, Rule 12-14 of Regulation S-X [17 CFR 210.12-14]; Schedule IV – Investments – securities sold short, Rule 12-12A of Regulation S-X [17 CFR 210.12-12A]; and Schedule V – Open option contracts written, Rule 12-12B of Regulation S-X [17 CFR 210.12-12B].

III. GENERAL REQUEST FOR COMMENTS

We request comment on the specific issues we discuss in this release, and on any other approaches or issues that we should consider in connection with the proposed amendments. We seek comment from any interested persons, including those required to file information with us on the EDGAR system, as well as investors, disseminators of EDGAR data, industry analysts, EDGAR filing agents, and any other members of the public.

IV. PAPERWORK REDUCTION ACT

The proposed amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995, or PRA.[124] The purpose of the proposed amendments is to make risk/return summary information easier for investors to analyze and to assist in automating regulatory filings and business information processing. We are submitting the proposed amendments to the Office of Management and Budget (OMB) for review in accordance with the PRA.[125] An agency may not conduct or sponsor, and a person is not required to respond to, an information collection unless it displays a currently valid OMB control number.

The title for the new collection of information for submitting risk/return summary information in interactive data format that the proposed amendments would establish is "Mutual Fund Interactive Data" (OMB Control No. 3235-XXXX). This collection of information relates to already existing regulations and forms adopted under the Securities Act, the Exchange Act, and the Investment Company Act that set forth disclosure

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[124] 44 U.S.C. 3501 et seq.

[125] 44 U.S.C. 3507(d) and 5 CFR 1320.11.

requirements for mutual funds and other issuers. The proposed amendments, if adopted, would require mutual funds to submit their risk/return summary information in interactive data format and post it on their Web sites, if any, in interactive data form. The specified risk/return summary information already is and would continue to be required to be submitted to the Commission in traditional format under existing disclosure requirements. Compliance with the proposed amendments would be mandatory beginning with initial registration statements, and post-effective amendments that are annual updates to effective registration statements, that become effective after December 31, 2009.[126] The information required to be submitted would not be kept confidential by the Commission.

The title for the collection of information for submitting portfolio holdings in interactive data format is "Voluntary XBRL-Related Documents" (OMB Control No. 3235-0611). The proposed amendments would permit investment companies that are registered under the Investment Company Act, business development companies, and other entities that report under the Exchange Act and prepare their financial statements in accordance with Article 6 of Regulation S-X to submit exhibits containing a tagged schedule of portfolio holdings without having to submit other financial information in interactive data format. Compliance with the proposed amendments would be voluntary. The information required to be submitted would not be kept confidential by the Commission.

126 See Part II.B.

A. Reporting and Burden Estimate

1. Submission of Risk/Return Summary Information Using Interactive Data

Form N-1A (OMB Control No. 3235-0307) under the Securities Act and the Investment Company Act[127] is used by mutual funds to register under the Investment Company Act and to offer their securities under the Securities Act. The information required by the new collection of information we propose, would correspond to the risk/return summary information now required by Form N-1A and would be required to appear in exhibits to Form N-1A and on mutual funds' Web sites.

Based on estimates from voluntary program participant responses to a questionnaire and our experiences with the voluntary program, we estimate that interactive data filers would require an average of approximately 13 burden hours to tag risk/return summary information in the first year, and the same task in subsequent years would require an average of approximately 11 hours.[128] The average annual burden over a three-year period is estimated at approximately 12 hours.[129] Based on estimates of 8,810 mutual funds submitting interactive data documents,[130] each incurring 12 hours per year on average, we estimate that, in the aggregate, interactive data adoption would result in an additional 105,720 burden hours, on average, for all mutual funds for each of the

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[127] 17 CFR 239.15A; 17 CFR 274.11A.

[128] The average burden hours for the first and subsequent submissions were calculated using data collected from 6 responses to a voluntary program participant questionnaire from mutual funds that participated in the voluntary program. See Part V, infra.

[129] (13.33 hours for the first submission + 11.275 hours for the second submission + 11.275 hours for the third submission) ÷ 3 years = approximately 12 hours.

[130] This estimate is based on analysis by the Division of Investment Management staff of publicly available data.

first three years.[131] Converted into dollars, this amounts to approximately $22,500,000.[132]

We further estimate that mutual funds would require an average of approximately 1 burden hour to post interactive data to their Web sites. Based on estimates of 8,810 mutual funds posting interactive data, each incurring 1 burden hour per year on average, we estimate that, in the aggregate, adoption of Web site posting requirements would result in an additional 8,810 burden hours for all mutual funds.[133] Converted into dollars, this amounts to approximately $2,200,000.[134]

We also estimate that software and consulting services would be used by mutual funds for an increase of approximately $803 per mutual fund.[135] Based on the estimate of

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131 8,810 mutual funds x 12 incremental burden hours per mutual fund = 105,720 burden hours.

132 This cost increase is estimated using an estimated hourly wage rate of $213.00 ((105,720 burden hours) x $213.00 hourly wage rate = $22,518,360 total incremental internal cost). The estimated wage figure is based on published rates for compliance attorneys and programmer analysts, modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead, yielding effective hourly rates of $270 and $194, respectively. See Securities Industry Association, Report on Management & Professional Earnings in the Securities Industry 2007 (Sept. 2007) ("SIA Report"). The estimated wage rate was further based on the estimate that compliance attorneys would account for one quarter of the hours worked and senior system analysts would account for the remaining three quarters, resulting in a weighted wage rate of $213.00 (($270 x .25) + ($194 x .75)).

133 8,810 mutual funds x 1 burden hour per mutual fund = 8,810 burden hours.

134 ($250 x 1 hour x 8,810 mutual funds). This cost estimate is based on informal discussions with a limited number of persons believed to be generally knowledgeable about preparing, submitting, and posting interactive data. See Part V, infra.

135 For purposes of this estimate, we assumed that the largest 50 fund complexes would develop software in-house incurring costs of $125,000 in the first year. Assuming that the largest 50 fund complexes would develop software for use in all of their funds, and that their funds encompass 80% of the number of funds (7,048), then the average first year cost for those funds would be ($125,000 x 50)/7,048 = $887. Therefore, for those funds using software developed internally, the average 3 year cost would be approximately $829 ($887 in the first year + $800 in the second year + $800 in the third year) ÷ 3 years = approximately $829. The average 3 year cost for those funds that use commercial software would be $700 ($500 in the first year + $800 in the second year +

8,810 mutual funds using software and consulting services at an annual cost of $803 we estimate that, in the aggregate, the total external costs to the industry would be approximately $7,100,000.[136]

Regulation C and Regulation S-T

Regulation C (OMB Control No. 3235-0074) describes the procedures to be followed in preparing and filing registration statements with the Commission. Regulation S-T (OMB Control No. 3235-0424) specifies the requirements that govern the electronic submission of documents. The proposed changes to these items would add and revise rules under Regulations C and S-T. The filing requirements themselves, however, are included in Form N-1A and we have reflected the burden for these new requirements in the burden estimate for Mutual Fund Interactive Data. The rules in Regulations C and S-T do not impose any separate burden.

2. Changes to the Voluntary Program

We are proposing to decrease the burden associated with the existing collection of information for Voluntary XBRL-Related Documents to reflect the proposed amendments. If we adopt rules requiring mutual funds to submit risk/return information in interactive data format, we intend that mutual funds would no longer be able to submit risk/return summary information in interactive data format through the voluntary program after the compliance date for the mandatory rules.

$800 in the third year) ÷ 3 years = $700. Assuming 80% of funds incurred costs of $829 and 20% of funds incurred costs of $700, the average software and consulting cost per mutual fund would be approximately $803. These estimates were derived from responses to a voluntary program questionnaire. See Part V, infra.

136 8,810 mutual funds x $803 = approximately $7,100,000.

When we adopted the amendments to expand the voluntary program to enable mutual funds voluntarily to submit risk/return summary information in interactive data format, we estimated an increase to the existing collection of information for Voluntary XBRL-Related Documents.[137] We estimated that 10% of the approximately 545 fund complexes that have mutual funds, or 55 fund complexes, would each submit documents containing tagged risk/return summary information for one mutual fund.[138] We further estimated that the initial creation of tagged documents containing risk/return summary information would require, on average, approximately 110 burden hours per mutual fund, and the creation of such tagged documents in subsequent years would require an average 10 burden hours per mutual fund. Because the PRA estimates represent the average burden over a three-year period, we estimated the average hour burden for the submission of tagged documents containing risk/return summary information for one mutual fund to be approximately 43 hours.[139]

Based on the estimates of 55 participants submitting tagged documents containing risk/return summary information for one mutual fund once per year and incurring 43 hours per submission, we estimated that, in the aggregate, the industry would incur an additional 2,365 burden hours associated with the amendments.[140] We further estimated that 75% of this burden increase, or approximately 1,774 hours, would be borne internally by the mutual fund complexes. We estimated that this internal burden increase

137 See Voluntary Program Adopting Release, supra note 16.

138 In the case of a mutual fund with multiple series, our estimate treated each series as a separate mutual fund.

139 (110 hours in the first year + 10 hours in the second year + 10 hours in the third year) ÷ 3 years = 43 hours.

140 55 documents per year x 43 hours per submission = 2,365 hours.

converted to dollars would amount to a total annual increase of internal costs of approximately $393,828.[141]

We also estimated that 25% of the burden, or approximately 591 hours, would be outsourced to external professionals and consultants retained by the mutual fund complex at an average cost of $256.00 per hour for a total annual increase of approximately $151,296.[142] In addition, we estimated that the cost of licensing software would be $333 per participant per year, for a total annual increase of $18,315.[143] Altogether, we estimated the total annual increase in external costs related to the amendments would be $169,611.[144]

Given that mutual funds would no longer be able to submit risk/return summary information in interactive data format through the voluntary program if the proposed amendments are adopted, we would reduce the internal hour burden associated with the voluntary program by 1,774 hours and the internal cost burden by $393,828. We would also reduce the external cost burden by $169,611.

We also are proposing amendments to the voluntary program to enable investment companies that are registered under the Investment Company Act, business development companies, and other entities that report under the Exchange Act and prepare their financial statements in accordance with Article 6 of Regulation S-X to submit exhibits containing a tagged schedule of portfolio holdings without having to

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141 See note 82 of the Voluntary Program Adopting Release, supra note 16.

142 See note 83 of the Voluntary Program Adopting Release, supra note 16.

143 $333 per participant x 55 participants = $18,315.

144 This annual total consisted of $151,296 in outside professional costs plus $18,315 in software costs.

submit other financial information in interactive data format. As with the current voluntary program, volunteers could participate, without pre-approval, merely by submitting Schedule I in interactive data format.[145]

Investors, financial intermediaries, and third party information providers, among others, use the portfolio holdings data contained in Schedule I to make decisions concerning the purchase and continued holding of funds and for other purposes. Portfolio holdings data promises to be even more useful to these various stakeholders if this data is interactive. In addition, allowing volunteers to submit tagged portfolio holdings information without having to submit other financial information in interactive data format would increase the range of options for participation in the voluntary program and encourage increased participation.

We estimate that 20 registrants would choose to submit a schedule of portfolio holdings in interactive data format. We believe that investment companies that are registered under the Investment Company Act, business development companies, and other entities that report under the Exchange Act and prepare their financial statements in accordance with Article 6 of Regulation S-X would participate, given the flexibility provided by a new option to submit exhibits containing just portfolio holdings information in interactive data format.

Submission of portfolio holdings information in interactive data format would not affect the burden of preparing the registrants' traditional format filings. In order to provide portfolio holdings information in interactive data format, a participating registrant would have to tag Schedule I and submit the resulting interactive data file as an

[145] Rule 12-12 of Regulation S-X [17 CFR 210.12-12].

exhibit to its filing on Form N-CSR or Form N-Q.[146] The Commission anticipates entering into a contract to develop a list of tags that could be used to tag portfolio holdings. Based on our experience with mutual funds that have submitted risk/return summary information in the current voluntary program, we estimate that the initial creation of portfolio holdings information in interactive data format would require, on average, approximately 12 burden hours per registrant,[147] and the creation of such information in interactive data format in subsequent years would require an average 10 burden hours per registrant.[148] Because the PRA estimates represent the average burden over a three-year period, we estimate the average hour burden for the submission of portfolio holdings information in interactive data format for one registrant to be approximately 11 hours.[149]

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146 Form N-CSR [17 CFR 249.331; 17 CFR 274.128]; Form N-Q [17 CFR 249.332; 17 CFR 274.130].

147 Mutual funds submitting risk/return summary information in our voluntary program indicated that an initial submission in the voluntary program took approximately 13 hours of labor. Given that the submission of portfolio holdings in interactive data format is less complex than the submission of risk/return summary information in interactive data format but potentially requires the tagging of many more individual items, we estimate that the initial creation of interactive data files containing portfolio holdings information would require, on average, approximately 12 burden hours per volunteer.

148 Mutual funds submitting risk/return summary information in the current voluntary program indicated that each set of submissions, after the initial set, would take approximately 11 burden hours, or 2 hours less than the initial submission. We estimate that the reduction in burden hours for subsequent submissions of portfolio holdings information in interactive data format would be a similar 2 hour reduction, or approximately 10 burden hours per volunteer.

149 (12 hours in the first year + 10 hours in the second year + 10 hours in the third year) ÷ 3 years = approximately 11 hours. While the PRA requires an estimate based on a hypothetical three years of participation, a registrant, as noted earlier, could participate in the voluntary program by submitting portfolio holdings information in interactive data format over a shorter period or even just once as the registrant chooses.

Based on the estimate of 20 registrants submitting interactive data files containing portfolio holdings information once each year and incurring 11 hours per submission we estimate that, in the aggregate, the industry would incur an additional 220 burden hours associated with the proposed amendments.[150] We estimate that this internal burden increase converted to dollars would amount to approximately $47,000.[151]

We also estimate that external professionals and consultants would be retained by the registrant for an increase of approximately $600.00.[152] It is our understanding that annual software licensing costs generally would be included in the cost of hiring external professionals and consultants.[153] Based on the estimate of 20 registrants retaining external professionals and consultants at an annual cost of $600.00 we estimate that, in the aggregate, the total external cost to the industry would be $12,000.[154]

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150 20 documents per year x 11 hours per submission = 220 hours. We note that mutual funds submit portfolio holdings information to the Commission four times per year. However, for purposes of our analysis, we estimate that mutual funds choosing to participate in the voluntary program would submit portfolio holdings information in interactive data format once each year.

151 This cost increase is estimated by multiplying the increase in annual internal hour burden (220) by the estimated hourly wage rate of $213.00. <u>See</u> <u>supra</u> note 132.

152 ($100.00 in the first year + $800.00 in the second year + $800.00 in the third year) ÷ 3 years = approximately $600.00. Mutual funds participating in our voluntary program for the submission of risk/return summary information in interactive data format indicated an initial external cost of $100.00 for the hiring of external professionals and consultants and projected an annual cost of $800.00 for external service providers going forward. The increase going forward was due to the fact that a couple of participants indicated that their external service provider had waived its fee for the initial submission.

153 We note that one respondent spent over $100,000 internally to develop software to submit risk/return summary information in interactive data format. We did not include this number in our calculations as this software was developed solely for purposes of submitting risk/return summary information and not for submitting financial information in interactive data format. <u>See</u> <u>infra</u> note 170.

154 20 registrants submitting interactive data files under the voluntary program x $600.00 = $12,000.

As a result of the changes to the voluntary program, we therefore estimate a total decrease in internal burden hours of approximately 1,600[155] and a total decrease in internal costs of approximately $347,000.[156] We further estimate a total decrease in external costs of approximately $158,000.[157]

B. Request for Comments

We solicit comment on the expected Paperwork Reduction Act effects of the proposed amendments, including the following:

- the accuracy of our estimates of the additional burden hours that would result from adoption of the proposed amendments;
- whether the proposed new collection of information is necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility;
- ways to enhance the quality, utility, and clarity of the information to be collected;
- ways to minimize the burden of the collection of information on those who respond, including through the use of automated collection techniques or other forms of information technology; and

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155 (1,774 hours for the removal of risk/return summary information from the voluntary program – 220 hours for the submission of schedule of portfolio holdings in interactive data format = approximately 1,600 hours.)

156 ($393,828 for the removal of risk/return summary information from the voluntary program – $47,000 for the submission of schedule of portfolio holdings in interactive data format = approximately $347,000.)

157 ($169,611 for the removal of risk/return summary information from the voluntary program – $12,000 for the submission of schedule of portfolio holdings in interactive data format = approximately $158,000.)

- any effects of the proposed amendments on any other collections of information not previously identified.

Any member of the public may direct to us any comments concerning these burden estimates and suggestions for reducing the burdens. Persons submitting comments on the collection of information requirements should direct their comments to the OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and send a copy of the comments to Office of the Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303, with reference to File No. S7-12-08. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-12-08, and be submitted to the Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

V. COST/BENEFIT ANALYSIS

A. Submission of Risk/Return Summary Information Using Interactive Data

The proposed rules would require submission of interactive data-formatted risk/return summary information and the posting of such information on a mutual fund's Web site, if any. We believe that the proposed rules likely would result in the benefits and costs described below. We base our belief on an economic analysis of data obtained from several sources, including voluntary program participant responses to a staff-prepared questionnaire and our experiences with the voluntary program.[158]

Interactive data are intended to remove a barrier in the flow of information between mutual funds and users of information that is conveyed through mutual fund disclosures. This should enable less costly dissemination of information and thereby improve the allocation of capital. The cost of implementation will depend primarily on the costs of transition by mutual funds to the new mode of reporting. The magnitudes of these benefits and costs from any individual mutual fund's adoption of interactive data reporting will depend on the number of other mutual funds that also adopt and on the availability of supporting software and other infrastructures that enable analysis of the information. To the extent that submitted information allows investors to make investment decisions based on market-wide comparison and analysis, the value to the investors of the reported information tends to increase with the total number of mutual funds adopting the regime. Likewise, mutual funds' incentives to report their information using interactive data depends on the interest level of the investors in this mode of reporting. By mandating implementation, the rule will expand the network of adopters and thereby create positive network externalities of reported information for the investors.

1. Benefits of Interactive Data Submissions and Web Site Posting

The proposed rules have the potential to benefit investors both directly and by facilitating the exchange of information between mutual funds and the third party information providers and other intermediaries who receive and process mutual fund disclosures.

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158 The proposed required program, similar to the voluntary program, would require use of interactive data in XBRL format.

Information Access

Benefits of the proposed rulemaking accrue from the acceleration of market-wide adoption of interactive data format reporting. The magnitudes of the benefits thus depend on the value to investors of the new reporting regime relative to the old reporting regime and on the extent to which the mandated adoption speeds up the market-wide implementation.

Requiring mutual funds to file their risk/return summary information using the interactive data format would enable investors, third party information providers, and the Commission staff to capture and analyze that information more quickly and at a lower cost than is possible using the same information provided in a static format.[159] Even though the new regime does not require any new information to be disclosed or reported, certain benefits accrue when mutual funds use an interactive data format to report their risk/return summary information. These include the following. Through interactive data, what is currently static, text-based information could be dynamically searched and analyzed, facilitating the comparison of mutual fund cost, performance, and other information across multiple classes of the same fund and across the more than 8,000 funds currently available. Any investor with a computer would have the ability to acquire and download data that have generally been available only to intermediaries and third-party analysts. For example, users of risk/return summary information could download it directly into spreadsheets, analyze it using commercial off-the-shelf software, or use it within investment models in other software formats. Also, to the extent investors currently are required to pay for access to mutual fund risk/return summary information that has been extracted and reformatted into an interactive data

[159] See Part I.

format by third-party sources, the availability of interactive data in Commission filings could allow investors to avoid additional costs associated with third-party sources.

The magnitude of this informational benefit varies, however, with the availability of sophisticated tools that will allow investors to analyze the information. The growing development of software products for users of interactive data is helping to make interactive data increasingly useful to both institutional and retail investors.[160] For example, currently there are many software providers and financial printers that are developing interactive data viewers. We anticipate that these will become widely available and increasingly accessible to investors. We expect that the open standard feature of the interactive data format will facilitate the development of applications, and software, and that some of these applications may be made available to the public for free or at a relatively low cost. The continued improvement in this software would allow increasingly useful ways to view and analyze mutual fund risk/return summary information to help investors make more well-informed investment decisions.

Interactive data also could provide a significant opportunity for mutual funds to automate their regulatory filings and business information processing, with the potential to increase the speed, accuracy, and usability of mutual fund disclosure. This reporting regime may in turn reduce filing and processing costs.

By enabling mutual funds to further automate their disclosure processes, interactive data may eventually help funds improve the speed at which they generate information. For example, with standardized interactive data tags, registration statements may require less time for information gathering and review.

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[160] See SEC's Office of Interactive Disclosure Urges Public Comment as Interactive Data Moves Closer to Reality for Investors, Securities and Exchange Commission Press Release, Dec. 5, 2007, available at http://www.sec.gov/news/press/2007/2007-253.htm.

A mutual fund that uses a standardized interactive data format at earlier stages of its reporting cycle may also increase the accuracy of its disclosure by reducing the need for repetitive data entry that could introduce errors and enhancing the ability of a mutual fund's in-house professionals to identify and correct errors in the fund's registration statements filed in traditional electronic format. There has been a growing development of software products to assist mutual funds to tag their risk/return summary information using interactive data helping make interactive data increasingly useful.[161]

Mutual funds that automate their regulatory filings and business information processing in a manner that facilitates their generation and analysis of disclosures could, as a result, realize a reduction in costs.

Market Efficiency

The proposed requirements could benefit investors by making financial markets more efficient in regard to the following:[162]

- capital formation as a result of mutual funds' being in a better position to attract shareholders because of greater (less costly) awareness on the part of investors of mutual fund risk/return summary information; and
- capital allocation as a result of investors' being better able to allocate capital among those mutual funds seeking it because of interactive data reporting's

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161 Id.

162 We believe the benefits will stem primarily from the requirement to submit interactive data to the Commission and the Commission's disseminating that data. We also believe, however, that the requirement that mutual funds with Web sites post the interactive data required to be submitted would encourage its widespread dissemination thereby contributing to lower access costs for users and the related benefits described. We solicit comment in Part II.E regarding what advantages dual Commission and Web site availability would have.

facilitating innovations in efficient communication of mutual fund risk/return summary information.

More Efficient Capital Formation

An increase in the efficiency of capital formation is a benefit that may accrue to the extent that interactive data reduces some of the information barriers that make it costly for mutual funds to find appropriate sources of new investors. In particular, smaller mutual fund complexes are expected to benefit from enhanced exposure to investors. If interactive data risk/return summary reporting increases the availability, or reduces the cost of collecting and analyzing, mutual fund risk/return summary data, then there could be improved coverage of mutual funds in smaller fund complexes by third party information providers and commercial data vendors.

At present, some mutual funds in smaller fund complexes do not provide their data to third party information providers.[163] This may reduce the likelihood that their data is readily available to investors who use commercially available products to assess mutual fund performance. Hence, if interactive data reporting increases coverage of mutual funds in smaller fund complexes by third party information providers, and this increases their exposure to investors, then lower search costs for shareholders could result.

More Efficient Capital Allocation

An increase in the efficiency of capital allocation may accrue to the extent that interactive data increase the quality of information by reducing the cost to access, collect, and analyze mutual fund risk/return summary information or improve the content of

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[163] Analysis by Division of Investment Management staff based on publicly available data.

collection costs (through a requirement to submit interactive data information) should increase this benefit. If this is so, then there should be no degradation in the level of information quality as a result of changes in third-party provider behavior under an interactive data reporting regime. However, if one competitor in the industry can subsidize its operations through an alternative revenue stream, both quality and competition may suffer.[166]

Another potential information consequence of the proposed requirements may be changes to the precision and comparability of the information disseminated by data service providers since the interactive data requirements would shift the source of data formatting that allows aggregation and facilitates comparison and analysis from end-users to mutual funds submitting interactive data. At present, data service providers manually key risk/return summary information into a format that allows aggregation. As a result, the data service provider makes interpretive decisions on how to aggregate reported items so that they can be compared across all mutual funds. Consequently, when a subscriber of the commercial product offered by a data service provider uses this aggregated data, it can expect consistent interpretation of the reported items. In contrast, a requirement for mutual funds to submit interactive data information would require the mutual funds to independently decide within the confines of applicable requirements which "tag" best describes each item within the risk/return summary – perhaps with the help from a filing

166 For illustration purposes only, assume that an Internet service company develops an interactive data-based tool that easily provides mutual fund risk/return summary information for free to all subscribers, and it uses this product as a loss leader to increase viewership and advertising revenue. If the data provided is of the same quality as data provided through subscription to other available commercial products, then there should be no informational efficiency loss. However, if a data aggregator's providing information that improves investor interpretation and goes beyond risk/return summary information is possible, but no longer profitable to produce for competitors without the subsidy, then valuable information production may be lost.

agent or consultant – lessening the amount of interpretation required by data aggregators or end-users of the data. Once a tag is chosen, comparison to other funds is straightforward. However, since mutual funds have some discretion in how to select tags, and can choose extensions (new tags) when they can not find an appropriate existing tag, unique interpretations by each fund could result in reporting differences from what current data service providers and other end-users would have chosen. This view suggests that the information disseminated by data aggregators may be, on the one hand, less comparable because they have not normalized it across mutual funds but, on the other hand, more accurate because the risk of human error in the manual keying and interpretation of filed information would be eliminated and more precise because it will reflect decisions by the mutual funds themselves. Replication of prior methods of interpretation still would be possible, however, because mutual funds would continue to be required to file risk/return summary information in traditional format. As a result, nothing would prohibit data aggregators from continuing to provide normalized data. Nonetheless, interactive data benefits could diminish if other reporting formats are required for clarification in data aggregation.

The content of mutual fund-reported information may improve because, as previously discussed, a mutual fund that uses a standardized interactive data format at earlier stages of its disclosure cycle may increase the accuracy of its disclosure. In contrast, the content of mutual fund-reported information may improve or decline to the extent that the interactive data process influences what mutual funds disclose. While the proposed requirements to submit and post interactive data information are intended to be disclosure neutral, it is possible they would affect what is disclosed.[167]

2. Costs of Interactive Data Submissions and Web Site Posting

The primary cost of the rulemaking is the cost of mutual funds' implementation of the rule, which includes the costs of submitting and posting interactive data. We discuss this cost element extensively below. In addition, because the proposed rules would allow an increase in the flow of risk/return summary information being reported directly to third party information providers and investors, there will be a cost of learning on the part of the investors in using and analyzing risk/return summary information at the interactive data level.

As for the cost of implementation of the rule, based on currently available data, we estimate the average direct costs of submitting and posting interactive data-formatted risk/return summary information for all mutual funds under the proposed rules would, based on certain assumptions, be as follows:

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167 We solicit comment on whether the proposed requirements would affect mutual fund disclosure in Part II.C.

Table. Estimated direct costs of submitting interactive data-formatted risk/return summary information

	First submission	Subsequent submissions
Preparation[168]	$2,600	$2,300
Software and consulting services[169]	$20,600 [170]	$800

168 Estimates based on risk/return summary voluntary program questionnaire responses. The voluntary program questionnaire responses indicated that different filers use different personnel to prepare interactive data submissions. We calculated costs for each participant based upon the personnel each individual respondent to the voluntary program questionnaire indicated it used and the length of time it indicated the personnel spent on the preparation. The numbers in the table represent the average of all of these calculations. The following wage rates were assumed for preparation cost estimates: operations specialist -- $129; paralegal -- $168; senior compliance examiner -- $180; intermediate business analyst -- $183; senior accountant -- $185; programmer analyst -- $194; financial reporting manager -- $268; and attorney -- $295. These estimated wage figures are based on published rates for the personnel above, modified to account for bonuses, firm size, employee benefits, and overhead, yielding the effectively hourly rates above. See SIA Report, supra note 132.

169 Software licensing and the use of a consultant can be substitutionary – mutual funds can choose to do one or the other, or do both – and are thus aggregated.

170 We note that one volunteer expended over $100,000 in information technology to develop internal software that applies interactive data tags to risk/return summary information. This one expenditure by one fund resulted in a higher average software and consulting services cost per fund of $20,600 for the first submission. Excluding this data, the average software and consulting services costs per fund would have been approximately $500.

While our averages imply that the costs of internally developing software is allocated to one fund in the sample, in reality the complex that developed the software will likely use that software for all of its funds. Thus the development cost could be allocated across all funds within that complex rather than to one fund.

Web site posting[171]	$250	$250
Total cost	$23,450	$3,350

The above estimates are generated from a limited number of voluntary program participant questionnaire responses. In particular, these responses provided detail on the actual and projected costs of preparing risk/return summary information in interactive data format and for purchasing software or related filing agent services. A detailed analysis of the costs associated with voluntary program participation suggests that the estimated direct cost of submitting risk/return summary information in interactive data format falls within the range of $735.50 to $127,500 per fund for the first submission.[172] This cost reflects expenditures on interactive data-related software, consulting or filing agent services used, and the market rate for all internal labor hours spent (including training) to prepare, review, and submit the first interactive data format risk/return summary information. The future experiences of individual mutual funds regarding risk/return summary information filed in an interactive data format still may vary according to the mutual funds' size, complexity, and other factors not apparent from the voluntary program participant responses. The discussion below summarizes the direct

171 Voluntary program participants were not required to post on their Web sites, if any, the interactive data information they submitted. Consequently, the costs of the requirement to post interactive data information are not derived from the voluntary program participant questionnaire responses or discussed in our analysis of those responses. Those costs are, instead, derived from informal discussions with a limited number of persons believed to be generally knowledgeable about preparing, submitting, and posting interactive data.

172 See supra note 170 with respect to the high end of the range.

cost estimates of compliance regarding risk/return summary submissions based on voluntary program participant questionnaire responses and the specified assumptions.[173]

- Average cost of first submission, excluding the costs of Web site posting, from voluntary program questionnaire data is $23,200.
- Projected average cost of subsequent submissions, excluding the costs of Web site posting, from voluntary program questionnaire data is $3,100.

This analysis attempts to quantify some of the direct costs that mutual funds will incur if we require submission and posting of interactive data. Whether mutual funds choose to purchase and learn how to use software packages designed for interactive data submissions or outsource this task to a third party, internal (labor) resources would be required to complete the task. The cost estimates provided here using voluntary program participant questionnaire responses shed light on the potential dollar magnitude of the costs of requiring interactive data submissions.

At present, there are 22 mutual funds that have participated in the voluntary program. Of these, 9 were provided questionnaires on the details of their cost experience, and 6 responses were collected by the time of this analysis representing the cost data for 10 funds.[174] The table below summarizes the aggregate costs per mutual fund, including software and filing agent service costs and an estimated cost for the internal labor hours required to prepare and submit the interactive data format information. The low and high estimates of the cost for internal labor hours were calculated using a variety of billing

173 The details of this analysis regarding risk/return summary information, including the underlying assumptions and other considerations related to both the costs and benefits of requiring submission of interactive data, are provided following the summary.

174 The questionnaires requested data for one fund; however, several questionnaire respondents voluntarily submitted cost information for more than one fund.

rates corresponding to the job descriptions of internal personnel involved in preparing the tagged risk/return summaries.[175] The reported costs are calculated using responses from the six voluntary program participants that provided responses. Although there are only 6 voluntary program respondents to the questionnaire, those 6 respondents represent mutual fund complexes whose assets comprise approximately 26.35% of all the assets of the mutual funds that ultimately would be required to submit interactive data.[176]

Table. Summary of illustrative survey data on the direct cost estimates for voluntary program participants

	All voluntary program participants respondents	
	Low	High
First submission		
Estimated costs	$735.50	$127,500[177]
Subsequent submissions		
Estimated costs	$555.00	$5,640
Average reduction in cost		
from first to second submission	24.54%	95.58%[178]

Scalability of Interactive Data-Related Support Services and Technology

The final cost consideration in this section is the scalability of interactive data-related support services and technology. In particular, it is unclear how the market for

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175 See supra note 168. These estimates are from the Securities Industry and Financial Markets Association's Management & Professional Earnings in the Securities Industry 2007, modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead. Questionnaire respondents apportioned time spent tagging risk/return summaries among various job types.

176 Based on total mutual fund assets of $11.8 trillion. Lipper-Directors' Analytical Data, Reuters 2008.

177 We note that these costs are higher due to one questionnaire respondent who spent significantly more than all other respondents to create its own interactive data software in-house. See supra note 170.

178 Id.

complexes[180] participating) at a faster rate than the supply for these same services. More broadly, if an interactive data requirement resulted in clients subscribing for interactive data services faster than the rate at which these services can be supplied, then a price increase is the natural discriminator in how to allocate limited resources.

The submission costs discussed in this section suggest that if interactive data is implemented too quickly it could result in higher than necessary submission costs if the supply of interactive data-related resources is constrained, but the effect would likely diminish as a market place for interactive data services develops. Hence, this concern is mitigated by delaying the requirement that mutual funds submit interactive data until December 31, 2009. This delay would allow interactive data service suppliers to keep pace with demand.

B. Changes to Voluntary Program

In order to facilitate further evaluation of data tagging, the proposed amendments would enable investment companies that are registered under the Investment Company Act, business development companies, and other entities that report under the Exchange Act and prepare their financial statements in accordance with Article 6 of Regulation S-X to submit exhibits containing a tagged schedule of portfolio holdings without having to submit other financial information in interactive data format.

1. Benefits

We believe that portfolio holdings information in interactive data format may allow more efficient and effective retrieval, research, and analysis of registrants' portfolio holdings through automated means. The proposed amendments to the voluntary program

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180 Investment Company Institute, 2008 Investment Company Fact Book, at 14 (2008), available at: http://www.icifactbook.org/pdf/2008_factbook.pdf (683 fund sponsors).

will assist us in assessing whether using interactive data tags enhances users' ability to analyze and compare portfolio holdings information included in filings with the Commission.

Currently, a number of companies use computers and data entry staff to mine portfolio holdings information provided by mutual funds and others in order to populate databases that are used to package information for sale to analysts, funds, investors, and others. Permitting funds and other entities to tag portfolio holdings information in Commission filings will aid this data-mining process in that it will identify points of data at the source, which could reduce the cost to populate databases and improve the accuracy of that data. Additionally, the changes to the voluntary program may benefit funds and the public by permitting experimentation with data tagging using the new portfolio holdings list of tags when it is created.

In the future, the availability of potentially more accurate information about mutual funds and other entities could also reduce the cost of research and analysis and create new opportunities for companies that compile, provide, and analyze data to produce more value added services. Enhanced access to information submitted in interactive data format also has the potential to allow retail investors (or financial advisers assisting such investors) to perform more personalized and sophisticated analyses and comparisons of mutual funds and other investment options, which could result in investors making better informed investment decisions, and therefore in a more efficient distribution of assets by investors among different funds. This may, in turn, also contribute to increased competition among mutual funds and other entities and result in a more efficient allocation of resources among competing investment products. Although

B. Legal Basis

We are proposing the amendments under Sections 5, 6, 7, 10, 19(a), and 28 of the Securities Act,[190] Sections 3, 12, 13, 14, 15(d), 23(a), 35A, and 36 of the Exchange Act,[191] Sections 314 and 319 of the Trust Indenture Act[192] and Sections 6(c), 8, 24, 30, and 38 of the Investment Company Act.[193]

C. Small Entities Subject to the Proposed Rules

The proposed amendments would affect mutual funds that are small entities. For purposes of the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[194] Approximately 127 mutual funds registered on Form N-1A meet this definition.[195] All of these mutual funds would become subject to the proposed rules to require submission of risk/return summary information using interactive data. Regarding the proposed changes to the voluntary program, a smaller subset of small entity mutual funds may voluntarily submit tagged portfolio holdings information, but, because submitting portfolio holdings information would be voluntary, we anticipate that only

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190 15 U.S.C. 77e, 77f, 77g, 77s(a), and 77z-3.

191 15 U.S.C. 78c, 78l, 78m, 78n, 78o(d), 78w(a), 78ll, and 78mm.

192 15 U.S.C. 77nnn and 77sss.

193 15 U.S.C. 80a-6(c), 80a-8, 80a-24, 80a-29, and 80a-37.

194 17 CFR 270.0-10.

195 This estimate is based on analysis by the Division of Investment Management staff of publicly available data as of December 2007.

Based in part on our experience with the voluntary program, we believe that the proposed requirements are sufficiently clear and straightforward (although, we seek comment on this).

Changes to the Voluntary Program

The purpose of the proposed amendments is to help us evaluate the usefulness to investors, third party information providers, mutual funds and other entities, the Commission, and the marketplace of interactive data and, in particular, of submitting portfolio holdings information in interactive data format. Submitting documents containing portfolio holdings information in interactive data format would be entirely voluntary.

We have considered different or simpler procedures for small entities, but for interactive data to provide benefits such as ready comparability there cannot be alternative procedures in place for different entities. Similarly, in order to achieve the benefits of interactive data, use of a single technology is necessary. If we determine to require the filing of portfolio holdings information in interactive data format in the future, we will look to the results of the voluntary program, including those of the proposed changes to the voluntary program, to find alternatives to minimize any burden on small entities. We solicit comment on how the proposals could be modified to minimize the effect on small entities.

G. Solicitation of Comment

We encourage comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, we request comments regarding:

- the number of small entities that may be affected by the proposed amendments;
- the existence or nature of the potential impact of the proposed amendments on small entities as discussed in this analysis; and
- how to quantify the impact of the proposed amendments.

We ask those submitting comments to describe the nature of any impact and provide empirical data supporting the extent of the impact. These comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed amendments are adopted, and will be placed in the same public file as comments on the proposed amendments themselves.

VIII. SMALL BUSINESS REGULATORY ENFORCEMENT FAIRNESS ACT

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, a rule is "major" if it has resulted, or is likely to result in:

- An annual effect on the economy of $100 million or more;
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment, or innovation.

We request comment on whether our proposals would be a "major rule" for purposes of SBREFA. We solicit comment and empirical data on:

- The potential effect on the U.S. economy on an annual basis;
- Any potential increase in costs or prices for consumers or individual industries; and
- Any potential effect on competition, investment, or innovation.

§ 230.485 Effective date of post-effective amendments filed by certain registered investment companies.

* * * * *

(c) * * *

(3) A registrant's ability to file a post-effective amendment, other than an amendment filed solely for purposes of submitting an Interactive Data File, under paragraph (b) of this section is automatically suspended if a registrant fails to submit and post on its Web site any Interactive Data File exhibit as required by General Instruction C.3.(g) of Form N-1A. A suspension under this paragraph (c)(3) shall become effective at such time as the registrant fails to submit or post an Interactive Data File as required by General Instruction C.3.(g) of Form N-1A. Any such suspension, so long as it is in effect, shall apply to any post-effective amendment that is filed after the suspension becomes effective, but shall not apply to any post-effective amendment that was filed before the suspension became effective. Any suspension shall apply only to the ability to file a post-effective amendment pursuant to paragraph (b) of this section and shall not otherwise affect any post-effective amendment. Any suspension under this paragraph (c)(3) shall terminate as soon as a registrant has submitted and posted to its Web site the Interactive Data File as required by General Instruction C.3.(g) of Form N-1A.

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

3. The authority citation for Part 232 continues to read in part as follows:

HTML format part of the official filing with which an Interactive Data File appears as an exhibit or, in the case of a filing on Form N-1A, the ASCII or HTML format part of an official filing that contains the information to which an Interactive Data File corresponds.

* * * * *

5. Further amend § 232.202 as published at 73 FR 32828 by revising Note 4 to read as follows:

§ 232.202 Continuing hardship exemption.

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Note 4 to § 232.202: Failure to submit or post, as applicable, the Interactive Data File as required by Rule 405 by the end of the continuing hardship exemption if granted for a limited period of time, will result in ineligibility to use Forms S-3, S-8, and F-3 (§§ 239.13, 239.16b and 239.33 of this chapter), constitute a failure to have filed all required reports for purposes of the current public information requirements of Rule 144(c)(1) (§ 230.144(c)(1) of this chapter), and, pursuant to Rule 485(c)(3), suspend the ability to file post-effective amendments under Rule 485(b) (§ 230.485 of this chapter).

6. Further amend § 232.401 as published at 73 FR 32828 by revising paragraph (a) to read as follows:

§ 232.401 XBRL-Related Document submissions.

(a) Only an electronic filer that is an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et. seq.), a "business development company" as defined in Section 2(a)(48) of that Act, or an entity that reports under the Exchange Act and prepares its financial statements in accordance with Article 6 of Regulation S-X (17 CFR 210.6-01 et. seq.) is permitted to participate in the voluntary

XBRL (eXtensible Business Reporting Language) program. An electronic filer that participates in the voluntary XBRL program may submit XBRL-Related Documents (§232.11) in electronic format as an exhibit to: the filing to which the XBRL-Related Documents relate; an amendment to such filing, or, if the electronic filer is eligible to file a Form 8-K (§249.308 of this chapter) or a Form 6-K (§249.306 of this chapter), a Form 8-K or a Form 6-K, as applicable, that references the filing to which the XBRL-Related Documents relate if such Form 8-K or Form 6-K is submitted no earlier than the date of that filing. The XBRL-Related Documents must comply with the content and format requirements of this section, be submitted as an exhibit to a form that contains the disclosure required by this section and be submitted in accordance with the EDGAR Filer Manual and, as applicable, one of Item 601(b)(100) of Regulation S-K (§229.601(b)(100) of this chapter), Item 601(b)(100) of Regulation S-B (§228.601(b)(100) of this chapter), Form 20-F (§249.220f of this chapter), Form 6-K or §270.8b-33 of this chapter.

* * * * *

7. Amend § 232.401 by revising paragraphs (b)(1)(iv), (d)(1)(i), and (d)(2) to read as follows:

§ 232.401 XBRL-Related Document submissions.

* * * * *

(b) * * *

(1) * * *

(iv) If the electronic filer is an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et. seq.), a "business development company" as defined in Section 2(a)(48) of that Act, or an entity that reports under the

Exchange Act and prepares its financial statements in accordance with Article 6 of Regulation S-X (17 CFR 210.6-01 et. seq.), Schedule I – Investments in Securities of Unaffiliated Issuers (§ 210.12-12 of this chapter).

*   *   *   *   *

(d)   *   *   *

(1)   *   *   *

(i)   That the financial information contained in the XBRL-Related Documents is "unaudited" or "unreviewed," as applicable;

*   *   *   *   *

(2)   The disclosures required by paragraph (d)(1) of this section must appear within the XBRL-Related Documents as a tagged data element and, as applicable, in:

(i)   The exhibit index of a Form 10-K (§249.310 of this chapter), 10-Q (§249.308a of this chapter), 10 (§249.210 of this chapter), 10-SB (§249.210b of this chapter), 10-KSB (§249.310b of this chapter), 10-QSB (§249.308b of this chapter) or 20-F;

*   *   *   *   *

8.   Further amend § 232.405 as published beginning at 73 FR 32828 by:

a.   Revising Preliminary Note 1;

b.   Revising paragraph (a);

c.   Redesignating paragraph (b) as paragraph (b)(1) and adding the phrase "If the electronic filer is not an open-end management investment company registered under the Investment Company Act of 1940," to the beginning of the paragraph;

d. Redesignating paragraphs (b)(1) and (b)(2) as paragraphs (b)(1)(i) and (b)(1)(ii);

e. Redesignating Note to paragraph (b) as Note to paragraph (b)(1);

f. Adding paragraph (b)(2); and

g. Adding a sentence at the end of the Note to § 232.405.

The revisions and additions read as follows:

§ 232.405 Interactive Data File submissions and postings.

Preliminary Notes

1. Sections 405 and 406 of Regulation S-T (§§232.405 and 232.406) apply to electronic filers that submit or post Interactive Data Files. Item 601(b)(101) of Regulation S-K (§229.601(b)(101) of this chapter), Item 101 of the Instructions as to Exhibits of Form 20-F (§249.220f of this chapter), and General Instruction C.3.(g) of Form N-1A (§§ 239.15A and 274.11A of this chapter) specify when electronic filers are required or permitted to submit or post an Interactive Data File (§232.11), as further described below in the Note to Section 405.

* * * * *

(a) Content, Format, Submission and Posting Requirements – General. An Interactive Data File (§ 232.11) must:

(1) Comply with the content, format, submission and Web site posting requirements of this section;

(2) Be submitted only by an electronic filer either required or permitted to submit an Interactive Data File as specified by Item 601(b)(101) of Regulation S-K (§229.601(b)(101) of this chapter), Item 101 of the Instructions as to Exhibits of Form

20-F (§249.220f of this chapter), or General Instruction C.3.(g) of Form N-1A (§§ 239.15A and 274.11A of this chapter), as applicable, as an exhibit to a form that contains the disclosure required by this section;

(3) Be submitted in accordance with the EDGAR Filer Manual and, as applicable, Item 601(b)(101) of Regulation S-K, Item 101 of the Instructions as to Exhibits of Form 20-F, or General Instruction C.3.(g) of Form N-1A; and

(4) Be posted on the electronic filer's corporate Web site, if any, in accordance with, as applicable, Item 601(b)(101) of Regulation S-K, Item 101 of the Instructions as to Exhibits of Form 20-F, or General Instruction C.3.(g) of Form N-1A.

(b)(1) <u>Content - Categories of Information Presented</u>. If the electronic filer is not an open-end management investment company registered under the Investment Company Act of 1940, * * *

(i) * * *

(ii) * * *

(2) If the electronic filer is an open-end management investment company registered under the Investment Company Act of 1940, an Interactive Data File must consist of only a complete set of information for all periods required to be presented in the corresponding data in the Related Official Filing, no more and no less, from the risk/return summary information set forth in Items 2 and 3 of Form N-1A.

* * * * *

Note to §232.405: * * * For an issuer that is an open-end management investment company registered under the Investment Company Act of 1940, General Instruction C.3.(g) of Form N-1A specifies the circumstances under which an

Interactive Data File must be submitted as an exhibit and be posted to the company's Web site, if any.

*　　*　　*　　*　　*

PART 239 – FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

9. 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

10. The authority citation for Part 270 continues to read in part as follows:

Authority: 15 U.S.C. 80a-1 et seq., 80a-34(d), 80a-37, and 80a-39, unless otherwise noted.

*　　*　　*　　*　　*

11. Amend § 270.8b-33 by revising it to read as follows:

§ 270.8b-33 XBRL-Related Documents.

A registrant that participates in the voluntary XBRL (eXtensible Business Reporting Language) program may submit, in electronic format as an exhibit to a filing on Form N–CSR (§§ 249.331 and 274.128 of this chapter) or Form N-Q (§§ 249.332 and 274.130 of this chapter) to which they relate, XBRL-Related Documents (§ 232.11 of this chapter). A registrant that submits XBRL-Related Documents as an exhibit to a form must name each XBRL-Related Document "EX 100" as specified in the EDGAR Filer Manual and submit the XBRL-Related Documents in such a manner that will permit the information for each series and, for any information that does not relate to all of the classes in a filing, each class of an investment company registrant and each contract of an insurance company separate account to be separately identified. A registrant may submit such exhibit with, or in an amendment to, the filing to which it relates.

PART 239 – FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

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

12. 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.

* * * * *

13. Amend Form N-1A (referenced in §§ 239.15A and 274.11A) by adding a paragraph (g) to General Instruction C.3.

The addition is to read as follows:

Note: The text of Form N-1A does not, and these amendments will not, appear in the Code of Federal Regulations.

FORM N-1A

* * * * *

GENERAL INSTRUCTIONS

* * * * *

C. Preparation of the Registration Statement

* * * * *

3. Additional Matters:

* * * * *

(g) Interactive Data File. An Interactive Data File (§ 232.11 of this chapter) is required to be submitted to the Commission and posted on the Fund's Web site, if any, in the manner provided by Rule 405 of Regulation S-T (§ 232.405 of this chapter) for any registration statement or post-effective amendment thereto on Form N-1A that includes or amends information provided in response to Items 2 and/or 3. The Interactive Data File must be submitted as an exhibit to Form N-1A and must be named "EX-101" as specified in the EDGAR Filer Manual and be submitted in such a manner that will permit the information for each series and, for any information that does not relate to all of the classes in a filing, each class of the Fund to be separately identified. The Interactive Data File must be submitted as an amendment to the registration statement to which the Interactive Data File relates. The amendment must be submitted after the registration statement or post-effective amendment that contains the related information becomes effective but not later than 15 business days after the effective date of that registration statement or post-effective amendment.

By the Commission.

Florence E. Harmon
Acting Secretary

June 10, 2008

3. Additional Matters:

* * * * *

(g) Interactive Data File. An Interactive Data File (§ 232.11 of this chapter) is required to be submitted to the Commission and posted on the Fund's Web site, if any, in the manner provided by Rule 405 of Regulation S-T (§ 232.405 of this chapter) for any registration statement or post-effective amendment thereto on Form N-1A that includes or amends information provided in response to Items 2 and/or 3. The Interactive Data File must be submitted as an exhibit to Form N-1A and must be named "EX-101" as specified in the EDGAR Filer Manual and be submitted in such a manner that will permit the information for each series and, for any information that does not relate to all of the classes in a filing, each class of the Fund to be separately identified. The Interactive Data File must be submitted as an amendment to the registration statement to which the Interactive Data File relates. The amendment must be submitted after the registration statement or post-effective amendment that contains the related information becomes effective but not later than 15 business days after the effective date of that registration statement or post-effective amendment.

By the Commission.

Florence E. Harmon

Florence E. Harmon
Acting Secretary

June 10, 2008

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
June 10, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13061

In the Matter of **Struthers, Inc.** **(n/k/a Global Marine, Ltd.),** **Sun Vacation Properties Corp.,** **Sunshine Mining & Refining Co., and** **Surrey, Inc.** **(n/k/a WOW 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 Struthers, Inc. (n/k/a Global Marine, Ltd.), Sun Vacation Properties Corp., Sunshine Mining & Refining Co., and Surrey, Inc. (n/k/a WOW Holdings, Inc.).

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Struthers, Inc. (n/k/a Global Marine, Ltd.) (CIK No. 1105518) is a revoked Nevada corporation located in North Charleston, South Carolina with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Struthers is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2001, which reported a net loss of $1.3 million for the prior nine months. As of June 6, 2008, the company's common stock (symbol "GLBM") was quoted on the Pink Sheets, had eight market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

2. Sun Vacation Properties Corp. (CIK No. 1166016) is a defaulted Nevada corporation located in Indian Wells, California with a class of securities registered with

Document 9 of 48

the Commission pursuant to Exchange Act Section 12(g). Sun Vacation 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, 2003, which reported a net loss of $271,081 for the prior three months. As of June 6, 2008, the company's common stock (symbol "SVPC") was quoted on the Pink Sheets, had six market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

3. Sunshine Mining & Refining Co. (CIK No. 833376) is a delinquent Delaware corporation located in Kellogg, Idaho with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Sunshine is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2001, which reported a net loss of over $2.3 million for the prior eight months. As of June 6, 2008, the company's stock (symbol "SSMR") was quoted on the Pink Sheets, had twelve market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

4. Surrey, Inc. (n/k/a WOW Holdings, Inc.) (CIK No. 1044847) is a Wyoming corporation located in Hallandale, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Surrey is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2001, which reported a net loss of $586,000 for the prior three months. As of June 6, 2008, the company's stock (symbol "WOWH") was quoted on the Pink Sheets, had eleven market makers makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

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

Florence E. Harmon
Acting Secretary

Attachment

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

Appendix 1

Chart of Delinquent Filings

In the Matter of Struthers, Inc. (n/k/a Global Marine, Ltd.), et al.

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Struthers, Inc. (n/k/a Global Marine, Ltd.)					
	10-K	12/31/01	04/01/02	Not filed	74
	10-Q	03/31/02	05/15/02	Not filed	73
	10-Q	06/30/02	08/14/02	Not filed	70
	10-Q	09/30/02	11/14/02	Not filed	67
	10-K	12/31/02	03/31/03	Not filed	63
	10-Q	03/31/03	05/15/03	Not filed	61
	10-Q	06/30/03	08/14/03	Not filed	58
	10-Q	09/30/03	11/14/03	Not filed	55
	10-K	12/31/03	03/30/04	Not filed	51
	10-Q	03/31/04	05/17/04	Not filed	49
	10-Q	06/30/04	08/16/04	Not filed	46
	10-Q	09/30/04	11/15/04	Not filed	43
	10-K	12/31/04	03/31/05	Not filed	39
	10-Q	03/31/05	05/16/05	Not filed	37
	10-Q	06/30/05	08/15/05	Not filed	34
	10-Q	09/30/05	11/14/05	Not filed	31
	10-K	12/31/05	03/31/06	Not filed	27
	10-Q	03/31/06	05/15/06	Not filed	25
	10-Q	06/30/06	08/14/06	Not filed	22
	10-Q	09/30/06	11/14/06	Not filed	19
	10-K	12/31/06	04/02/07	Not filed	14
	10-Q	03/31/07	05/15/07	Not filed	13
	10-Q	06/30/07	08/14/07	Not filed	10
	10-Q	09/30/07	11/14/07	Not filed	7
	10-K	12/31/07	03/31/08	Not filed	3
	10-Q	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	26				

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Sun Vacation Properties Corp.					
	10-KSB	03/31/04	06/29/04	Not filed	48
	10-QSB	06/30/04	08/16/04	Not filed	46
	10-QSB	09/30/04	11/15/04	Not filed	43
	10-QSB	12/31/04	02/14/05	Not filed	40
	10-KSB	03/31/05	06/29/05	Not filed	36
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/14/05	Not filed	31
	10-QSB	12/31/05	02/14/06	Not filed	28
	10-KSB	03/31/06	06/29/06	Not filed	24
	10-QSB	06/30/06	08/14/06	Not filed	22
	10-QSB	09/30/06	11/14/06	Not filed	19
	10-QSB	12/31/06	02/14/07	Not filed	16
	10-KSB	03/31/07	06/29/07	Not filed	12
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/30/07	11/14/07	Not filed	7
	10-KSB	12/31/07	02/14/08	Not filed	4
Total Filings Delinquent	16				
Sunshine Mining & Refining Co.					
	10-K	12/31/01	04/01/02	Not filed	74
	10-Q	03/31/02	05/15/02	Not filed	73
	10-Q	06/30/02	08/14/02	Not filed	70
	10-Q	09/30/02	11/14/02	Not filed	67
	10-K	12/31/02	03/31/03	Not filed	63
	10-Q	03/31/03	05/15/03	Not filed	61
	10-Q	06/30/03	08/14/03	Not filed	58
	10-Q	09/30/03	11/14/03	Not filed	55
	10-K	12/31/03	03/30/04	Not filed	51
	10-Q	03/31/04	05/17/04	Not filed	49
	10-Q	06/30/04	08/16/04	Not filed	46
	10-Q	09/30/04	11/15/04	Not filed	43
	10-K	12/31/04	03/31/05	Not filed	39

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Sunshine Mining & Refining Co.	*10-Q*	03/31/05	05/16/05	Not filed	37
(continued)	*10-Q*	06/30/05	08/15/05	Not filed	34
	10-Q	09/30/05	11/14/05	Not filed	31
	10-K	12/31/05	03/31/06	Not filed	27
	10-Q	03/31/06	05/15/06	Not filed	25
	10-Q	06/30/06	08/14/06	Not filed	22
	10-Q	09/30/06	11/14/06	Not filed	19
	10-K	12/31/06	04/02/07	Not filed	14
	10-Q	03/31/07	05/15/07	Not filed	13
	10-Q	06/30/07	08/14/07	Not filed	10
	10-Q	09/30/07	11/14/07	Not filed	7
	10-K	12/31/07	03/31/08	Not filed	3
	10-Q	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	26				
Surrey, Inc.					
(n/k/a WOW Holdings, Inc.)	*10-QSB*	06/30/01	08/14/01	Not filed	82
	10-QSB	09/30/01	11/14/01	Not filed	79
	10-KSB	12/31/01	04/01/02	Not filed	74
	10-QSB	03/31/02	05/15/02	Not filed	73
	10-QSB	06/30/02	08/14/02	Not filed	70
	10-QSB	09/30/02	11/14/02	Not filed	67
7	*10-KSB*	12/31/02	03/31/03	Not filed	63
	10-QSB	03/31/03	05/15/03	Not filed	61
	10-QSB	06/30/03	08/14/03	Not filed	58
	10-QSB	09/30/03	11/14/03	Not filed	55
	10-KSB	12/31/03	03/30/04	Not filed	51
	10-QSB	03/31/04	05/17/04	Not filed	49
	10-QSB	06/30/04	08/16/04	Not filed	46
	10-QSB	09/30/04	11/15/04	Not filed	43
	10-KSB	12/31/04	03/31/05	Not filed	39
	10-QSB	03/31/05	05/16/05	Not filed	37
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/14/05	Not filed	31
	10-KSB	12/31/05	03/31/06	Not filed	27
	10-QSB	03/31/06	05/15/06	Not filed	25

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Surrey, Inc.					
(n/k/a WOW Holdings, Inc.)	*10-QSB*	06/30/06	08/14/06	Not filed	22
(continued)	*10-QSB*	09/30/06	11/14/06	Not filed	19
	10-KSB	12/31/06	04/02/07	Not filed	14
	10-QSB	03/31/07	05/15/07	Not filed	13
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/30/07	11/14/07	Not filed	7
	10-KSB	12/31/07	03/31/08	Not filed	3
	10-QSB	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	28				

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

June 10, 2008

IN THE MATTER OF **Struthers, Inc.** **(n/k/a Global Marine, Ltd.),** **Sun Vacation Properties Corp., and** **Sunshine Mining & Refining Co.,** **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 Struthers, Inc. (n/k/a Global Marine Ltd.) because it has not filed any periodic reports since the period ended September 30, 2001.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Sun Vacation Properties Corp. because it has not filed any periodic reports since the period ended December 31, 2003.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Sunshine Mining & Refining Co. because it has not filed any periodic reports since September 30, 2001.

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.

Document 10 of 48

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. EDT on June 10, 2008, through 11:59 p.m. EDT on June 23, 2008.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

(Release Nos. 33–8927, 34–57929; File No. 4–559)

International Roundtable on Interactive Data for Public Financial Reporting

AGENCY: Securities and Exchange Commission.

ACTION: Notice of roundtable meeting; request for comment.

SUMMARY: On Tuesday, June 10, 2008, the Securities and Exchange Commission will hold a roundtable discussion on the experience in countries that have already adopted interactive data; the views of countries currently considering adopting interactive data; and the perspectives from analysts and users of financial information about how best to take advantage of the capabilities of interactive data. The event begins with remarks by SEC Chairman Christopher Cox on the use of interactive data by public companies and mutual funds to improve disclosure for individual investors. Following Chairman Cox's remarks, a panel discussion will consider the use of interactive data for public financial reporting. Panelists will include representatives from foreign securities regulators that already require interactive-data reporting as well as representatives from foreign securities regulators that are considering adopting a form of interactive-data disclosure. In addition, the panel will feature users of such disclosure and solicit their views on the use of interactive data for public financial reporting. The panel will be moderated by Chicago Sun-Times personal finance columnist Terry Savage.

The roundtable will take place at the Commission's headquarters at 100 F Street, NE, Auditorium, Room L-002, Washington, DC from 9:30 am to 12:00 pm. The public is invited to observe the roundtable discussions. Seating is available on a first-come, first-serve basis. The roundtable discussions also will be available via webcast on the

Document 11 of 48

Commission's Web site at www.sec.gov. The Roundtable Agenda and other materials related to the Roundtable, including written statements submitted by participants for public distribution, will be accessible at http://www.sec.gov/spotlight/xbrl/xbrl-meetings.shtml.

DATES: Comments should be received on or before August 1, 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
- S7–11–08 on the subject line.

Paper Comments:

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

All submissions should refer to File Number S7–11–08. 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: J. Troy Beatty, Senior Counsel, Office of International Affairs at (202) 551–6681.

SUPPLEMENTARY INFORMATION: The Roundtable follows the issuance on May 30, 2008 of a proposed rule on Interactive Data to Improve Financial Reporting. The proposed rule may be accessed on the Commission's Web site (http://www.sec.gov/rules/proposed/2008/33-8924.pdf). The Commission welcomes feedback regarding the proposed rule and any of the topics to be addressed at the Roundtable, including those raised in the questions below.

Questions for Panelists

- How did your interactive data program originate? Was it driven by investors, the regulator, or some other organization? What is the current status of your interactive data program?

- What is the scope of interactive filings required in your jurisdiction? If none, what filings are currently being considered that might be subject to an interactive data reporting requirement?

- What levels of detail of interactive data are you considering or have been the most effective in implementing? What issues arose in assessing the level of detail to be tagged in required filings? In what manner were these issues resolved? Were the primary considerations in addressing these issues based on technological or regulatory developments?

- How did issuers in your jurisdiction respond, or how do you anticipate they will respond, to the requirement to provide reports using interactive data for financial reporting? Does your response differ depending on the size of the issuer or the level of detail required to be submitted?

- Did the use of interactive data in your jurisdiction impact what or how issuers report financial information? Does interactive data filing pose a burden to filers?

- What factors have most impacted the timing and ability of issuers to move to the use of interactive data for financial reporting in your jurisdiction?

- Do you find, or do you anticipate, that issuer filings in interactive data in your jurisdiction benefit, or will benefit, the investor and the larger investment community? What have been your experiences to date in realizing these benefits? In what ways are investors assessing and using interactive data? Are any alternatives for easier access for investors being considered to increase usage of the data?

- What regulatory filings would benefit investors by being subject to an interactive data filing requirement? Are there portions of existing filings that would benefit investors by being subject to an interactive data filing requirement?

- In your experience, what "works" in terms of designing and implementing interactive data regulatory requirements?

- Should interactive data filing tags be interoperable across national markets? If so, what efforts could be made to make data filing tags interoperable? Should regulatory authorities collaborate on or encourage this?

By the Commission.

Florence E. Harmon

Florence E. Harmon
Acting Secretary

June 5, 2008

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 57944 / June 10, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2837 / June 10, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13062

In the Matter of **SALVATORE LAGRECA, 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 Salvatore LaGreca ("Respondent" or "LaGreca") 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.

Document 12 of 48

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.4. 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. Salvatore LaGreca, age 55, a resident of Port Washington, New York, served as McCann-Erickson Worldwide's ("McCann") Vice-Chairman, Finance and Operations and Chief Financial Officer from January 1996 to October 2002. LaGreca is a Certified Public Accountant licensed in the State of New York, although his license is currently inactive. LaGreca oversaw McCann's accounting, financial reporting, strategic planning, mergers and acquisitions, and budgeting.

2. Interpublic Group of Companies, Inc. ("IPG") is an advertising and media holding company that owns over 600 advertising agencies and other companies in approximately 130 countries. IPG is headquartered in New York, New York, and its stock is listed on the New York Stock Exchange.

3. McCann is a Delaware corporation that IPG wholly owns. (IPG owns 100% of McCann's voting securities.) McCann maintains its headquarters in New York. McCann's revenues during the relevant period constituted approximately one-third to over one-half of IPG's revenues. McCann is organized into regional divisions: North America, EMEA, Asia Pacific and Latin America. In terms of number of operating agencies, which were generally all separately incorporated companies, EMEA was McCann's largest region with 193 operating agencies in 40 countries.

4. On May 6, 2008, a final judgment was entered by consent against LaGreca, permanently enjoining him from future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and from aiding and abetting violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder, in the civil action entitled Securities and Exchange Commission v. Salvatore LaGreca et. al, Civil Action Number 08-CV-4076 (GBD), in the United States District Court for the Southern District of New York. LaGreca was also ordered to pay $36,000 in disgorgement of ill-gotten gains, $10,947 in prejudgment interest, and a $25,000 civil money penalty.

5. The Commission's complaint alleged, among other things, in the Fall of 2002, IPG restated its financial results in the amount of $181 million for the period 1997 to 2002. The largest component of this restatement, approximately $101 million, was due to the failure of McCann and its officers and employees, including LaGreca, to eliminate properly imbalances in McCann's intercompany accounts. LaGreca oversaw the financial reporting and consolidation process at McCann, and he knew IPG consolidated McCann's financial results into its own financial results. For six years, LaGreca failed to ensure McCann's financial staff fully reconciled intercompany accounts, and then eliminated intercompany charges. McCann financial management failed to take these actions at least in part so that McCann would hit internal annual profit projections. Among other things, LaGreca ignored the red flags that McCann's misstated intercompany accounts would have a material impact on IPG's financial results.

IV.

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

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

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

B. After five (5) 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
June 11, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13063

In the Matter of MICHAEL K. BRUGMAN, Respondent.	ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Section 203(f) 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 K. Brugman ("Brugman" or "Respondent").

II.

After an investigation, the Division of Enforcement alleges that:

Summary

1. From mid-2001 through December 2002, Brugman, who was at that time a securities salesman for Invesco Funds Group, Inc. ("IFG"), accepted personal payments totaling over $3 million from various entities in exchange for procuring market timing capacity within the Invesco funds. Brugman never disclosed these payments to IFG.

Document 13 of 48

Respondent

2. Brugman, age 40, is a resident of Mount Kisco, New York. From approximately June 2000 through December 2002, Brugman was employed by IFG as a salesman for the Invesco funds. He was also a registered representative associated with Invesco's affiliated broker-dealer, Invesco Distributors, Inc. Brugman sold shares of the Invesco funds to institutional clients.

Other Relevant Entity

3. IFG, formerly a Delaware corporation headquartered in Denver, Colorado, was registered with the Commission as an investment adviser from 1957 until October 2004, when IFG withdrew its registration. IFG no longer conducts business. During the time period relevant to this action, IFG served as an investment adviser to over forty-five mutual funds, each included within one of a series of eight registered open-end investment companies (the "Invesco funds").

Background

4. In 2004, IFG settled an administrative action brought against it by the Commission based on IFG's undisclosed "market timing" agreements. The order issued by the Commission in the action made findings that, under the market timing agreements, which existed from at least 2001 through 2003, IFG permitted certain investors ("market timers") to make excessive redemptions and exchanges in select Invesco funds. See Securities Exchange Act of 1934 Release Number 50506 (October 8, 2004).

Brugman's Fraudulent Conduct

5. While employed with IFG, Brugman sold shares of the Invesco funds to institutional clients. From the middle of 2001 until his resignation from IFG in December 2002, Brugman introduced at least four market timers to IFG in exchange for personal payments made to Brugman by the market timers. Brugman received some of these personal payments indirectly through entities established by a family member.

6. Brugman began accepting personal payments in approximately July 2001, when he successfully introduced a market timer to IFG that would potentially invest a substantial amount in the Invesco funds.

7. At the beginning of this market timing relationship, this market timer executed its trades in the Invesco funds through a registered broker-dealer that was not affiliated with IFG. The market timer paid that broker-dealer a management fee equal to approximately 120 basis points for the market timing assets placed in the Invesco funds. The broker-dealer split these fees with Brugman, paying Brugman the equivalent of 30 of the 120 basis points fee it received. In an attempt to conceal this arrangement from Brugman's employer, Brugman's fee was first transferred to another entity, which in turn paid the fees to an entity associated with Brugman.

8. At the beginning of 2002, this market timer began placing its trades directly with the Invesco funds, rather than using the other broker-dealer, and continued to pay Brugman for its market timing arrangement with IFG. For 2002 alone, this market timer transferred over $3 million to Brugman.

9. Brugman also received personal payments from at least three other market timers that utilized the same broker-dealer as the market timer described above. Brugman received these payments by splitting with the broker-dealer the fees the market timers paid to the broker-dealer. Brugman received over $50,000 in such personal payments in 2002.

10. Brugman resigned from IFG when it appeared that his practice of accepting personal payments for procuring market timing capacity in the Invesco funds might be uncovered.

11. As an employee of IFG, Brugman was IFG's agent and fiduciary. Therefore, Brugman had a duty to disclose to IFG that he intended to and did receive personal payments in connection with the market timing transactions. Brugman was further obligated to disclose his intention to receive personal payments to IFG based on his written agreement, entered into during his employment with IFG, to abide by certain policies enforced by IFG, including policies prohibiting him from accepting compensation from outside sources or engaging in outside business activities without prior approval from IFG. However, Brugman never sought IFG's permission to accept the personal payments nor did he ever disclose to IFG his receipt of these payments.

12. By accepting the personal payments and knowingly participating in the scheme to conceal them from IFG, Brugman acted with scienter. Brugman's actions in personally profiting by over $3 million dollars from market timers, and concealing this fact from IFG and the funds, were material.

Violations

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

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 Respondent an opportunity to establish any defenses to such allegations;

B. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 15(b) of the Exchange Act including, but not limited to, disgorgement and civil penalties pursuant to Sections 21B(a) and (e) of the Exchange Act;

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

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

E. Whether, pursuant to Section 21C of the Exchange Act, Respondent should be ordered to cease and desist from committing or causing violations of, and any future violations of, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and whether Respondent should be ordered to pay disgorgement pursuant to Section 21C(e) of the Exchange Act.

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

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

If Respondent fails to file the directed answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against him upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the

Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

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

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

Florence E. Harmon
Acting 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. 57961 / June 12, 2008

INVESTMENT ADVISERS ACT OF 1940
Release No. 2744 / June 12, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13067

In the Matter of **DKR Oasis Management Company, L.P.,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 203(e) OF THE INVESTMENT ADVISERS ACT OF 1940**

I.

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

II.

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

Document 14 of 48

Section 21C of the Securities Exchange Act of 1934 and Section 203(e) of the Investment Advisers Act of 1940 ("Advisers Act") ("Order"), as set forth below.

III.

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

Summary

1. In connection with a follow-on offering conducted after the market close on May 10, 2005, DKR Oasis, on behalf of one of the hedge funds it advises (the "Hedge Fund"), sold securities short during the five business days before the pricing of the offering and then covered the short positions with securities purchased in the offering ("offering shares"). These transactions violated Rule 105 of Regulation M, and resulted in the Hedge Fund earning a profit of $185,000.

Respondent

2. DKR Oasis Management Company, L.P., a Delaware limited partnership which has its headquarters and principal place of business in Stamford, Connecticut, is an unregistered investment adviser to five hedge funds.

Background

3. At the time of the conduct, Rule 105 of Regulation M, "Short Selling in Connection with a Public Offering," prohibited covering a short sale with securities obtained in a public offering if the short sale occurred within the Rule 105 restricted period, which is the shorter of (1) the period five business days before pricing and ending with pricing or (2) the period beginning with the initial filing of the registration statement or notification on Form 1-A and ending with pricing (the "Rule 105 restricted period"). In pertinent part, Rule 105 provided:

> In connection with an offering of securities for cash pursuant to a registration statement… filed under the Securities Act, it shall be unlawful for any persons to cover a short sale with offered securities purchased from an underwriter or broker or dealer participating in the offering, if such short sale occurred during the… period beginning five business days before the pricing of the offered securities and ending with such pricing…."

17 C.F.R. § 242.105. "The goal of Rule 105 is to promote offering prices that are based upon open market prices determined by supply and demand rather than artificial forces." Final Rule: Short Sales, Exchange Act Release No. 50103, 2004 WL 1697019, at *19 (July 28, 2004).

4. Following the market close on May 10, 2005, shares of Satyam Computer Services Ltd. (NYSE: SAY) American Depository Shares ("ADSs") were offered on a follow-on basis at $21.50 per ADS. On May 9, 2005, DKR Oasis, on behalf of the Hedge Fund, sold short 100,000 Satyam ADSs at $23.35 per ADS within the Rule 105 restricted period. Then, on May 11, 2005, DKR Oasis, again on behalf of the Hedge Fund, purchased 200,000 ADSs at $21.50 per ADS in the offering. It used 100,000 of the offering ADSs to cover its short position created during the Rule 105 restricted period and made a profit of $185,000 for the Hedge Fund.

5. As a result of the conduct described above, DKR Oasis willfully[1] violated Rule 105 of Regulation M, which makes it "unlawful for any person to cover a short sale with offered securities purchased from an underwriter or broker or dealer participating in an offering, if such short sale occurred during the . . . period beginning five business days before the pricing of the offered securities and ending with such pricing."

DKR Oasis's Remedial Efforts

6. In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent and cooperation afforded the Commission staff.

IV.

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

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

A. Respondent DKR Oasis cease and desist from committing or causing any violations and any future violations of Rule 105 of Regulation M.

B. Respondent DKR Oasis is censured.

C. IT IS FURTHERED ORDERED that Respondent shall, within 15 days of the entry of this Order, pay disgorgement of $185,000, prejudgment interest in the amount of $37,413.06, and a civil money penalty of $60,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of

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[1] A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, VA 22312, Stop 0-3; and (D) submitted under cover letter that identifies DKR Oasis 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 Stephen E. Donahue, Assistant Regional Director, Division of Enforcement, Securities and Exchange Commission, 3475 Lenox Road, Suite 500, Atlanta, GA 30326.

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

By the Commission.

Florence E. Harmon
Acting Secretary

J. Lynn Taylor

By: J. Lynn Taylor
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
June 12, 2008

In the Matter of **Harbour Intermodal, Ltd.** **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 Harbour Intermodal, Ltd. because it has not filed any periodic reports since 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 company.

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the above-listed company is suspended for the period from 9:30 a.m. EDT on June 12, 2008, through 11:59 p.m. EDT on June 25, 2008.

By the Commission.

Florence E. Harmon
Acting Secretary

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

Document 15 of 48

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
June 12, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13065

In the Matter of **American Ship Building Co., and Harbour Intermodal, Ltd.,** **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 American Ship Building Co. and Harbour Intermodal, Ltd.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. American Ship Building Co. (CIK No. 5818) is an inactive New Jersey corporation located in Tampa, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Ship is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended June 30, 1993. On November 4, 1993, American Ship filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Middle District of Florida, and the case was closed on June 30, 2004.

2. Harbour Intermodal, Ltd. (CIK No. 933649) is a Delaware corporation located in Newark, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Harbour 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 $4,300 for the

Document 16 of 48

prior three months. As of June 2, 2008, Harbour Intermodal's common stock (symbol "HICC") was quoted on the Pink Sheets operated by Pink OTC Markets, Inc. ("Pink Sheets"), had four market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

3. As discussed in more detail above, 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.

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

5. 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 or Express Mail, or by other means permitted by the Commission's Rules of Practice.

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

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

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Attachment

Appendix 1

Chart of Delinquent Filings
American Ship Building Co., et al.

Company Name	Form Type	Period Ended	Due Date	Date Rec'd	Months Delinquent (rounded up)
American Ship Building Co.					
	10-K	09/30/93	12/29/93	Not filed	174
	10-Q	12/31/93	02/17/94	Not filed	172
	10-Q	03/31/94	05/15/94	Not filed	169
	10-Q	06/30/94	08/14/94	Not filed	166
	10-K	09/30/94	12/29/94	Not filed	162
	10-Q	12/31/94	02/16/95	Not filed	160
	10-Q	03/31/95	05/17/95	Not filed	157
	10-Q	06/30/95	08/16/95	Not filed	154
	10-K	09/30/95	12/29/95	Not filed	150
	10-Q	12/31/95	02/14/96	Not filed	148
	10-Q	03/31/96	05/15/96	Not filed	145
	10-Q	06/30/96	08/14/96	Not filed	142
	10-K	09/30/96	12/29/96	Not filed	138
	10-Q	12/31/96	02/14/97	Not filed	136
	10-Q	03/31/97	05/15/97	Not filed	133
	10-Q	06/30/97	08/14/97	Not filed	130
	10-K	09/30/97	12/29/97	Not filed	126
	10-Q	12/31/97	02/14/98	Not filed	124
	10-Q	03/31/98	05/15/98	Not filed	121
	10-Q	06/30/98	08/14/98	Not filed	118
	10-K	09/30/98	12/29/98	Not filed	114
	10-Q	12/31/98	02/14/99	Not filed	112
	10-Q	03/31/99	05/15/99	Not filed	109
	10-Q	06/30/99	08/14/99	Not filed	106
	10-K	09/30/99	12/31/99	Not filed	102
	10-Q	12/31/99	02/14/00	Not filed	100
	10-Q	03/31/00	05/15/00	Not filed	97
	10-Q	06/30/00	08/14/00	Not filed	94
	10-K	09/30/00	12/29/00	Not filed	90
	10-Q	12/31/00	02/14/01	Not filed	88
	10-Q	03/31/01	05/15/01	Not filed	85
	10-Q	06/30/01	08/14/01	Not filed	82
	10-K	09/30/01	12/31/01	Not filed	78
	10-Q	12/31/01	02/14/02	Not filed	76

Company Name	Form Type	Period Ended	Due Date	Date Rec'd	Months Delinquent (rounded up)
American Ship Building Co.					
	10-Q	03/31/02	05/15/02	Not filed	73
	10-Q	06/30/02	08/14/02	Not filed	70
	10-K	09/30/02	12/30/02	Not filed	66
	10-Q	12/31/02	02/14/03	Not filed	64
	10-Q	03/31/03	05/15/03	Not filed	61
	10-Q	06/30/03	08/14/03	Not filed	58
	10-K	09/30/03	12/29/03	Not filed	54
	10-Q	12/31/03	02/17/04	Not filed	52
	10-Q	03/31/04	05/17/04	Not filed	49
	10-Q	06/30/04	08/16/04	Not filed	46
	10-K	09/30/04	12/29/04	Not filed	42
	10-Q	12/31/04	02/14/05	Not filed	40
	10-Q	03/31/05	05/16/05	Not filed	37
	10-Q	06/30/05	08/15/05	Not filed	34
	10-K	09/30/05	12/29/05	Not filed	30
	10-Q	12/31/05	02/14/06	Not filed	28
	10-Q	03/31/06	05/15/06	Not filed	25
	10-Q	06/30/06	08/14/06	Not filed	22
	10-K	09/30/06	12/29/06	Not filed	18
	10-Q	12/31/06	02/14/07	Not filed	16
	10-Q	03/31/07	05/15/07	Not filed	13
	10-Q	06/30/07	08/14/07	Not filed	10
	10-K	09/30/07	12/31/07	Not filed	6
	10-Q	12/31/07	02/14/08	Not filed	4
	10-Q	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	59				
Harbour Intermodal, Ltd.					
	10-KSB	12/31/02	03/31/03	Not filed	63
	10-QSB	03/31/03	05/15/03	Not filed	61
	10-QSB	06/30/03	08/14/03	Not filed	58
	10-QSB	09/30/03	11/14/03	Not filed	55
	10-KSB	12/31/03	03/30/04	Not filed	51
	10-QSB	03/31/04	05/17/04	Not filed	49
	10-QSB	06/30/04	08/16/04	Not filed	46
	10-QSB	09/30/04	11/15/04	Not filed	43

Company Name	Form Type	Period Ended	Due Date	Date Rec'd	Months Delinquent (rounded up)
Harbour Intermodal, Ltd.					
	10-KSB	12/31/04	03/31/05	Not filed	39
	10-QSB	03/31/05	05/16/05	Not filed	37
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/14/05	Not filed	31
	10-KSB	12/31/05	03/31/06	Not filed	27
	10-QSB	03/31/06	05/15/06	Not filed	25
	10-QSB	06/30/06	08/14/06	Not filed	22
	10-QSB	09/30/06	11/14/06	Not filed	19
	10-KSB	12/31/06	04/02/07	Not filed	14
	10-QSB	03/31/07	05/15/07	Not filed	13
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/30/07	11/14/07	Not filed	7
	10-KSB	12/31/07	03/31/08	Not filed	3
	10-QSB	03/31/08	05/15/08	Not filed	1

Total Filings Delinquent 22

Commissioner Atkins Disapproved

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 57970 / June 16, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2838 / June 16, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13070

In the Matter of **CITIGROUP INC.,** **Respondent.**	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Citigroup Inc. ("Citigroup," "company," or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement of Citigroup Inc. (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 Citigroup and the subject matter of these proceedings, which Respondent admits, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.

Document 17 of 48

III.

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

A. SUMMARY

This action concerns Citigroup's improper accounting relating to the impact of the economic and political crisis in Argentina on the company's operations during the fourth quarter of 2001. In the latter part of 2001 and continuing into 2002, Argentina experienced a severe economic and political crisis during which, among other things, the Argentine government defaulted on certain of its sovereign debt obligations, devalued its currency, and abandoned the one-to-one ratio between the Argentine peso and the United States dollar.

The actions of the Argentine government during the crisis required Citigroup to make a number of significant accounting decisions for the fourth quarter of 2001. Most relevant for purposes of these proceedings, Citigroup was required to account for (1) the impact of the company's participation in a government-sponsored exchange of Argentine government bonds for loans (the "Bond Swap"); (2) the value of Argentine government bonds held by Citigroup that were not eligible for the Bond Swap (the "Non-Swapped Bonds"); (3) the sale of Banco Bansud S.A. ("Bansud"), the Argentine subsidiary of Banco Nacional de Mexico, S.A. ("Banamex"), which Citigroup had acquired in August 2001; and (4) the impact of government actions that resulted in the conversion of over $1 billion of Citigroup loans from dollars to Argentine pesos. Citigroup accounted for each of these items in a manner that did not conform with generally accepted accounting principles ("GAAP") and thereby overstated its income reported in the company's earnings press release included in a Form 8-K filed with the Commission on January 18, 2002, and in the company's annual report on Form 10-K for 2001 filed with the Commission on March 12, 2002. For the fourth quarter of 2001, Citigroup recorded $470 million of pre-tax charges related to Argentina and earnings per share of $.74. If Citigroup had accounted for the four Argentina-related items described above in conformity with GAAP, the company would have recorded additional charges of at least $479 million pre-tax, or at least $311 million after-tax, and would have reduced fourth quarter 2001 earnings by more than 8%. In accounting for the four items improperly and thereby reporting incorrect results both in the Form 8-K and the Form 10-K, Citigroup violated reporting, record-keeping, and internal accounting controls provisions of the Exchange Act.

B. RESPONDENT

Respondent Citigroup Inc. is a Delaware corporation with its principal place of business in New York, New York. Citigroup is a global financial services company whose businesses provide a broad range of financial services to consumer and corporate clients. During the relevant time, Citigroup was the largest foreign bank in Argentina, with a market share of approximately 9% and assets totaling more than $8 billion. Citigroup's securities are registered with the Commission under Sections 12(b) and 12(g) of the Exchange Act, and its common stock is traded on the New York Stock Exchange.

C. FACTS

The Crisis in Argentina

During the latter part of 2001 and continuing into 2002, Argentina suffered a severe economic and political crisis. As the economy weakened, thousands of Argentineans withdrew money from their bank accounts, with a significant spike in deposit withdrawals occurring in late November 2001. To avoid a continuing "run on the banks," the Argentine government issued a policy known as the "corralito" on December 3, 2001, which severely limited the amount of money that an individual could withdraw each month. In response to the corralito and general economic woes, widespread rioting occurred throughout Argentina. The crisis worsened in December and into January as the Argentine government began to default on its sovereign debt obligations; issued various decrees that ended the one-to one ratio between the dollar and the Argentine peso, allowing the peso to devalue; and pesified certain dollar-denominated loans. International credit rating agencies significantly downgraded Argentine sovereign debt, and the majority of Argentine government bonds began trading at substantial discounts. The Argentine government itself was in flux during this period of turmoil. Between December 2001 and early January 2002, when Citigroup was finalizing its results for 2001 and the fourth quarter of the year, there were five changes in leadership of the Argentine government.

The developments in Argentina had a significant impact on Citigroup's Argentine operations and required Citigroup to make a number of complex accounting decisions as events occurred. In making these accounting decisions, Citigroup improperly accounted for certain items related to the crisis in a manner that significantly reduced the impact of these items on the company's earnings.

Argentine Bond Swap

In early November 2001, the Argentine government issued a decree offering holders of certain market-traded Argentine government bonds the opportunity to exchange such bonds for Argentine government loans called Guaranteed Promissory Notes ("GPNs") that would not be market-traded. The Argentine government offered the Bond Swap in an effort to reduce Argentina's debt service in the short-term and to avoid defaulting on its sovereign debt by extending the maturities of its debt obligations and reducing the coupon rates of the instruments. In addition to lower interest rates and longer terms, the GPNs offered in the Bond Swap had certain features that the swapped bonds did not have, including tax-exempt interest, a tax credit option that allowed the holder to offset any unpaid principal or interest against certain taxes, a collateral protection feature that gave the GPNs first call on certain tax receipts, and a provision for a step-up in tax basis. There was significant participation by local institutions in the Bond Swap.

Citigroup owned a total in book value of $681 million of Argentine government bonds eligible for the Bond Swap. Citigroup's Argentine insurance subsidiary, Siembra Administradora de Fondos de Jubilacianes y Pensiones S.A. ("Siembra"), owned $595 million of these bonds. In addition, Citigroup's Argentine banking operations owned approximately $86 million in bonds eligible for the Bond Swap. In mid-November 2001, Citigroup local management decided to swap all $681 million of its eligible bonds and tendered these bonds to the Argentine government on November 29 and 30, 2001. The Bond Swap was executed in mid-December 2001.

In accounting for the Bond Swap, GAAP required that the transaction be accounted for based on the most readily determinable fair value.[1] Under GAAP, quoted market prices are considered to be the most reliable evidence of fair value.[2] In certain circumstances, however, other approaches to determining fair value may be appropriate. Citigroup consulted with its auditor as well as informally with Commission accounting staff regarding the proper approach to account for the Bond Swap. Both the Commission staff and Citigroup's auditor came to express a preference for using the market value of the bonds surrendered in the exchange to account for the Bond Swap (the "Market Approach"). The company, however, took the position that the bonds that were trading were not reflective of the fair value of the GPNs received and chose to use an alternate approach of looking to the value of the GPNs received in the exchange.

Citigroup used a discounted cash flow analysis to determine the fair value of the GPNs.[3] To arrive at the fair value, Citigroup incorporated several unreasonable assumptions into its analysis of the discount rate and thus overstated the value of the GPNs. In particular, Citigroup used a pre-crisis risk rate that assumed that the collapsing Argentine economy would recover in the short term. Notwithstanding the economic crisis and near daily changes in the Argentina government, Citigroup further assumed that, in the event the Argentine government defaulted on the GPNs, there was a high likelihood that the government would honor the collateral features of the GPNs, enabling Citigroup to recover all principal and interest. Using the above assumptions and others, Citigroup determined that the fair value of the GPNs received in the Bond Swap by its Siembra subsidiary was $520 million and that the fair value of the GPN's received by its Argentine banking operations was $79 million. Based on this analysis, Citigroup recorded a pre-tax loss of $75 million on the Bond Swap by its Siembra subsidiary and a pre-tax loss of $7 million on the Bond Swap by its Argentine banking operations, for a total pre-tax loss on the Bond Swap of $82 million. This loss was reflected in Citigroup's January 18, 2002, Form 8-K and in the financial statements included in the company's 2001 Form 10-K.

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1 *See* Practice Bulletin 4, *Accounting for Foreign Debt/Equity Swaps;* FAS 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* at footnote 16; and APB 29, *Accounting for Non-monetary Transactions.*

2 *See* Statement of Financial Accounting Standards No. 115, *Accounting for Investments in Debt and Equity Securities.* In 2006, the Financial Accounting Standards Board adopted Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("FAS 157"). FAS 157, in part, codifies and simplifies previous approaches and provides that "[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 . . . ."

3 A discounted cash flow analysis is a calculation that multiplies an investment's future cash flows by discount factors to obtain the present value of the investment. The purpose of the calculation is to estimate the amount of money that will be received from a security or other type of investment, adjusting for the time value of money.

While Citigroup's approach may have been appropriate under the then existing circumstances, the assumptions that Citigroup applied were not reasonable and resulted in Citigroup understating its losses on the Bond Swap. For example, in analyzing the discount rate, if Citigroup had used a country risk rate that reflected the current status of the collapsing Argentine economy rather than the pre-crisis risk rate reflecting more stable economic conditions, its losses would have been much greater. Similarly, Citigroup's losses would have been greater had it sufficiently taken into account the likelihood that the defaulting Argentine government would not be able to honor the collateral on the GPNs. By applying reasonable assumptions to its discounted cash flow analysis, Citigroup would have recorded pre-tax Bond Swap losses of approximately $236 million for the fourth quarter of 2001, significantly more than the $82 million Citigroup actually recorded. These additional losses would have decreased the company's earnings for the fourth quarter by $100.1 million after-tax, or approximately $.02 per share.[4]

Under the Market Approach, Citigroup would have recorded Bond Swap losses of $416 million pre-tax, instead of the $82 million it actually recorded. The impact of employing such an approach would have decreased the company's earnings for the fourth quarter by $217.1 million after-tax, or approximately $.04 per share.

<u>Other-Than-Temporary Impairment of Non-Swapped Bonds</u>

A number of the Argentine government securities owned by Citigroup's Argentine banking operations were not eligible for the Bond Swap. These bonds, the Non-Swapped Bonds, totaled more than $380 million and were held in varying amounts by Citigroup throughout the fourth quarter of 2001. More specifically, at December 31, 2001, Citigroup's Argentine banking operations held PAR Bonds (commonly known as Brady Bonds) with book value of $98.4 million, Bonos del Gobierno Nacional with book value of $134.9 million, and Patriotic Bonds with book value of $150.9 million.

Under GAAP, specifically Statement of Financial Accounting Standards No. 115, *Accounting for Investments in Debt and Equity Securities* ("FAS 115"), Citigroup was required, at least quarterly, to assess the Non-Swapped Bonds to determine whether there was any decline in the fair value of these securities below their amortized cost and, if so, whether that decline was other-than-temporary. If the decline in fair value was other-than-temporary, Citigroup was required to record a charge to income for the quarter. The determination of whether a decline in the value of a security is other-than-temporary is based on the review of a number of factors such as the financial condition and near-term prospects of the issuer, including prospects for the geographic region; whether the issuer has defaulted on scheduled interest payments; the issuer's ability to make future scheduled interest and principal payments on a timely basis; and whether

[4] In the third quarter of 2003, the Argentine government required Citigroup to return the GPNs and take back the bonds because Citigroup declined to follow a 2002 government decree requiring it to change the dollar-denominated GPNs to pesos.

there has been any downgrade in ratings by rating agencies at the time of evaluation compared to the time of acquisition of the security.[5]

Citigroup determined that the Non-Swapped Bonds were not impaired as of December 31, 2001. As a result, the company did not record any charge to income for these bonds. At the time Citigroup reached this decision, the Argentine government was in the midst of an economic and political collapse. The Argentine government recently had announced that it intended to default on its sovereign debt. In addition, credit rating agencies had significantly downgraded Argentina's sovereign debt; and the majority of Argentine government bonds were trading well below $0.50 on the dollar. Thus, Citigroup's determination that these bonds were not impaired was not reasonable.

The Brady Bonds were market-traded bonds that were collateralized by U.S. Treasury securities that guaranteed the principal of the bonds and one-year of interest. Like almost all other Argentine bonds in the market, the Brady Bonds were trading well below their cost during the fourth quarter. At December 31, 2001, the market value of the Brady Bonds held by Citigroup was $63.4 million, approximately $35 million less than their cost of $98.4 million. Despite this significant decline in market value, notwithstanding the collateral, Citigroup determined that the bonds were not impaired.

The other two types of Non-Swapped Bonds, the Bonos del Gobierno Nacional and the Patriotic Bonds were not market-traded. Citigroup concluded that there was no other-than-temporary impairment of these bonds because they were collateralized by a tax credit option that allowed Citigroup to withhold tax payments to offset any government default on the bonds. Citigroup reached this conclusion, despite the fact that similar, market-traded securities were trading at a steep discount, including securities like the Brady Bonds that had reliable collateral. In finding no impairment of the Bonos del Gobierno Nacional and the Patriotic Bonds, Citigroup necessarily assumed that the Argentine government would abide by its commitment to provide the tax credit option. This was during a period when the Argentine government had announced that it intended to default on its sovereign debt and when the political upheaval accompanying the country's economic collapse led to five changes in leadership during December 2001 and early January 2002.[6] In light of the circumstances in Argentina at this time, Citigroup's assumptions were not reasonable.

Citigroup recorded no charges to income for the fourth quarter of 2001 in connection with the Non-Swapped Bonds. Had Citigroup determined that these bonds had an other-than-temporary impairment as of December 31, 2001, it would have been required to record a charge to income to reflect the decline in fair value of the bonds. The amount of impairment of the Brady Bonds can be reasonably estimated at $35 million, based on the quoted market price of these bonds as of

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5 *See, e.g.*, FAS 115; AICPA Statement of Auditing Standards No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

6 During the third quarter of 2002, the Argentine government suspended use of the tax credit option. At that time, Citigroup determined that the Patriotic Bonds and the Bonos del Gobierno Nacional were other-than-temporarily impaired. Citigroup also sold its Brady Bonds in the third quarter.

December 31, 2001. For the non-traded bonds, the Bonos del Gobierno Nacional and the Patriotic Bonds, the amount of impairment based on a reasonable determination of fair value, could be estimated at $22.5 million for the Bonos del Gobierno Nacional and $59.4 million for the Patriotic Bonds. With these estimates, had Citigroup determined that the Non-Swapped Bonds were other-than-temporarily impaired as of December 31, 2001, the company should have recorded an aggregate pre-tax charge of approximately $117 million or $76 million after-tax. This charge would have decreased the company's earnings per share for the fourth quarter by more than $.01.

Pesification of Consumer Loans

On January 6, 2002, the Argentine government issued a decree that, among other things, authorized it to mandate the conversion of certain consumer loans from dollars to pesos at a rate of one dollar to one peso (this mandatory conversion was referred to as "pesification"). Citigroup owned over $1 billion in consumer loans that were subject to pesification. Citigroup determined that it should account for the impact of the pesification decree in the fourth quarter of 2001.

In its January 6, 2002, decree and subsequent regulations, the Argentine government established an exchange rate for official transactions, namely import-export transactions, of 1.4 pesos to 1 dollar. The decree noted that all other transactions would be subject to a "free" exchange rate based on the rate used for open-market trading. Because Argentina suspended foreign exchange transactions and closed banks from the end of December 2001 through January 10, 2002, there was no "free" rate when Citigroup recorded its consumer loan pesification charge on January 9, 2002. Using the only rate available on that day, 1.4 pesos to 1 dollar, Citigroup recorded a $235 million charge for consumer loan pesification losses for the fourth quarter of 2001.

On Friday, January 11, 2002, two days after Citigroup recorded its pesification losses, the Argentine banks were reopened, the trading suspension was lifted, and the market established a "free" rate of between 1.6 and 1.7 pesos to 1 dollar. On Monday, January 14, 2002, Citigroup's auditor informed Citigroup senior management that this "free" rate was the proper rate under GAAP. On that day or the next, Citigroup's auditor further informed Citigroup senior management that all Argentine transactions, other than import/export transactions, were subject to the "free" rate and that members of the International Practices Task Force of the American Institute of Certified Public Accountants and the staffs of the Financial Accounting Standards Board and the Commission also had reached this conclusion.

Had Citigroup used a rate of 1.6, instead of 1.4, pesos to 1 dollar when accounting for these pesification losses, it should have recorded an additional charge of $57 million pre-tax or $37 million after-tax for the fourth quarter of 2001. This additional loss would have decreased the company's earnings per share for the fourth quarter by less than $.01.

Bansud Disposition

On August 6, 2001, Citigroup acquired Banamex, a Mexican holding company with diverse financial institution operations. At the time of acquisition, Citigroup intended to dispose of Bansud, a Banamex subsidiary conducting banking operations in Argentina. Citigroup agreed to sell Bansud in December 2001, and closed on the sale in early January 2002, several months after it had purchased Banamex. During the period when Citigroup held Bansud, Argentina experienced the economic and political crisis described above, and Bansud suffered a substantial decline in value.

Citigroup determined that the applicable accounting for the Bansud disposition was EITF Issue No. 87-11, *Allocation of Purchase Price to Assets to be Sold* ("EITF 87-11"). Under that provision, the decline in value of Bansud during the period when Citigroup held Bansud would impact Citigroup's income only if the decline was attributable to specific identifiable economic events that occurred during the holding period.[7]

Citigroup reached a tentative agreement to sell Bansud in September 2001 for a loss of $401 million. That agreement fell through in October 2001, and Citigroup continued holding Bansud until it reached a subsequent agreement to sell Bansud in early December 2001. The transaction closed in early January 2002, and Citigroup had a loss of $552 million on its sale of Bansud. Citigroup treated the entire loss as a reallocation of the purchase price of Banamex and recorded the loss in goodwill, which was a balance sheet item that did not affect the company's earnings. To reach this result, Citigroup concluded that the adverse developments in the Argentine economy and the related actions by the Argentine government, described above, during the fourth quarter of 2001 were not specific identifiable economic events that caused the decline in the value of Bansud. Citigroup's position was not reasonable, particularly considering the impact of the Argentine economic crisis on financial institutions like Bansud.

By improperly treating the entire $552 million loss on the sale of Bansud as a reallocation of the purchase price rather than as a loss due to specific identifiable economic events, Citigroup avoided a charge to income. Had Citigroup properly accounted for the transaction, it would have recorded a pre-tax charge to income of at least $151 million, representing the difference between the $552 million ultimate loss on the sale of Bansud and the $401 million anticipated loss from the October 2001 failed attempt to sell Bansud.[8] This additional $151 million pre-tax or $98.2

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[7] In relevant part, EITF 87-11 provides that the difference between the carrying amount at the time of sale of a subsidiary intended to be disposed of and the proceeds from the sale lead to a reallocation of the purchase price rather than a gain or loss to earnings, unless specific identifiable economic events occurred during the holding period that change the fair value of the subsidiary from the fair value estimated at the time of acquisition. If specific identifiable economic events that decrease the value of the subsidiary occur during the holding period, that decline in value is to be reflected as a charge to the parent company's income for the quarter.

[8] The lack of documentation relating to Citigroup's accounting for the disposition of Bansud makes it difficult to reach a conclusive determination of the full amount of the losses that should have been charged to income.

million after-tax loss would have decreased the company's earnings per share for the fourth quarter by nearly $.02.

Citigroup's Financial Results

On January 17, 2002, Citigroup issued a press release announcing its results. Among other things, the company reported that its earnings for the fourth quarter of 2001 were $3.88 billion,[9] or diluted earnings per share of $.74, which included a $470 million pre-tax charge related to Argentina. Citigroup's reported results were $.01 per share above analysts' consensus earnings estimates for the period.[10] If Citigroup had properly recorded the charges related to the Bond Swap, the Non-Swapped Bonds, the pesification of consumer loans, and the Bansud disposition described above, the company's earnings per share for the quarter would have been no more than $.68, or $.05 below consensus earnings estimates for the quarter.

On January 18, 2002, Citigroup filed a Form 8-K with the Commission that incorporated the company's January 17, 2002, earnings release. In addition to reporting earnings of $3.88 billion, and diluted earnings per share of $.74, the company further reported that its core earnings per share increased 14% over those earnings for the fourth quarter of 2000. If Citigroup had recorded the charges described above related to the Bond Swap, the Non-Swapped Bonds, the pesification of consumer loans, and the Bansud disposition, these results would have differed materially because the company would have recorded additional charges after tax of at least $311 million.

On March 12, 2002, Citigroup filed its annual report on Form 10-K for 2001. For the fourth quarter of 2001, Citigroup reported earnings of $3.875 billion and diluted earnings per share of $.74. As set forth above, these results were misstated. The company's earnings for the quarter were no more than $3.56 billion. In its 2001 Form 10-K, Citigroup also reported earnings for fiscal year 2001 of $14.13 billion, or $2.72 per diluted share. If Citigroup had recorded the charges described above related to the Bond Swap, the Non-Swapped Bonds, the pesification of consumer loans, and the Bansud disposition, it would have reported 2001 earnings of no more than $13.82 billion and its diluted earnings per share for the year would have been no more than $2.66.

D. LEGAL ANALYSIS

As a result of the conduct described above, Citigroup violated Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1, and 13a-11.

Section 13(a) of the Exchange Act requires issuers of registered securities to file periodic reports with the Commission containing information prescribed by Commission rules and

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9 The $3.88 billion in earnings was a rounded number from the $3.875 billion that the company reported in its financial supplement to its January 17, 2002, press release and, subsequently, in its Form 10-K filed on March 12, 2002.

10 At the time, each $52 million of after-tax earnings equated to earnings per share of $.01.

regulations. Exchange Act Rule 13a-1 requires issuers to file annual reports on Form 10-K, and Exchange Act Rule 13a-11 requires issuers to file current reports on Form 8-K. Further, Exchange Act Rule 12b-20 requires that, in addition to the information required to be included in annual and current reports, such further material information as may be necessary to make the required statements not misleading also must be included. These annual and current reports must be complete and accurate. *See SEC v. Savoy Industries*, 587 F.2d 1149, 1165 (D.C. Cir. 1978). Rule 210.4-01 of Regulation S-X provides that financial statements filed with the Commission are presumed misleading or inaccurate if they are not prepared in conformity with GAAP.[11] Citigroup's accounting for the Bond Swap, the Non-Swapped Bonds, the pesification of consumer loans, and the sale of Bansud was not in conformity with GAAP.

With respect to the Bond Swap, the relevant accounting guidance, which Citigroup reviewed at the time,[12] provided that registrants should determine fair value by following an approach that provides the most clearly evident or readily determinable value of the instrument received in the exchange. This GAAP guidance reflected a preference for using quoted market prices because they provide an objective and reliable value of the instrument exchanged.[13] The guidance provided, however, that, in certain circumstances, other approaches to determining fair value may also be appropriate.

Citigroup took the position that the quoted market prices of the bonds surrendered were not a reliable indicator of the value of the GPNs that it received. Instead, Citigroup used a discounted cash flow analysis of the GPNs to determine their fair value. Regardless of whether this approach was appropriate, Citigroup's discounted cash flow analysis was based on unreasonable assumptions that caused Citigroup to overvalue the GPNs.

A discounted cash flow analysis of the GPNs using reasonable assumptions would have resulted in a fourth quarter pre-tax loss of approximately $236 million on the Bond Swap. Thus, Citigroup's pre-tax Bond Swap losses for the fourth quarter should have been in the range of $236 million to $416 million (the amount of the loss under the Market Approach). Citigroup thus should have recorded a pre-tax loss of at least $236 million on the Bond Swap, or at least $154 million more than the amount included in the financial statements and other financial results in Citigroup's 2001 Form 10-K and the company's January 18, 2002, Form 8-K.

With respect to the Non-Swapped Bonds, for the reasons described above, Citigroup improperly failed to record any charge to income. Had Citigroup properly assessed the fair value

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11 17 CFR § 210.4-01(a)(1).

12 Because it determined that there was no accounting guidance specifically addressing an exchange of bonds for loans, Citigroup considered the following analogous accounting literature: Statement of Financial Accounting Standards No. 115, *Accounting for Investments in Debt and Equity Securities*; Practice Bulletin 4, *Accounting for Foreign Debt/Equity Swaps*; and EITF Issue No. 94-8, *Accounting for a Conversion of a Loan into a Debt Security in a Debt Restructuring.*

13 *See id.*; *see also* Statement of Financial Accounting Standards No. 157, *Fair Value Measurements.*

of the Non-Swapped Bonds, Citigroup would have found that the fair value of these bonds had declined significantly. Applying a reasonable valuation indicates that these bonds had an other-than-temporary impairment as of the fourth quarter in the amount of approximately $117 million pre-tax or $76 million after-tax. Thus, Citigroup should have recorded a pre-tax loss of $117 million on the Non-Swapped Bonds and included this loss in the financial statements and other financial results set forth in Citigroup's 2001 Form 10-K and the company's January 18, 2002, Form 8-K.

In connection with Citigroup's accounting for its consumer loan pesification losses, Citigroup improperly recorded a loss to income in its fourth quarter financial results of only $235 million pre-tax. As discussed, Citigroup's reported loss was based on an exchange rate of 1.4 pesos to one dollar. Statement of Financial Accounting Standards No. 52, *Foreign Currency Translation*, provides that the appropriate exchange rate is the rate at which the foreign-currency denominated asset could be settled at the end of the period. Pursuant to the Argentine government's pesification decree, that rate was the free market rate on the date the markets opened, or between 1.6 and 1.7 pesos to 1 dollar. Citigroup did not follow these GAAP guidelines or guidance from its auditor, who advised Citigroup to use a rate of at least 1.6 pesos to one dollar, and instead used a rate of 1.4 pesos to one dollar. Had Citigroup used a rate of 1.6 pesos to one dollar, it would have incurred an additional loss of $57 million pre-tax or $37 million after-tax for the fourth quarter. Thus, Citigroup should have recorded a pre-tax loss of $292 million on the consumer loan pesification issue, or $57 million more than the amount included in the financial statements and other financial results set forth in Citigroup's 2001 Form 10-K and the company's January 18, 2002, Form 8-K.

Citigroup's accounting for the disposition of Bansud also was not in conformity with GAAP. As discussed above, EITF Issue No. 87-11 provides that, if specific identifiable economic events occurred during the holding period that decreased the value of the subsidiary, that decline in value was to be reflected as a charge to the parent company's income for the quarter. Despite the collapse of the Argentine economy and the related actions by the Argentine government during the holding period, Citigroup did not record a charge to income for the fourth quarter to reflect Bansud's decline in value, as required by EITF 87-11. Had Citigroup complied with EITF 87-11, the company would have incurred a loss to income of at least $151 million for the fourth quarter of 2001. Thus, Citigroup should have recorded a pre-tax loss of $151 million or $98.2 million after-tax on the sale of Bansud and included that loss in the financial statements and other financial results set forth in Citigroup's 2001 Form 10-K and the company's January 18, 2002, Form 8-K.

As a result of its improper accounting for the Bond Swap, the Non-Swapped Bonds, the pesification of consumer loans, and the Bansud disposition, Citigroup materially misstated the financial results that it reported in its 2001 Form 10-K and its January 18, 2002, Form 8-K. As set forth above, these misstatements included Citigroup's reported fourth quarter 2001 earnings of $3.875 billion, which were overstated by at least $311 million, or 8%, after tax, and the company's reported diluted earnings per share of $.74, which were overstated by at least $.06. Citigroup thus violated Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1, and 13a-11.

Section 13(b)(2)(A) of the Exchange Act requires reporting companies to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer. As described above, the manner in which Citigroup accounted for the Bond Swap, the Non-Swapped Bonds, the pesification of the consumer loans, and the disposition of Bansud resulted in the company's financial statements for 2001, including the results for the fourth quarter of the year, being inaccurate, and the underlying documentation related to the improper accounting also was inaccurate.[14] Citigroup thus violated Section 13(b)(2)(A) of the Exchange Act.

Section 13(b)(2)(B) of the Exchange Act, in relevant part, requires reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in conformity with GAAP or other applicable criteria. As reflected above, Citigroup's system of internal controls was not sufficient to provide reasonable assurances that the value of the GPNs received in the Bond Swap, the changes in value of the Non-Swapped Bonds, and the disposition loss on the sale of Bansud were recorded in accordance with GAAP. Citigroup thus violated Section 13(b)(2)(B) of the Exchange Act.

IV.

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

Accordingly, it is hereby ORDERED that:

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

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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14 In this regard, it is noteworthy that Citigroup's purported support for the company's accounting related to the Non-Swapped Bonds and the Bansud transaction consisted of brief internal memoranda. Among other things, the memorandum concerning the Non-Swapped Bonds did not properly analyze whether the bonds were impaired. The memorandum related to the Bansud transaction was not prepared until months after the company filed its Form 10-K for 2001 and set forth the erroneous conclusion that there were no specific identifiable economic events, as defined in EITF 87-01, that occurred during the holding period to change the value of Bansud.

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-57965; File No. SR-NASDAQ-2006-060)

June 16, 2008

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing of Amendment No. 2 and Order Granting Accelerated Approval to Proposed Rule Change, as Modified by Amendment Nos. 1 and 2 Thereto, to Establish Nasdaq Last Sale Data Feeds

I. Introduction

On December 19, 2006, 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 to create, and impose fees for, the "Nasdaq Last Sale for Nasdaq" and "Nasdaq Last Sale for NYSE/Amex" data feeds ("Nasdaq Last Sale Data Feeds"). The Nasdaq Last Sale Data Feeds would provide real-time last sale information for executions occurring within the Nasdaq Market Center, as well as those reported to the jointly-operated FINRA/Nasdaq Trade Reporting Facility ("Nasdaq TRF"). On January 26, 2007, Nasdaq filed Amendment No. 1 to the proposed rule change. The proposed rule change, as modified by Amendment No. 1, was published for comment in the Federal Register on February 14, 2007.[3] The Commission received three comment letters on the proposal.[4] On December 13, 2007,

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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. 55255 (February 8, 2007), 72 FR 7100.

4 Letters to Nancy M. Morris, Secretary, Commission, from Christopher Gilkerson and Gregory Babyak, Co-Chairs of the Market Data Subcommittee of the Technology and Regulation Committee, Securities Industry and Financial Markets Association ("SIFMA"), dated March 7, 2007 ("SIFMA Letter"); Chuck Thompson, President, eSignal, Interactive Data Corporation, dated March 8, 2007 ("eSignal Letter"); and letter to Chairman Cox, Commission, from Alan Davidson, Senior Policy Counsel, Google Inc. ("Google"), dated June 12, 2007 ("Google Letter").

Document 18 of 48

Nasdaq responded to the comment letters.[5] On June 10, 2008, Nasdaq filed Amendment No. 2 to the proposed rule change. In Amendment No. 2, Nasdaq proposed to impose fees for the Nasdaq Last Sale Data Feeds only for a four-month pilot period beginning July 1, 2008.[6]

The Commission is publishing this notice to solicit comments on the proposed rule change as modified by Amendment Nos. 1 and 2 and is simultaneously approving the proposed rule change, as modified by Amendment Nos. 1 and 2, on an accelerated basis.

II. Description of the Proposal

Nasdaq proposes to create two separate data products containing real-time last sale information for trades executed on Nasdaq or reported to the Nasdaq TRF.[7] First, the Nasdaq Last Sale for Nasdaq data product would be a real-time data feed providing last sale information, including execution price, volume, and time, for Nasdaq securities executions on the Nasdaq system or reported to the Nasdaq TRF. Second, the Nasdaq Last Sale for NYSE/Amex data product would be a real-time data feed providing last sale information, including execution price, volume, and time, for NYSE and Amex securities executions on the Nasdaq system or reported to the Nasdaq TRF.

Nasdaq proposes two different pricing models, one for clients that are able to maintain username/password entitlement systems and/or quote counting mechanisms to account for usage,

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5 Letters to Nancy M. Morris, Secretary, Commission, from Jeffrey S. Davis, Vice President and Deputy General Counsel, Nasdaq, dated December 13, 2007.

6 On June 2, 2008, Nasdaq filed a proposed rule change, designated as eligible for immediate effectiveness pursuant to Section 19(b)(3)(A) of the Act, to offer the Nasdaq Last Sale Data Feeds immediately without charge for one month, and thereafter impose fees for an additional five-month pilot period. <u>See</u> SR-NASDAQ-2008-050. On June 16, 2008, Nasdaq withdrew SR-NASDAQ-2008-050, except for the provisions permitting Nasdaq to offer the Nasdaq Last Sale Data Feeds at no charge for one month.

7 In Amendment No. 2, Nasdaq removed from the proposal Nasdaq Market Velocity and Nasdaq Market Forces services that Nasdaq included in its initial proposal and Amendment No. 1.

and a second for those that are not. Firms with the ability to maintain username/password entitlement systems or quote counting mechanisms would be eligible for a specified fee schedule for the Nasdaq Last Sale for Nasdaq product and a separate fee schedule for the Nasdaq Last Sale for NYSE/Amex product. This pricing would be "stair-stepped," such that the tiered fees would be effective for incremental users in the new tier. For example, a distributor of the Nasdaq Last Sale for Nasdaq product with 20,000 users would pay $0.60 for each of the first 10,000 users and $0.48 for each of the next 10,000 users. Distributors may elect to pay per query for their users if, for example, a substantial portion of their users request a relatively small number of queries each month. Firms would also be permitted to "cap" their payments for individual queries at the corresponding monthly user rate.

Firms that are unable to maintain username/password entitlement systems or quote counting mechanisms would also have options for purchasing the Nasdaq Last Sale Data Feeds. These firms could choose between a "Unique Visitor" model for Internet delivery or a "Household" model for Television delivery. Unique Visitor and Household populations would have to be reported monthly and validated by a third party vendor or ratings agency approved by Nasdaq at Nasdaq's sole discretion. This proposed pricing would also be stair-stepped such that the tiered fees would be effective for the incremental users in the new tier. For example, a distributor of Nasdaq Last Sale for Nasdaq product that reports 600,000 Unique Visitors would pay $0.036 for the first 100,000 visitors and $0.03 for the next 500,000 visitors. A Distributor that reports 3,000,000 households reached would pay $0.0096 for each of the first 1,000,000 households and $0.0084 for each of the next 2,000,000 households.

In addition, Nasdaq proposes to offer reduced fees for a single distributor of Nasdaq Last Sale Data Feeds via multiple distribution mechanisms. Specifically, Nasdaq would discount the applicable fees for distribution of Nasdaq Last Sale Data Feeds via Television for Distributors that also distribute those products via the Internet and achieve a new pricing tier for Unique Visitors, Users, or Queries. Nasdaq proposes the following tiered discounts for a firm's Television fees based on its number of Unique Visitors, Users, or Queries -- 10% discount for the second tier, 15% discount for the third tier, and a 20% discount for the fourth tier. In addition, Nasdaq proposes to establish a cap of $100,000 per month for Nasdaq Last Sale for Nasdaq data product and $50,000 per month for Nasdaq Last Sale for NYSE/Amex data product.

As with other Nasdaq proprietary products, all distributors of the Nasdaq Last Sale for Nasdaq and/or Nasdaq Last Sale for NYSE/Amex products would pay a single $1500/month Nasdaq Last Sale Distributor Fee in addition to any applicable usage fees. The $1,500 monthly fee would apply to all distributors and would not vary based on whether the data is distributed internally or externally or via both the Internet and Television.

III. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change

The Commission finds that the proposed rule change, to be implemented on a four-month pilot basis, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.[8] In particular, it is consistent with Section 6(b)(4) of the Act,[9] which requires that the rules of a national securities exchange provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other parties using its facilities, and Section 6(b)(5) of the Act,[10] which requires, among other things, that the rules of a national securities exchange be designed to promote just and

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8 In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

9 15 U.S.C. 78f(b)(4).

10 15 U.S.C. 78f(b)(5).

equitable principles of trade, 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, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

The Commission also finds that the proposed rule change is consistent with the provisions of Section 6(b)(8) of the Act,[11] which requires that the rules of an exchange not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. Finally, the Commission finds that the proposed rule change is consistent with Rule 603(a) of Regulation NMS,[12] adopted under Section 11A(c)(1) of the Act, which requires an exclusive processor that distributes information with respect to quotations for or transactions in an NMS stock to do so on terms that are fair and reasonable and that are not unreasonably discriminatory.[13]

The Commission received two comment letters expressing concerns with the proposed rule change, and one comment letter supporting the proposed rule change. Generally, SIFMA and eSignal suggested that Nasdaq did not adequately demonstrate that the proposed rule change was consistent with the Act.[14] SIFMA asserted that Nasdaq had failed to demonstrate that its proposal met the relevant requirements of the Act, including that its market data fees be fair and reasonable and not unreasonably discriminatory.[15] eSignal asserted that Nasdaq's proposal

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11 15 U.S.C. 78f(b)(8).

12 17 CFR 242.603(a).

13 Nasdaq is an exclusive processor of its last sale data under Section 3(a)(22)(B) of the Act, 15 U.S.C. 78c(a)(22)(B), which defines an exclusive processor as, among other things, an exchange that distributes data on an exclusive basis on its own behalf.

14 See SIFMA Letter and eSignal Letter.

15 See SIFMA Letter.

unreasonably discriminated against smaller market data distributors.[16] Google, however, expressed strong support for the proposal and noted its enthusiasm regarding the opportunity to give more of its users access to real-time financial information online.[17]

The Commission notes that Nasdaq amended the proposed rule change so that its fees would be imposed only for a four-month pilot period. On June 4, 2008, the Commission published for public comment a draft approval order that sets forth a market-based approach for analyzing proposals by self-regulatory organizations to impose fees for "non-core" market data products that would encompass the Nasdaq Last Sale Data Feeds.[18] The Commission believes that Nasdaq's proposal is consistent with the Act for the reasons noted preliminarily in the Draft Approval Order. Pending review by the Commission of comments received on the Draft Approval Order, and final Commission action thereon, the Commission believes that approving Nasdaq's proposal on a pilot basis would be beneficial to investors and in the public interest, in that it should result in broad public dissemination of real-time pricing information. Therefore, the Commission is approving Nasdaq's proposed fees for a four-month pilot beginning July 1, 2008. The broader approach ultimately taken by the Commission with respect to non-core market data fees will necessarily guide Commission action regarding fees for the Nasdaq Last Sale Data Feeds beyond the four-month pilot period.

The Commission finds good cause for approving the proposed rule change, as modified by Amendment Nos. 1 and 2 thereto, before the thirtieth day after the date of publication of notice of filing thereof in the Federal Register. As noted above, accelerating approval of this proposal should

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16 See eSignal Letter.

17 See Google Letter.

18 See Securities Exchange Act Release No. 57917 (June 4, 2008), 73 FR 32751 (June 10, 2008) (Notice of Proposed Order Approving Proposal by NYSE Arca, Inc. to Establish Fees for Certain Market Data and Request for Comment) ("Draft Approval Order").

benefit investors by facilitating their prompt access to widespread, free, real-time pricing information contained in the Nasdaq Last Sale Data Feeds. In addition, the Commission notes that the proposal is approved only on a four-month pilot period while the Commission analyzes comments on the Draft Approval Order. Therefore, the Commission finds good cause, consistent with Section 19(b)(2) of the Act, to approve the proposed rule change, as modified by Amendment Nos. 1 and 2, on an accelerated basis.

IV. 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 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 No. SR-NASDAQ-2006-060 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-NASDAQ-2006-060. 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 Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASDAQ-2006-060 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[19] that the proposed rule change (SR-NASDAQ-2006-060), as modified by Amendment Nos. 1 and 2, be, and it hereby is, approved on an accelerated basis until October 31, 2008.

By the Commission.

Florence E. Harmon

Florence E. Harmon
Acting Secretary

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19 15 U.S.C. 78s(b)(2).

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240 and 249b

[Release No. 34-57967; File No. S7-13-08]

RIN 3235-AK14

Proposed Rules for Nationally Recognized Statistical Rating Organizations

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

ACTION: Proposed rule.

SUMMARY: Today, in the first of three related actions the Commission is proposing rule amendments that would impose additional requirements on nationally recognized statistical rating organizations ("NRSROs") in order to address concerns about the integrity of their credit rating procedures and methodologies in the light of the role they played in determining credit ratings for securities collateralized by or linked to subprime residential mortgages. Second, the Commission also today makes a proposal related to structured finance products rating symbology. And third, two weeks from today, the Commission intends to propose rule amendments that would be intended to reduce undue reliance in the Commission's rules on NRSRO ratings.

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

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

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or

Document 19 of 48

- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-13-08 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 Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-13-08. 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 10:00am and 3:00pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director, at (202) 551-5525; Thomas K. McGowan, Assistant Director, at (202) 551-5521; Randall W. Roy, Branch Chief, at (202) 551-5522; Joseph I. Levinson, Attorney, at (202) 551-5598; Carrie A. O'Brien, Attorney, at (202) 551-5640; Sheila D. Swartz, Special Counsel, at (202) 551-5545; Rose Russo Wells, Special Counsel, at (202) 551-5527; Division of Trading and Markets, Securities and Exchange Commission, 100 F

Street, NE, Washington, DC 20549-6628 or, with respect to questions involving the proposed amendments as they implicate the Securities Act of 1933, Kathy Hsu, Special Counsel, at (202) 551-3306 or Eduardo Aleman, Special Counsel, at (202) 551-3646; Division of Corporation Finance, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3628.

SUPPLEMENTARY INFORMATION:

I. BACKGROUND

A. Introduction

Beginning in the early 2000s, originators started to increasingly make residential mortgage loans based on lower underwriting standards ("subprime loans").[1] For the first few years there did not appear to be any negative repercussions from this lending practice. However, beginning in mid-2006, home values leveled off and soon began to decline, which, in turn, led to a corresponding increase in delinquencies and, ultimately, defaults in subprime loans.[2] This marked increase in subprime loan delinquencies and, ultimately, in defaults has had substantial adverse effects on the markets for, and market values and liquidity of, residential mortgage-backed securities ("RMBS") backed by

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1 There is no standard definition of a subprime loan. However, such a loan can broadly be described as a mortgage loan that does not conform to the underwriting standards required for sale to the government sponsored enterprises (non-conforming loans) and are made to borrowers who: (1) have weakened credit histories such as payment delinquencies, charge-offs, judgments, and bankruptcies; (2) have reduced repayment capacity as measured by credit scores (e.g., FICO), debt-to-income ratios, loan-to-value rations, or other criteria; (3) have not provided documentation to verify all or some of the information, particularly financial information, in their loan applications; or (4) have any combination of these factors. Non-conforming loans made to less risky borrowers fall into two other classifications: jumbo and Alt-A.

2 See e.g., Testimony of John C. Dugan, Comptroller of the Currency, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (March 4, 2008) ("Dugan March 4, 2008 Senate Testimony"), pp. 8-12; Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, before U.S. Senate Committee on Banking, Housing, and Urban Affairs (March 4, 2008) ("Bair March 4, 2008 Senate Statement"), pp. 5-6.

subprime loans and on collateralized debt obligations ("CDOs") linked to such loans (collectively "subprime RMBS and CDOs").[3]

Moreover, the impacts from the troubles experienced by subprime loans extended beyond subprime RMBS and CDOs to the broader credit markets and the economy as a whole.[4] As a result, the parties that participated in various parts of the process of making subprime loans, packaging them into subprime RMBS and CDOs, and selling these debt instruments, including mortgage brokers, loan originators, securities sponsors and underwriters, and NRSROs have come under intense scrutiny. Today, the Commission is proposing a series of new requirements that are designed to address concerns that have been raised about NRSROs in light of the role they played in this process. Additionally, two weeks from today, the Commission will complete its proposal of this series of rule changes. These changes would be intended to reduce undue reliance in the Commission's rules on NRSRO ratings, thereby promoting increased investor due diligence.

B. The Credit Rating Agency Reform Act of 2006

The purpose of the Credit Rating Agency Reform Act of 2006 (the "Rating Agency Act"), enacted on September 29, 2006, is to "improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency,

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3 See e.g., Dugan March 4, 2008 Senate Testimony, pp. 12-14; Bair March 4, 2008 Senate Statement, pp. 6-7.

4 See e.g., Statement of Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (February 28, 2008) ("Bernanke February 28, 2008 Senate Statement"), pp. 1-3; Dugan March 4, 2008 Senate Testimony, pp. 12-15.

and competition in the credit rating industry."[5] The operative provisions of the Rating Agency Act became applicable upon the Commission's adoption in June 2007 of a series of rules implementing a registration and oversight program for credit rating agencies that register as NRSROs.[6]

To date, a total of nine credit rating agencies have been granted registration with the Commission as NRSROs pursuant to the Rating Agency Act and the rules thereunder.[7] These registrants include the credit rating agencies most active in rating subprime RMBS and CDOs: Fitch Ratings, Inc. ("Fitch"), Moody's Investors Service ("Moody's"), and Standard and Poor's Rating Services ("S&P").[8] In the fall of 2007, the

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5 Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 3850, Credit Rating Agency Reform Act of 2006, S. Report No. 109-326, 109th Cong., 2d Sess. (Sept. 6, 2006) ("Senate Report"), p. 1.

6 See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Securities Exchange Act of 1934 ("Exchange Act") Release No. 55857 (June 5, 2007), 72 FR 33564 (June 18, 2007) ("Adopting Release"). The rules adopted by the Commission prescribe: how a credit rating agency must apply to the Commission for registration as an NRSRO (Rule 17g-1 (17 CFR 240.17g-1)); the form of the application and the information that must be provided in the application (Form NRSRO and the Instructions to Form NRSRO (17 CFR 240.249b.300)); the records an NRSRO must make and maintain (Rule 17g-2 (17 CFR 240.17g-2)); the reports an NRSRO must furnish to the Commission annually (Rule 17g-3 (17 CFR 240.17g-3)); the areas that must be addressed in an NRSRO's procedures to prevent the misuse of material nonpublic information (Rule 17g-4 (17 CFR 240.17g-4)); the types of conflicts of interest an NRSRO must disclose and manage or is prohibited from having (Rule 17g-5 (17 CFR 240.17g-5)); and certain unfair, coercive, or abusive practices an NRSRO is prohibited from engaging in (Rule 17g-6 (17 CFR 240.17g-6)).

7 See Commission Orders granting registration of A.M. Best Company, Inc. (34-56507, September 24, 2007), DBRS Ltd. (34-56508, September 24, 2007), Fitch, Inc. (34-56509, September 24, 2007), Japan Credit Rating Agency, Ltd, (34-56510, September 24, 2007), Moody's Investor Services, Inc. (34-56511, September 24, 2007), Rating and Investment Information, Inc. (34-56512, September 24, 2007), Standard & Poor's Rating Services (34-56513, September 24, 2007), Egan-Jones Rating Company (34-57031, December 21, 2007) and LACE Financial Corp. (34-57300, February 11, 2008).

8 According to their most recent Annual Certifications on Form NRSRO, S&P rates 197,700 issuers of asset-backed securities, the category that includes RMBS, Moody's rates 110,000 such issuers, and Fitch rates 75,278 such issuers. No other registered NRSRO reports rating more than 1,000 issuers of asset-backed securities. See Standard & Poor's 2007 Annual Certification on Form NRSRO, available at www.standardandpoors.com; Moody's Investor Services 2007 Annual Certification on Form NRSRO, available at www.moodys.com; Fitch, Inc. 2007 Annual Certification on Form NRSRO, available at www.fitchratings.com.

Commission, exercising the new authority conferred by the Rating Agency Act, began a staff examination of the NRSROs' activities in rating subprime RMBS and CDOs in order to review whether they adhered to their stated and documented procedures and methodologies for rating these debt instruments and the extent, if any, to which their ratings may have been impaired by conflicts of interest.[9]

In addition to the examination, the Commission has worked closely with other regulators and supervisors of the financial markets in analyzing the credit market turmoil and in developing recommendations and principles for market participants, including NRSROs.[10] For example, the President's Working Group on Financial Markets issued a Policy Statement on Financial Market Developments in March 2008.[11] Further, as a member of the International Organization of Securities Commissions ("IOSCO"), the Commission played a substantial role in drafting The Role of Credit Rating Agencies in Structured Finance Markets, which was issued for consultation by IOSCO in March 2008.[12] Also, the Commission, as part of its participation in the Financial Stability Forum, worked with its counterparts in the US and abroad on The Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience released in April 2008, which discussed credit rating agencies.[13]

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9 See Testimony of Christopher Cox, Chairman, Commission, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (April 22, 2008) ("Cox April 22, 2008 Senate Testimony"), pp. 2-3.

10 See Id, p. 4.

11 A copy of the policy statement is available at: www.ustreas.gov.

12 A copy of the report is available at: www.iosco.org.

13 A copy of the report is available at: www.fsforum.org.

These and other efforts have assisted the Commission in identifying a number of areas in which its current NRSRO rules could be augmented to address concerns about the role NRSROs played in the credit market turmoil.[14] As a result, the Commission is proposing amendments to its existing NRSRO rules and a new rule with the goal of improving the quality of credit ratings determined by NRSROs generally and, in particular, for structured finance products such as RMBS and CDOs.[15] These proposals and the proposals to be considered in two weeks are designed to:

- Enhance the disclosure and comparability of credit ratings performance statistics;
- Increase the disclosure of information about structured finance products;
- Require more information about the procedures and methodologies used to determine credit ratings for structured finance products;
- Strengthen internal control processes through reporting requirements; and
- Address conflicts of interest arising from the process of rating structured finance products; and
- Reduce undue reliance in the Commission's rules on NRSRO ratings, thereby promoting increased investor due diligence.

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14 See Cox April 22, 2008 Senate Testimony, pp. 6-8.

15 The term "structured finance product" as used throughout this release refers broadly to any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. This broad category of financial instrument includes, but is not limited to, asset-backed securities ("ABS") such as RMBS and to other types of structured debt instruments such as CDOs, including synthetic and hybrid CDOs.

The Commission believes these proposals would further the purpose of the Rating Agency Act to improve the quality of NRSRO credit ratings by fostering accountability, transparency, and competition in the credit rating industry.[16]

C. The Role of Credit Ratings in the Credit Market Turmoil

The growth in the origination of subprime loans began in the early 2000s.[17] For example, Moody's reports that subprime loans amounted to $421 billion of the $3.038 trillion in mortgages originated in 2002 (14%) and $640 billion of the $2.886 trillion in mortgages originated in 2006 (22%).[18] This growth was facilitated by steadily rising home values and a low interest rate environment.[19] In addition, increases in the breadth of the credit risk transfer markets as a result of new investors willing to purchase credit based structured finance products provided an opportunity for lenders to originate subprime loans and then move them off their balance sheets by packaging and selling them through the securitization process to investors as subprime RMBS and CDOs.[20] The investors in subprime RMBS and CDOs included domestic and foreign mutual funds, pension funds, hedge funds, banks, insurance companies, special investment vehicles, and state government operated funds.

This "originate to distribute" business model created demand for residential mortgage loans, including subprime loans. For example, according to Moody's, of the

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16 See Senate Report, p. 2.

17 See e.g., Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, before U.S. Senate Committee on Banking, Housing, and Urban Affairs (January 31, 2008) ("Bair January 31, 2008 Senate Statement"), p. 4.

18 According to Moody's, subprime mortgage loans represented $421 billion of $3.038 trillion total mortgage origination in 2002 and $640 billion of $2.886 trillion total mortgage origination in 2006. See A Short Guide to Subprime, Moody's, March 25, 2008, p. 1.

19 See e.g., Dugan March 4, 2008 Senate Testimony, pp. 8-11.

20 Id.

approximately $2.5 trillion worth of mortgage loans originated in 2006, $1.9 trillion were securitized into RMBS and approximately 25%, or $520 billion worth, of these loans were categorized as subprime.[21] The demands of the loan securitization markets encouraged lenders to lower underwriting standards to maintain a steady volume of loans and to use less traditional products such as adjustable rate, negative amortization, and closed-end second lien mortgages.[22]

1. The Creation of Subprime RMBS and CDOs

The creation of an RMBS begins by packaging a pool of mortgage loans, usually numbering in the thousands, and transferring them to a bankruptcy remote trust. The trust purchases the loan pool and becomes entitled to the interest and principal payments made by the borrowers. The trust finances the purchase of the loan pool through the issuance of RMBS. The monthly interest and principal payments from the loan pool are used to make monthly interest and principal payments to the investors in the RMBS.

The trust typically issues different classes of RMBS (known as "tranches") offering a sliding scale of coupon rates based on the level of credit protection afforded to the security. Credit protection is designed to shield the tranche securities from loss of interest and principal arising from defaults of the loans backing the RMBS. The degree of credit protection afforded a tranche security is known as its "credit enhancement" and is provided through several means. The primary source of credit enhancement is subordination, which creates a hierarchy of loss absorption among the tranche securities. For example, if a trust issued securities in 10 different tranches of securities, the first (or

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21 Subprime Residential Mortgage Securitizations: Frequently Asked Questions, Moody's, April 19, 2007, p. 1.

22 See e.g., Bernanke February 28, 2008 Senate Testimony, p. 1; Dugan March 4, 2008 Senate Testimony, pp. 8-10.

senior) tranche would have nine subordinate tranches, the next highest tranche would have eight subordinate tranches and so on down the capital structure. Losses of interest and principal experienced by the trust from delinquencies and defaults among loans in the pool are allocated first to the lowest tranche until its principal amount is exhausted and then to the next lowest tranche and so on up the capital structure. Consequently, the senior tranche would not incur any loss until the principal amounts from all the lower tranches have been exhausted through the absorption of losses from the underlying loans.

A second form of credit enhancement is over-collateralization, which is the amount that the principal balance of the mortgage pool underlying the trust exceeds the principal balance of the tranche securities issued by the trust. This excess principal creates an additional "equity" tranche below the lowest tranche security to absorb losses. In the example above, the equity tranche would sit below the 10th tranche security and protect it from the first losses experienced as a result of defaulting loans.

A third form of credit enhancement is excess spread, which consists of the amount by which the interest derived from the underlying loans in the aggregate exceeds interest payments due to investors in the tranche securities in the aggregate plus the administrative expenses of the trust such as fees due the loan servicer as well as premiums due on derivatives contracts and bond insurance. In other words, the excess spread is the amount that the monthly interest income from the pool of loans exceeds the weighted average interest due to the RMBS bondholders. This excess spread can be used to build up loss reserves or pay off delinquent interest payments due to a tranche security.

A fourth form of credit enhancement sometimes employed is bond insurance. When used, bond insurance is typically purchased only for the senior RMBS tranche.

The creation of a typical CDO is similar to that of an RMBS. A bankruptcy remote trust is created to hold the CDO's assets and issue its securities. The underlying assets, however, are generally debt securities rather than mortgage loans. The CDO trust uses the interest and principal payments from the approximately 200 underlying debt securities to make interest and principal payments to investors in the securities issued by the trust. The trust is structured to provide differing levels of credit enhancement to the securities it issues. Similar to RMBS, credit enhancement is provided through subordination, over-collateralization, excess spread, and bond insurance. In addition to the underlying assets, one significant difference between a CDO and an RMBS is that the CDO may be actively managed such that its underlying assets change over time, whereas the mortgage loan pool underlying an RMBS remains static for the most part.

In recent years, CDOs have been some of the largest purchasers of subprime RMBS and the drivers of demand for those securities. For example, according to Fitch, the average percentage of subprime RMBS in the collateral pools of CDOs it rated grew from 43.3% in 2003 to 71.3% in 2006.[23] Generally, the CDOs holding subprime RMBS issued fell into one of two categories: high grade and mezzanine. High grade CDOs are generally defined as those that hold RMBS tranches with AAA, AA, or A credit ratings, whereas mezzanine CDOs are those that hold RMBS tranches rated predominantly BBB. Securities issued by mezzanine CDOs pay higher yields than those issued by high grade CDOs since the BBB-rated RMBS underlying the mezzanine CDOs pay higher yields than the AAA to A rated RMBS underlying high grade CDOs. In addition to CDOs holding subprime RMBS, a market for CDOs holding other CDOs that held subprime

[23] Rating Stability of Fitch-Rated Global Cash Mezzanine Structured Finance CDOs with Exposure to U.S. Subprime RMBS, Fitch, April 2, 2007, p. 1.

RMBS developed in recent years. These debt instruments are known as "CDOs-squared."

As the market for mortgage related CDOs grew, CDO issuers began to use credit default swaps to replicate the performance of subprime RMBS and CDOs. In this case, rather than purchasing subprime RMBS or CDOs, the CDO entered into credit default swaps referencing subprime RMBS or CDOs, or indexes on RMBS. These CDOs, in some cases, are composed entirely of credit default swaps ("synthetic CDOs") or a combination of credit default swaps and cash RMBS ("hybrid CDOs"). The use of credit default swaps allowed the CDO securities to be issued more quickly, since the issuer did not have to wait to accumulate actual RMBS for the underlying collateral pool.

2. Determining Credit Ratings for Subprime RMBS and CDOs

A key step in the process of creating and ultimately selling a subprime RMBS and CDO is the issuance of a credit rating for each of the tranches issued by the trust (with the exception of the most junior "equity" tranche). The credit rating for each rated tranche indicated the credit rating agency's view as to the creditworthiness of the debt instrument in terms of the likelihood that the issuer would default on its obligations to make interest and principal payments on the debt instrument.[24] To varying degrees, many investors rely on credit ratings in making the decision to purchase subprime RMBS or CDOs, particularly with respect to the senior AAA rated tranches. Some investors use the credit ratings to assess the risk of the debt instruments. In part, this may be due to the large

[24] See, e.g., Inside the Ratings: What Credit Ratings Mean, Fitch, August 2007 ("Inside the Ratings"), p. 2; Testimony of Michael Kanef, Group Managing Director, Moody's Investors Service, Before the United States Senate Committee on Banking, Housing, and Urban Affairs (September 26, 2007) ("Kanef September 26, 2007 Senate Testimony"), p. 2; Principles-Based Rating Methodology For Global Structured Finance Securities, S&P, May 29, 2007, p. 3. Since credit ratings are issued for tranches of RMBS and CDOs individually, rather than for the issuers of those tranches, the NRSRO credit ratings are estimates of the probability of default of each RMBS or CDO tranche as an independent instrument.

number of debt instruments in the market and their complexity. Other investors use credit ratings to satisfy client investment mandates regarding the types of securities they can invest in or to satisfy regulatory requirements based on certain levels of credit ratings, or a combination of these conditions. Moreover, investors typically only have looked to ratings issued by Fitch, Moody's, and S&P, which causes the arrangers[25] of the subprime RMBS and CDOs to use these three NRSROs to obtain credit ratings for the tranche securities they brought to market.

The procedures followed by these three NRSROs in developing ratings for subprime RMBS are generally similar. The arranger of the RMBS initiates the rating process by sending the credit rating agency a range of data on each of the subprime loans to be held by the trust (e.g., principal amount, geographic location of the property, credit history and FICO score of the borrower, ratio of the loan amount to the value of the property, and type of loan: first lien, second lien, primary residence, secondary residence), the proposed capital structure of the trust, and the proposed levels of credit enhancement to be provided to each RMBS tranche issued by the trust. Upon receipt of the information, the NRSRO assigns a lead analyst who is responsible for analyzing the loan pool, proposed capital structure, and proposed credit enhancement levels and, ultimately, for formulating a ratings recommendation for a rating committee composed of analysts and/or senior-level personnel not involved in the analytic process.

The next step in the ratings process is the development of predictions, based on a quantitative expected loss model and other qualitative factors, as to how many of the

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25 As bankruptcy remote stand-alone legal entities, RMBS and CDO trusts had no employees. Consequently, they relied on third-parties to create and manage them. The term "arranger" is used herein to refer to the party that oversees the creation of the RMBS and CDO, which would include the process of obtaining credit ratings for the various tranches. Frequently, the arranger also served as the underwriter of the securities.

loans in the collateral pool would default under stresses of varying severity. This analysis also includes assumptions as to how much principal would be recovered after a defaulted loan is foreclosed. Each NRSRO generally uses between 40 and 60 specific credit characteristics to analyze each loan in the collateral pool of an RMBS in order to assess the potential future performance of the loan under various possible scenarios. These characteristics include the loan information described above as well as the amount of equity that the borrowers have in their homes, the amount of documentation provided by borrowers to verify their assets and/or income levels, and whether the borrowers intend to rent or occupy the homes.[26]

The purpose of this loss analysis is to determine how much credit enhancement a given tranche security would need for a particular category of credit rating. The severest stress test (i.e., the one that would result in the greatest number of defaults among the underlying loans) is run to determine the amount of credit enhancement required for an RMBS tranche issued by the trust to receive an AAA rating. For example, this test might result in an output that predicted that under the "worst case" scenario, 40 percent of the loans in the underlying pool would default and that after default the trust would recover only 50 percent of the principal amount of each loan in foreclosure. Consequently, to get an AAA rating, an RMBS tranche security issued by the trust would need credit enhancement sufficient to cover at least 20 percent of the principal amount of all the RMBS tranches issued by the trust. In other words, absent other forms of credit enhancement such as excess spread, at least 20 percent of the principal amount of the RMBS tranches issued by the trust, including the equity tranche, would have to be subordinate to the senior tranche and, therefore, obligated to absorb the losses resulting

[26] See, e.g., Kanef September 26, 2007 Senate Testimony, p. 7.

from 40% of the underlying loans defaulting.[27] The next severest stress test is run to determine the amount of credit enhancement required of the AA tranche and so on down the capital structure. The lowest rated tranche (typically BB or B) is analyzed under a more benign market scenario. Consequently, its required level of credit enhancement – typically provided primarily or exclusively by a subordinate equity tranche – is based on the number of loans expected to default in the normal course given the lowest possible level of macroeconomic stress.

Following the determination of the level of credit enhancement required for each credit rating category, the next step in the ratings process is to check the proposed capital structure of the RMBS against these requirements. For example, if the proposed structure would create a senior RMBS tranche that had 18 percent of the capital structure subordinate to it (the other RMBS tranches, including, as applicable, an equity tranche), the analyst reviewing the transaction might conclude that based on the output of the loss model the senior tranche should be rated AA since it would need 20 percent subordination to receive an AAA credit rating. Additionally, the analyst could take other factors into consideration such as the quality of the loan servicer or the actual performance of similar pools of loans underlying other RMBS trusts to determine that in this case 18 percent subordination would be sufficient to support an AAA rating (to the extent these factors were not covered by the model).

Typically, if the analyst concludes that the capital structure of the RMBS did not support the desired ratings – in the example above, if it determined that 18 percent credit enhancement is insufficient for the desired AAA rating – this preliminary conclusion

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27 To the extent that the RMBS included other forms of credit enhancement besides the subordination and over-collateralization provided in this example, e.g., excess spread, this 20 percent subordination figure would be reduced accordingly.

would be conveyed to the arranger. The arranger could accept that determination and have the trust issue the securities with the proposed capital structure and the lower rating or adjust the structure to provide the requisite credit enhancement for the senior tranche to get the desired AAA rating (e.g., shift 2 percent of the principal amount of the senior tranche to a lower tranche or add or remove certain mortgages from the proposed asset pool). Generally, arrangers aim for the largest possible senior tranche, i.e., to provide the least amount of credit enhancement possible, since the senior tranche – as the highest rated tranche – pays the lowest coupon rate of the RMBS' tranches and, therefore, costs the arranger the least to fund.

The next step in the process is a cash flow analysis on the interest and principal expected to be received by the trust from the pool of subprime loans to determine whether it will be sufficient to pay the interest and principal due on each RMBS tranche issued by the trust. The NRSROs use quantitative cash flow models that analyze the amount of principal and interest payments expected to be generated from the loan pool each month over the terms of the RMBS tranche securities under various stress scenarios. The outputs of this model are compared against the priority of payments (the "waterfall") to the RMBS tranches specified in the trust legal documents. The waterfall documentation could specify over-collateralization and excess spread triggers that, if breached, would reallocate principal and interest payments from lower tranches to higher tranches until the minimum levels of over-collateralization and excess spread were reestablished. Ultimately, the monthly principal and interest payments derived from the loan pool need to be enough to satisfy the monthly payments of principal and interest due by the trust to the investors in the RMBS tranches as well as to cover the administrative expenses of the trust.

In addition to expected loss and cash flow analysis, the analysts review the legal documentation of the trust to evaluate whether it is bankruptcy remote, i.e., isolated from the effects of any potential bankruptcy or insolvency of the arranger. They also review operational and administrative risk associated with the trust, using the results of periodic examinations of the principal parties involved in the issuance of the security, including the mortgage originators, the issuer of the security, the servicer of the mortgages in the loan pool, and the trustee.[28] In assessing the servicer, for example, an NRSRO might review its past performance with respect to loan collection, billing, recordkeeping, and the treatment of delinquent loans.

Following these steps, the analyst develops a rating recommendation for each RMBS tranche, which then is presented to a rating committee composed of analysts and/or senior-level personnel not involved in the analytic process. The rating committee votes on the ratings for each tranche and usually approaches the arranger privately to notify it of the ratings decisions. In most cases, an arranger can appeal a rating decision, although the appeal is not always granted (and, if granted, may not necessarily result in any change in the rating decision). Final ratings decisions are published and subsequently monitored through surveillance processes. The NRSRO typically is paid only if the credit rating is issued, though sometimes it receives a breakup fee for the analytic work undertaken even if the credit rating is not issued.

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[28] Principal parties are not rated de novo in each RMBS transaction; rather, each NRSRO has its own procedures and schedules for reviewing those parties on a periodic basis in order to incorporate its assessment of those entities into the rating process.

The process for assigning ratings to subprime CDOs also involves a review of the creditworthiness of each tranche of the CDO. As with RMBS, the process centers on an examination of the pool of assets held by the trust and analysis of how they would perform individually and in correlation during various stress scenarios. However, this analysis is based primarily on the credit rating of each RMBS or CDO in the underlying pool or referenced through a credit default swap entered into by the CDO. In other words, the credit rating is the primary characteristic of the underlying debt instruments that the NRSROs take into consideration when performing their loss analysis. Hence, this review of the debt instruments in the collateral pool and the potential correlations among those securities does not "look through" those securities to their underlying asset pools. The analysis, consequently, generally only goes one level down to the credit ratings of the underlying instruments or reference securities.

CDOs collateralized by RMBS or by other CDOs often are actively managed. Consequently, there can be frequent changes to the composition of the cash assets (RMBS or CDOs), synthetic assets (credit default swaps), or combinations of cash and synthetic assets in the underlying pool. As a result, NRSRO ratings for managed CDOs are based not on the closing date composition of the pool but instead on covenanted limits for each potential type of asset that could be put in the pool. Typically, following a post-closing period in which no adjustments can be made to a CDO's collateral pool, the CDO's manager has a predetermined period of several years in which to adjust that asset pool through various sales and purchases pursuant to covenants set forth in the CDO's indenture. These covenants set limitations and requirements for the collateral pools of

CDOs, often by establishing minimum and maximum concentrations for certain types of securities or certain ratings.

NRSROs use a CDO's indenture guidelines to run "worst-case" scenarios based on the various permutations of collateral permitted under the indenture. For example, an indenture might specify that a CDO's collateral pool must include between 10 and 20 percent AAA-rated subprime RMBS, with the remaining 80 to 90 percent composed of investment-grade, but not AAA, subprime RMBS. In preparing a rating for that CDO, an NRSRO will run its models based on all possible collateral pools permissible under the indenture guidelines, placing the most weight on the results from the weakest potential pools (i.e., the minimum permissible amount, 10 percent, of AAA-rated securities and the lowest-rated investment grade securities for the remaining 90 percent). As with RMBS ratings, the model results are then compared against the capital structure of the proposed CDO to confirm that the level of subordination, over-collateralization and excess spread available to each tranche provides the necessary amount of credit enhancement to sustain a particular rating.

3. The Downgrades in Credit Ratings of Subprime RMBS and CDOs

As noted above, the development of the credit risk transfer markets gave rise to an "originate to distribute" model whereby mortgage loans are originated with the intent to securitize them. Under this model, arrangers earn fees from originating, structuring, and underwriting RMBS and servicing the loans underlying the RMBS, as well as frequently a third set of fees from structuring, underwriting, and managing CDOs composed of RMBS. Moreover, the yields offered by subprime RMBS and CDO tranches (as compared to other types of similarly rated debt instruments) led to increased investor demand for these debt instruments. The originate to distribute model creates incentives for originating high volumes of mortgage loans while simultaneously reducing the incentives to maintain high underwriting standards for making such loans. The continued growth of the housing market through 2006, which led to increased competition among lenders, also contributed to looser subprime loan underwriting standards.[29]

By mid-2006, however, the steady rise in home prices that had fueled this growth in subprime lending came to an end as prices began to decline.[30] Moreover, widespread areas of the country began to experience declines whereas, in the past, poor housing markets generally had been confined to distinct geographic areas.[31] The downturn in the housing market has been accompanied by a marked increase in delinquencies and defaults of subprime loans.[32]

The increases in delinquency and default rates have been concentrated in loans made in 2006 and 2007, which indicates that borrowers have been falling behind within months of the loans being made.[33] For example, by the fourth quarter of 2006, the percentage of subprime loans underlying RMBS rated by Moody's that were in default within six months of the loans being made stood at 3.54 percent, nearly four times the average six month default rate of 0.90 percent between the first quarter of 2002 and the second quarter of 2005. Similarly, default rates for subprime loans within 12 months of

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29 See e.g., Dugan March 4, 2008 Senate Testimony, p. 10; Bernanke February 28, 2008 Senate Testimony, p. 1.

30 See e.g., Id; Bair March 4, 2008 Senate Statement, pp. 5-8; Bair January 31, 2008 Senate Statement, p.3.

31 See e.g., Bair January 31, 2008 Senate Statement, p. 3.

32 Id.

33 See e.g., Bair March 24, 2008 Senate Statement, p. 6 ("Serious delinquency rates on subprime mortgages securitized in 2006 are significantly higher than those for any of the previous three years.").

the loans being made rose to 7.39 percent as compared to 2.00 percent for the period from the first quarter of 2002 through the second quarter of 2005.[34] Figures released by S&P show similar deterioration in the performance of recent subprime loans.[35] According to S&P, the serious delinquency rate[36] for subprime loans underlying RMBS rated by S&P within twelve months of the initial rating was 4.97 percent of the current aggregate pool balance for subprime RMBS issued in 2005, 10.55 percent for subprime RMBS issued in 2006, and 15.19 percent for subprime RMBS issued in 2007.[37]

Along with the deterioration in the performance of subprime loans, there has been an increase in the losses incurred after the loans are foreclosed. According to S&P, the actual realized losses on loans underlying 2007 subprime RMBS after 12 months of seasoning were 65 percent higher than the losses recorded for RMBS issued in 2006 at the same level of seasoning.[38]

The rising delinquencies and defaults in subprime loans backing the RMBS rated by the NRSROs has exceeded the projections on which they based their initial ratings. Furthermore, the defaults and foreclosures on subprime loans have resulted in realizable losses to the lower RMBS tranches backed by the loans and, correspondingly, to the lower CDO tranches backed by those RMBS. As discussed above, the reduction in the amount of monthly principal and interest payments coming from the underlying pool of

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34 Early Defaults Rise In Mortgage Securitizations: Updated Data Show Continued Deterioration, Moody's, September 19, 2007, pp. 3-4.

35 U.S. Subprime RMBS Performance Update: January 2008 Distribution Date, S&P, February 25, 2008, p. 1.

36 Defined as 90-plus day delinquencies, foreclosures, and real estate owned. Id.

37 Id.

38 Id.

subprime loans or, in the case of a CDO, RMBS tranches or other CDO tranches is allocated to the tranches in ascending order. In addition to directly impairing the affected tranche, the losses – by reducing the principal amount of these tranches – decreased the level of subordination protecting the more senior tranches. In other words, losses suffered by the junior tranches of an RMBS or CDO directly reduced the level of credit enhancement – the primary factor considered by NRSROs in rating tranched securities – protecting the senior tranches of the instrument. These factors have caused the NRSROs to reevaluate, and in many cases downgrade, their ratings for these instruments.

- As of February 2008, Moody's had downgraded at least one tranche of 94.2 percent of the subprime RMBS deals it rated in 2006 (including 100 percent of 2006 RMBS deals backed by subprime second-lien mortgage loans) and 76.9 percent of all subprime RMBS deals it rated in 2007. Overall, 53.7 percent and 39.2 percent of 2006 and 2007 tranches, respectively, had been downgraded by that time. RMBS tranches backed by first lien loans issued in 2006 were downgraded an average of 6.0 notches from their original ratings, while RMBS tranches backed by second-lien loans issued that year were downgraded 9.7 notches on average. The respective figures for 2007 first- and second-lien backed tranches were 5.6 and 7.8 notches.[39]
- As of March 2008, S&P had downgraded 44.3 percent of the subprime RMBS tranches it had rated between the first quarter of 2005 and the third quarter of 2007, including 87.2 percent of second-lien backed securities.

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39 U.S. Subprime RMBS 2005-2007 Vintage Rating Actions Update: January 2008, Moody's, February 1, 2008, pp. 2-4.

Downgrades to subprime RMBS issued in 2005 averaged four to six notches, while the average for those issued in 2006 and 2007 was 6.0 to 11 notches.[40]

- As of December 7, 2007, Fitch had issued downgrades to 1,229 of the 3,666 tranches of subprime RMBS issued in 2006 and the first quarter of 2007, representing a par value of $23.8 billion out of a total of $193 billion.[41] Subsequently, on February 1, 2008, Fitch placed all subprime first-lien RMBS issued in 2006 and the first half of 2007, representing a total outstanding balance of approximately $139 billion, on Rating Watch Negative.[42]

The extensive use of subprime RMBS in the collateral pools of CDOs has led to similar levels of downgrade rates for those securities as well. Moreover, the use of subprime RMBS as reference securities for synthetic CDOs magnified the effect of RMBS downgrades on CDO ratings. Surveillance of CDO credit ratings has been complicated by the fact that the methodologies used by the NRSROs to rate them relied heavily on the credit rating of the underlying RMBS or CDOs. Consequently, to adjust the CDO rating, the NRSROs first have needed to complete their reviews of the ratings for the underlying RMBS or adjust their methodologies to sufficiently account for the

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40 Transition Study: Structured Finance Rating Transition And Default Update As Of March 21, 2008, S&P, March 28, 2008, pp. 2-3.

41 U.S. RMBS Update, Fitch, February 20, 2008 p. 5.

42 Update On U.S. Subprime And Alt-A: Performance And Rating Reviews, Fitch, March 20, 2008, p. 13.

anticipated poor performance of the RMBS.[43] Ultimately, the NRSROs have downgraded a substantial number of CDO ratings.

- Over the course of 2007, Moody's issued 1,655 discrete downgrade actions (including multiple rating actions on the same tranche), which constituted roughly ten times the number of downgrade actions in 2006 and twice as many as in 2002, previously the most volatile year for CDOs. Further, the magnitude of the downgrades (number of notches) was striking. The average downgrade was roughly seven notches as compared to a previous average of three to four notches prior to 2007. In the words of a March 2008 report by Moody's, "[T]he scope and degree of CDO downgrades in 2007 was unprecedented."[44]
- As of April 1, 2008, S&P had downgraded 3,068 tranches from 705 CDO transactions, totaling $321.9 billion in issuance, and placed 443 ratings from 119 transactions, with a value of $33.8 billion, on CreditWatch negative, "as a result of stress in the U.S. residential mortgage market and credit deterioration of U.S. RMBS."[45]

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43 For example, in November 2007, Fitch announced that in rating CDOs with asset pools which included subprime RMBS, it would adjust all subprime RMBS securities on Rating Watch Negative downwards by three categories – or notches – (six in the case of 2007 subprime RMBS rated BBB+ or lower) before factoring them into a re-assessment of the CDO's rating. <u>See Global Criteria For The Review Of Structured Finance CDOs With Exposure To US Subprime RMBS</u>, Fitch, November 15, 2007, p. 4.

44 <u>2008 U.S. CDO Outlook And 2007 Review</u>, Moody's, March 3, 2008, p. 6.

45 <u>86 Ratings Lowered On 20 U.S. CDOs Of ABS Deals; $9.107 Billion In Issuance Affected</u>, S&P, April 1, 2008, p. 1.

- By mid-December, 2007, Fitch had issued downgrades to 158 of the 431 CDOs it had rated with exposure to RMBS.[46] Among the 30 CDOs with exposure to the subprime RMBS which "suffered the greatest extent and magnitude of negative rating migration," all but $82.7 million of the $20.7 billion in balance was downgraded.[47]

The scope and magnitude of these downgrades has caused a loss of confidence among investors in the reliability of RMBS and CDO credit ratings issued by the NRSROs.[48] This lack of confidence in the accuracy of NRSRO ratings has been a factor in the broader dislocation in the credit markets.[49] For example, the complexity of assessing the risk of structured finance products and the lack of commonly accepted methods for measuring the risk has caused investors to leave the market, including the market for AAA instruments, particularly investors that had relied primarily on NRSRO credit ratings in assessing whether to purchase these instruments.[50] This has had a significant impact on the liquidity of the market for these instruments.[51]

In the wake of these events, the NRSROs that rated subprime RMBS and CDOs have come under intense criticism and scrutiny. It has been suggested that changes may be needed to address the conflicts of interest inherent in the process of rating RMBS and

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46 Summary of Global Structured Finance CDO Rating Actions, Fitch, December 14, 2007, p. 1.

47 Id, p. 6.

48 See e.g., Dugan March 4, 2008 Senate Testimony, p. 13.

49 Id; Bair March 4, 2008 Senate Statement, p. 7.

50 Id; Bernanke February 28, 2008 Senate Testimony, p. 3.

51 See e.g., Dugan March 4, 2008 Senate Testimony, p. 13; Bair January 31, 2008 Senate Testimony, pp. 3-4.

CDOs.[52] The NRSROs that have been the primary ratings providers for subprime RMBS and related CDOs each operate under an "issuer-pays" model in which they are paid by the arranger to rate a proposed RMBS or CDO. The arranger has an economic interest in obtaining the highest credit rating possible for each security issued by the trust and the NRSRO has an economic interest in having the arranger select it to rate the next RMBS or CDO brought by the arranger to market. Observers have questioned whether, given the incentives created by this arrangement, the NRSROs are able to issue unbiased ratings, particularly as the volume of deals brought by certain arrangers increased in the mid-2000s.[53] The above concerns are compounded by the arrangers' ability to "ratings shop." Ratings shopping is the process by which an arranger will bring its proposed RMBS and CDO transaction to multiple NRSROs and choose, on a deal-wide or tranche-by-tranche basis, which two (or in some cases one) to use based on the preliminary ratings of the NRSROs.

In addition, the interaction between the NRSRO and the arranger during the RMBS and CDO rating process has raised concerns that the NRSROs are rating products they designed (i.e., evaluating their own work).[54] A corporate issuer is more constrained in how it can adjust in response to an NRSRO to improve its creditworthiness in order to obtain a higher rating. In the context of structured finance products, the arranger has much more flexibility to make adjustments to obtain a desired credit rating by, for

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52 See, e.g., Opening Statement of Senator Richard C. Shelby for the Hearing of the U.S. SenateCommittee on Banking, Housing, and Urban Affairs (September 26, 2007), p. 1-2.

53 See, e.g., Testimony of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (September 26, 2007), pp. 4-5.

54 See, e.g., Opening Statement of Senator Jack Reed for the Hearing of the U.S. Senate Committee on Banking, Housing, and Urban Affairs (September 26, 2007), pp. 1-2.

example, changing the composition of the assets in the pool held by the trust or the subordination levels of the tranche securities issued by the trust. In fact, an arranger frequently will inform the NRSRO of the rating it wishes to obtain for each tranche and will choose an asset pool, trust structure, and credit enhancement levels based on its understanding of the NRSROs' quantitative and qualitative models. The credit analyst will use the expected loss and cash flow models to, in effect, check whether the proposed assets, trust structure and credit enhancement levels are sufficient to support the credit ratings desired by the arranger.

The NRSRO rules adopted by the Commission in June of 2007 preceded the full emergence of the credit market turmoil. The Commission, in light of its experience since the final rules became effective, is proposing amendments to those rules and a new rule with the goal of further enhancing the utility of NRSRO disclosure to investors, strengthening the integrity of the ratings process, and more effectively addressing the potential for conflicts of interest inherent in the ratings process for structured finance products.

II. PROPOSED AMENDMENTS

A. Amendments to Rule 17g-5

The Commission adopted Rule 17g-5, in part, pursuant to authority "to prohibit, or require the management and disclosure of, any conflicts of interest relating to the issuance of credit ratings by an [NRSRO]."[55] The rule identifies a series of conflicts arising from the business of determining credit ratings. Under the rule, some of these

[55] See Section 15E(h)(2) of the Exchange Act (15 U.S.C. 78o-7(h)(2)).

conflicts must be disclosed and managed, while other specified conflicts are prohibited outright.

Paragraph (a) of Rule 17g-5 prohibits an NRSRO from having a conflict identified in paragraph (b) of the rule unless the NRSRO discloses the type of conflict on Form NRSRO and establishes, maintains, and enforces procedures to manage it.[56] Paragraph (b) identifies eight types of conflicts, which include being paid by issuers or underwriters to determine credit ratings with respect to securities or money market instruments they issue or underwrite[57] or being paid by persons for subscriptions to receive or access credit ratings where such persons also may own investments or have entered into transactions that could be favorably or adversely impacted by a credit rating.[58]

Paragraph (c) of Rule 17g-5 prohibits outright four types of conflicts of interest. Consequently, an NRSRO would violate the rule if it has the type of conflict described in paragraph (c) even if it disclosed the conflict and established procedures to manage it. In the Adopting Release, the Commission explained that these conflicts were prohibited because they would be difficult to manage given their potential to cause undue influence.[59]

The Commission is proposing to amend Rule 17g-5 to require the disclosure and establishment of procedures to manage an additional conflict and to prohibit certain other conflicts outright, as described below.

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56 17 CFR 240.17g-5(a).

57 17 CFR 240.17g-5(b)(1).

58 17 CFR 240.17g-5(b)(5).

59 Adopting Release, 72 FR at 33598.

1. Addressing the Particular Conflict Arising from Rating Structured Finance Products by Enhancing the Disclosure of Information Used in the Rating Process

a. The Proposed Amendment

The Commission is proposing to amend Rule 17g-5[60] to add to the list of conflicts that must be disclosed and managed the additional conflict of repeatedly being paid by certain arrangers to rate structured finance products. This conflict is a subset of the broader conflict already identified in paragraph (b)(1) of Rule 17g-5; namely, "being paid by issuers and underwriters to determine credit ratings with respect to securities or money market instruments they issue or underwrite."[61] In the case of structured finance products, the Commission preliminarily believes this "issuer/underwriter-pay" conflict is particularly acute because certain arrangers of structured finance products repeatedly bring ratings business to the NRSROs.[62] As sources of constant deal based revenue, some arrangers have the potential to exert greater undue influence on an NRSRO than, for example, a corporate issuer that may bring far less ratings business to the NRSRO.[63] Consequently, the Commission is proposing amendments to Rule 17g-5 that would require additional measures to address this particular type of "issuer/underwriter-pay" conflict.

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60 17 CFR 240.17g-5.

61 17 CFR 240.17g-5(b)(1). As the Commission noted when adopting Rule 17g-5, the concern with conflict identified in paragraph (b)(1) "is that an NRSRO may be influenced to issue a more favorable credit rating than warranted in order to obtain or retain the business of the issuer or underwriter." Adopting Release, 72 FR at 33595.

62 See e.g., Testimony of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (April 22, 2008) ("Coffee April 22, 2008 Senate Testimony"), pp. 4-6.

63 Id.

Specifically, the proposed amendment would re-designate paragraph (b)(9) of Rule 17g-5 as paragraph (b)(10) and in new paragraph (b)(9) identify the following conflict: issuing or maintaining a credit rating for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction that was paid for by the issuer, sponsor, or underwriter of the security or money market instrument. To address this conflict, proposed new paragraph (a)(3) would require that as a condition to the NRSRO rating a structured finance product the information provided to the NRSRO and used by the NRSRO in determining the credit rating would need to be disclosed through a means designed to provide reasonably broad dissemination of the information.[64] The intent behind this disclosure is to create the opportunity for other NRSROs to use the information to rate the instrument as well. Any resulting "unsolicited ratings" could be used by market participants to evaluate the ratings issued by the NRSRO hired to rate the product and, in turn, potentially expose an NRSRO whose ratings were influenced by the desire to gain favor with the arranger in order to obtain more business.[65]

The proposed amendment would require the disclosure of information provided to an NRSRO by the "issuer, underwriter, sponsor, depositor, or trustee." The Commission preliminarily believes that, taken together, these are the parties that provide all relevant information to the NRSRO to be used in the initial rating and rating monitoring processes. The Commission is not proposing to specify the party – NRSRO, arranger,

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64 This proposed requirement would be in addition to the current requirements of paragraph (a) that an NRSRO disclose the type of conflict of interest in Exhibit 6 to Form NRSRO; and establish, maintain and enforce written policies and procedures to address and manage the conflict of interest. 17 CFR 240 17g-5(a)(1) and (2).

65 As used herein, an "unsolicited rating" is one that is determined without the consent and/or payment of the obligor being rated or issuer, underwriter, or arranger of the securities being rated.

issuer, depositor, or trustee – that would need to disclose the information. It may be that the issuer through the arranger and trustee would be in the best positions to disclose the information. In this case, in contracting with these parties to provide a rating for a structured finance product, the NRSRO could require a representation from them that the necessary information would be disclosed as required by the proposed rule. The Commission notes, however, that the proposed rule does not provide a safe harbor for an NRSRO arising from such a representation. Consequently, an NRSRO would violate the proposed rule if it issued a credit rating for a structured finance product where the information is not disclosed notwithstanding any representations from the arranger.

The goal of this proposed amendment is to promote the effective management of this conflict of interest, increase the transparency of the process for rating structured finance products, and foster competition by making it feasible for more market participants, in particular NRSROs that are not contracted by the arranger to issue a rating but still wish to do so, to perform credit analysis on the instrument and to monitor the instrument's creditworthiness. As noted above, by providing the opportunity for more NRSROs to determine credit ratings for structured finance products, this proposal is designed to increase the number of ratings extant for a given instrument and, in particular, promote the issuance of ratings by NRSROs that are not hired by the arranger. The goal would be to expose an NRSRO that was unduly influenced by the "arranger-pay" conflict into issuing higher than warranted ratings.[66] An ancillary benefit would be

[66] The Commission notes that "unsolicited" ratings could be used to obtain business with arrangers by creating a track record of favorable ratings. The Commission believes the potential to expose such conduct would be equal to that of exposing an NRSRO influenced by the "arranger-pay" conflict insomuch as the paid for ratings (usually at least two) would be consistently lower than the "unsolicited" ratings.

that the proposal could make it easier for users of credit ratings to identify potentially inaccurate credit ratings and incompetent NRSROs. The proposal also is designed to make it more difficult for arrangers to exert influence on the NRSROs that they hire to determine ratings for structured finance products. Specifically, by opening up the rating process to greater scrutiny, the proposal is designed to make it easier for the hired NRSRO to resist pressure from the arranger by increasing the likelihood that any steps taken to inappropriately favor the arranger could be exposed to the market. Further, as noted above, an ancillary benefit of the proposal is that it could operate as a check on inaccuracy and incompetence.

To further these goals, the proposal would require the disclosure of the following information:

- All information provided to the nationally recognized statistical rating organization by the issuer, underwriter, sponsor, depositor, or trustee that is used in determining the initial credit rating for the security or money market instrument, including information about the characteristics of the assets underlying or referenced by the security or money market instrument, and the legal structure of the security or money market instrument;[67]
- All information provided to the nationally recognized statistical rating organization by the issuer, underwriter, sponsor, depositor, or trustee that is used by the nationally recognized statistical rating organization in undertaking credit rating surveillance on the security or money market

[67] See proposed paragraph (a)(3)(i)(A) and (B) of Rule 17g-5.

instrument, including information about the characteristics and performance of the assets underlying or referenced by the security or money market instrument.[68]

For the purposes of the proposed amendment, the Commission would consider only information that is taken into account in generating the credit rating or in performing surveillance to be "used" by the NRSRO in those contexts. This would exclude information about collateral pools (i.e., "loan tapes") provided by the arranger containing a mix of assets that is different than the composition of the final collateral pool upon which the credit rating is based. The proposed rule also would exclude from disclosure most, if not all, communications between the NRSRO and the issuer, underwriter, sponsor, depositor, or trustee to the extent the communications do not contain information necessary for the NRSRO to determine an initial credit rating or perform surveillance on an existing credit rating.

The Commission recognizes that the NRSRO would define the information that it uses for purposes of generating credit ratings and, likely, would obtain representations from the arranger that the information is being disclosed as required under the rule. There is a potential that an NRSRO that uses relatively little information to generate credit ratings would be favored by arrangers to minimize the amount of information subject to the disclosure requirement. The Commission preliminarily believes that there is some degree of standardization as to the information used by NRSROs to rate structured finance products (e.g., loan level information, payment priorities among the issued tranched securities, and legal structure of the issuer). An NRSRO that requires less than the standard level of information would need to convince users of credit ratings,

[68] See proposed paragraph (a)(3)(ii) of Rule 17g-5.

most notably investors, that its ratings process was credible. Otherwise, arrangers ultimately would not use the NRSRO since it would be more difficult to sell the structured finance products if they carried ratings that were not accepted by the marketplace. Nonetheless, the Commission, if this proposal is adopted, intends to monitor whether it results in a significant reduction in the information provided to NRSROs.

The timing and scope of the disclosures of the first set information described above – information used in determining the initial credit rating – would depend on the nature of the offering: public, private, or offshore.[69] In an offering registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.), the information would need to be disclosed on the date the underwriter and the issuer or depositor set the offering price of the securities being rated (the "pricing date").[70] In offerings that are not registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.), the information would need to be disclosed to investors in the offering and entities meeting the definition of "credit rating agency" in Section 3(a)(61) of the Exchange Act (which would include credit rating agencies registered, and not registered, as NRSROs)[71] and on the pricing date and disclosed publicly on the first business day after the transaction closes.

The Commission is proposing the pricing date as the time of the first disclosures because it preliminarily believes that this is the earliest date upon which the asset pool and legal structure of the trust are settled on. Thus, the information that would be

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69 See Sections II.A.1.b.i – iii below for a broader discussion of the scope of the disclosures that would be required under the proposed amendments.

70 See proposed paragraph (a)(3)(i)(A) of Rule 17g-5.

71 15 U.S.C. 78c(a)(61).

disclosed would reflect the actual characteristics of the securities to be issued and not, for example, preliminary assets pools with different compositions of loans. At the same time, the disclosure of the information before the securities are sold is designed to provide the opportunity for other credit rating agencies to use the information to develop "unsolicited ratings" for the tranche securities before they are purchased by investors. To the extent unsolicited ratings are issued, they would provide investors with a greater range of credit assessments and, in particular, assessments from credit rating agencies that are not subject to the "arranger-pay" conflict.

The Commission anticipates that the information that would need to be disclosed (i.e., the information used by the hired NRSRO to determine the initial rating) generally would include the characteristics of the assets in the pool underlying the structured finance product and the legal documentation setting forth the capital structure of the trust, payment priorities with respect to the tranche securities issued by the trust (the waterfall), and all applicable covenants regarding the activities of the trust. For example, for an initial rating for an RMBS, this information generally would include the "loan tape" (frequently a spreadsheet) that identifies each loan in the pool and its characteristics such as type of loan, principal amount, loan-to-value ratio, borrower's FICO score, and geographic location of the property. In addition, the disclosed information also would include a description of the structure of the trust, the credit enhancement levels for the tranche securities to be issued by the trust, and the waterfall cash flow priorities. With respect to the loan pool information, the Commission does not intend that the proposed disclosure would include any personal identifying information on individual borrowers or properties (such as names, phone numbers, addresses or tax identification numbers).

After the disclosure of the information used by the NRSRO to perform the initial rating, the proposed amendment would require the disclosure of information about the underlying assets that is provided to, and used by, the NRSRO to perform any ratings surveillance.[72] The Commission anticipates that generally this information would consist of reports from the trustee describing how the assets in the pool underlying the structured finance product are performing. For an RMBS credit rating, this information likely would include the "trustee report" customarily generated to reflect the performance of the loans constituting the collateral pool. For example, an RMBS trustee may generate reports describing the percentage of loans that are 30, 60, and 90 days in arrears, the percentage that have defaulted, the recovery of principal from defaulted loans, and information regarding any modifications to the loans in the asset pool. The disclosure of this information would allow NRSROs that were not hired to rate the deal, including ones that determined unsolicited initial ratings, to monitor on a continuing basis the creditworthiness of the tranche securities issued by the trust. The proposed amendment provides that this information would need to be disclosed at the time it is provided to the NRSRO. This is designed to put other NRSROs and other interested parties on an equal footing with the NRSRO hired by the arranger insomuch as they would all obtain the information at the same time. Consequently, they all could begin any surveillance processes simultaneously.

The goal of this aspect of the proposal again would be to expose an NRSRO that was allowing business considerations to impact its judgment. For example, in order to maintain favor with a particular arranger, an NRSRO may be reluctant to downgrade a credit rating for a structured finance product to its appropriate category even where a

[72] Proposed paragraph (a)(3)(ii) of Rule 17g-5.

downgrade is implied by its surveillance procedures and methodologies. Increasing the number of credit ratings extant for the instrument, including ratings not paid for by the arranger, would make it more difficult to conceal the fact that a particular NRSRO was being unduly influenced by an arranger as to its surveillance process.

As discussed below, the manner and breadth of the disclosures, including how widely the information could be disseminated, would depend on the nature of the offering for the rated structured finance product: public, private, or offshore. The proposed amendment's requirement that the information be "disclosed through a means designed to provide reasonably broad dissemination" would be interpreted by the Commission to mean in the manner described in sections II.A.1.b.i – iii below that discuss the proposed amendment in the context of public, private, and offshore offerings.

The Commission is proposing these amendments to Rule 17g-5, in part, pursuant to the authority in Section 15E(h)(2) of the Exchange Act.[73] The provisions in this section of the statute provide the Commission with authority to prohibit, or require the management and disclosure of, any potential conflict of interest relating to the issuance of credit ratings by an NRSRO.[74] The Commission preliminarily believes the proposed amendments are necessary and appropriate in the public interest and for the protection of investors because they are designed to address conflicts of interest and improve the quality of credit ratings for structured finance products by: (1) increasing the transparency of the ratings process and thereby making it more apparent when an NRSRO may be allowing business considerations to impair its objectivity and (2) enhancing competition by creating the opportunity for NRSROs that are not hired to rate

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73 15 U.S.C. 78o-7(h)(2).

74 Id.

structured products to nonetheless determine credit ratings and establish track records for rating these products.

The Commission preliminarily believes that it is appropriate to require an NRSRO to address and manage the conflict of interest raised by the NRSRO's recurring relationships with structured finance product arrangers by making the rating process more transparent in terms of the information used to determine the ratings. This would create an opportunity for other NRSROs (including subscriber based NRSROs), unregistered credit rating agencies, and other interested parties to assess the creditworthiness of these products and issue their own credit ratings or credit assessments.[75] Market participants and observers would be able to compare the ratings of the NRSROs hired by the arrangers against the ratings of NRSROs and others not hired by the arrangers. As discussed above, the Commission preliminarily believes that this would enhance the integrity of the ratings process by making it easier for users of credit ratings to compare NRSROs and evaluate whether an NRSRO's objectivity had been compromised by the undue influence of an arranger. It also could make it easier for the NRSROs hired to determine credit ratings for structured finance products to resist pressure from arrangers insomuch as the parties would be aware that the potential for exposing a compromised NRSRO had been increased through the proposed amendment's disclosure requirements.

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission requests comment on the following questions related to the proposal.

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75 As discussed below, for private offerings and offshore offerings, this information would not be disclosed publicly before the offering closes but instead would be provided via a password-protected Internet Web site to credit rating agencies and accredited investors. After the offering closes, the information would be required to be disclosed publicly and, therefore, made available to market observers such as academics.

- Would the information proposed to be required to be disclosed sufficient to permit the determination of an unsolicited credit rating? Conversely, would the proposed amendment require the disclosure of more information than would be necessary to permit the determination of an unsolicited credit rating? Commenters believing more information should be disclosed should specifically describe the additional information and the practicality of requiring its disclosure, while commenters believing that less information should be disclosed should specifically describe what information would be unnecessary and explain why it would be unnecessary to disclose.
- The proposed amendment would require the disclosure of information provided to an NRSRO by the "issuer, underwriter, sponsor, depositor, or trustee" based on the Commission's preliminary belief that these would be the parties relevant to an NRSRO's performance of the ratings process, i.e., that taken together, these are the parties that would provide all relevant information to the NRSRO. Are there other entities that should be included in this category?
- Should the Commission provide a "safe harbor" so that an NRSRO that obtained a representation from one or more parties to a transaction to disclose the required information would not be held in violation of the rule if the party did not fulfill its disclosure obligations under the representation?

- Should the Commission also require the disclosure of information about the steps, if any, that were taken by the NRSRO, issuer, underwriter, sponsor, depositor, or trustee to verify information about the assets underlying or referenced by the security or money market instrument, or, if no such steps were taken, a disclosure of that fact?
- Would the disclosure of the initial information on the pricing date provide enough time for other NRSROs to determine unsolicited ratings before the securities were sold to investors? If not, would it be appropriate to require that this information be disclosed prior to the pricing date? Alternatively, would it be more appropriate to require NRSROs hired by the arranger to wait a period of calendar or business days (e.g., 2, 4, 10 days) after the asset pool is settled upon by the arranger before issuing the initial credit rating in order to provide other NRSROs with sufficient time to determine an unsolicited rating?
- Should the Commission also require the disclosure of the results of any steps taken by the NRSRO, issuer, underwriter, sponsor, depositor, or trustee to verify information about the assets underlying or referenced by a structured finance product? Alternatively, should the Commission require a general disclosure of whether any steps were taken to verify the information and, if so, a description of those steps?
- Do NRSROs obtain information about the underlying assets of structured products – particularly in the surveillance process – from third-parties such as vendors rather than from issuers, underwriters,

sponsors, or trustees? If so, would it be necessary to require the disclosure of this information as proposed or can the goals of the proposed amendments in promoting unsolicited ratings be achieved under current practices insomuch as the information necessary for surveillance can be obtained from third-party vendors, albeit for a fee?

- Does the information provided to NRSROs by issuers, underwriters, sponsors, depositors, or trustees about assets underlying structured products (e.g., mortgage loans, home equity loans, consumer loans, credit card receivables) commonly include personal identifying information about individuals such as names, social security numbers, addresses, and telephone numbers? If so, are there practical ways to ensure that this information is not disclosed?
- Does any of the information provided to NRSROs by issuers, underwriters, sponsors, depositors, or trustees about assets underlying structured products contain proprietary information? Commenters that believe this is the case should specifically identify any such information.

b. Proposed Guidance for Compliance with Provisions of the Securities Act of 1933

As noted above, the proposed amendments to Rule 17g-5 that would require the disclosure of information about the underlying assets of a structured finance product implicate the Securities Act.[76] As explained below, the means by which information would be disclosed for the purposes of the proposed amendments to Rule 17g-5 would be

[76] 15 U.S.C. 77a et seq.

governed by the nature of the offering. The Securities Act restricts the types of offering communications that issuers or other parties subject to the Securities Act's provisions (such as underwriters) may use during a registered public offering and, for private offerings, restricts the methods by which communications may be made so as to avoid general solicitation or general advertising of the private offering to potential purchasers. Communications that may be considered offers[77] are subject to these restrictions.[78] Likewise, with respect to unregistered offshore offerings that are intended to comply with the safe harbor provisions of Regulation S, communications that are deemed to be offers in the United States or directed selling efforts in the United States are prohibited. Information about securities that are the subject of an offering that has been provided to NRSROs and is required to be disclosed pursuant to the proposed rules would be considered offers or directed selling efforts and therefore subject to these restrictions relating to offering communications.[79]

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77 Securities Act Section 2(a)(3) (15 U.S.C. 77b(a)(3)) defines an "offer" as any attempt to offer to dispose of, or solicitation of any offer to buy, a security or interest in a security for value. The term "offer" has been interpreted broadly and goes beyond the common law concept of an offer. See Diskin v. Lomasney & Co., 452 F. 2d 871 (2d Cir. 1971); SEC v. Cavanaugh, 1 F. Supp. 2d 337 (S.D.N.Y. 1998). The Commission has explained that "the publication of information and publicity efforts, made in advance of a proposed financing which have the effect of conditioning the public mind or arousing public interest in the issuer in its securities constitutes an offer * * *." Guidelines for the Release of Information by Issuers Whose Securities are in Registration, Securities Act Release No. 5180 (August 16, 1971), 36 FR 16506.

78 Before the registration statement is filed, all offers, in whatever form, are prohibited. See Securities Act Section 5(c) (15 U.S.C. 77e(c)). Between the filing of the registration statement and its effectiveness, offers made in writing (including by e-mail or Internet), by radio, or by television are limited to a "statutory prospectus" that conforms to the information requirements of Securities Act Section 10. See Securities Act Section 5(b)(1) (15 U.S.C. 77e(b)(1)) and Securities Act Section 10 (15 U.S.C. 77j). After the registration statement is declared effective, offering participants may make written offers only through a statutory prospectus, except that they may use additional offering materials if a final prospectus that meets the requirements of Securities Act Section 10(a) is sent or given prior to or with those materials. See Securities Act Section 2(a)(10) (15 U.S.C. 77b(a)(10)) and Section 5(b)(1).

79 This may be the case even if the information relates to pools backing prior issuances. In an offering of securities backed by the same class of assets, the information provided for surveillance

In the following three sections, the Commission provides guidance on how the information that would be required to be disclosed under proposed new paragraph (a)(3) of Rule 17g-5 ("Paragraph (a)(3) Information") would need to be disclosed under the proposed amendment and consistent with the Securities Act. As discussed below, the manner and breadth of the disclosures under the proposed amendment would depend on whether the structured finance product was issued under a public, private, or offshore offering.

i. Public Offerings

With respect to registered offerings at the time the Paragraph (a)(3) Information would be required to be disclosed (the pricing date), the information would be written communications and the issuer, underwriter, or other offering participant also would have to comply with the Securities Act with regard to the disclosure of such written communications.[80] In addition, such written communications would be subject to the civil liability and antifraud provisions of the Securities Act.[81]

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and required to be disclosed pursuant to proposed Rule 17g-5(a)(3)(iii) may be static pool data as described in Item 1105 of Regulation AB (17 CFR 229.1105).

80 See Securities Offering Reform, Securities Act Release 33-8591 (July 19, 2005), 70 FR 44722 (August 3, 2005) (the "Securities Offering Reform Release") for a discussion of the definition of written communications and rules relating to permitted communications in registered offerings. See also Asset-Backed Securities, Securities Act Release No. 8518 (December 22, 2004) 70 FR 1506 (January 7, 2005) (the "Asset-Backed Securities Release") for rules applicable to offerings of asset-backed securities.

81 Under the Securities Act, purchasers of an issuer's securities in a registered offering have private rights of action for materially deficient disclosure in registration statements under Section 11 and in prospectuses and oral communications under Section 12(a)(2). Under Securities Act Section 12(a)(2) and Securities Act Rule 159, the liability determination as to an oral communication, prospectus, or statement, as the case may be, does not take into account information conveyed to a purchaser only after the time of sale (including the contract of sale), including information contained in a final prospectus, prospectus supplement, or Exchange Act filing that is filed or delivered subsequent to the time of sale (including the contract of sale) where the information is not otherwise conveyed at or prior to that time. The time of sale under the Securities Act includes the time of the contract of sale – the time at which an investor has taken the action the investor

As discussed in the Commission's Securities Offering Reform Release adopting several reforms to the securities offering process,[82] issuers of structured finance products have potentially two sets of rules under the Securities Act on which they may rely in using written offering materials. If the offering is registered on Securities Act Form S-3,[83] then the written materials may constitute ABS informational and computational materials, as defined in Item 1101 of Regulation AB,[84] and should be filed on Exchange

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must take to become committed to purchase the securities and therefore entered into a contract of sale.

82 See Section III.D.3.b.iii(C)(3)(a)(iii) of the Securities Offering Reform Release, 70 FR at 44722, 44751.

83 17 CFR 239.13. An ABS issuer is eligible to use Form S-3 if the conditions of General Instruction V are met.

84 17 CFR 229.1101. Item 1101 of Regulation AB provides the following definition:
(a) ABS informational and computational material means a written communication consisting solely of one or some combination of the following:

(1) Factual information regarding the asset-backed securities being offered and the structure and basic parameters of the securities, such as the number of classes, seniority, payment priorities, terms of payment, the tax, Employment Retirement Income Security Act of 1974, as amended, (29 U.S.C. 1001 et seq.) ("ERISA") or other legal conclusions of counsel, and descriptive information relating to each class (*e.g.*, principal amount, coupon, minimum denomination, anticipated price, yield, weighted average life, credit enhancements, anticipated ratings, and other similar information relating to the proposed structure of the offering);

(2) Factual information regarding the pool assets underlying the asset-backed securities, including origination, acquisition and pool selection criteria, information regarding any prefunding or revolving period applicable to the offering, information regarding significant obligors, data regarding the contractual and related characteristics of the underlying pool assets (*e.g.*, weighted average coupon, weighted average maturity, delinquency and loss information and geographic distribution) and other factual information concerning the parameters of the asset pool appropriate to the nature of the underlying assets, such as the type of assets comprising the pool and the programs under which the loans were originated;

(3) Identification of key parties to the transaction, such as servicers, trustees, depositors, sponsors, originators and providers of credit enhancement or other support, including a brief description of each such party's roles, responsibilities, background and experience;

(4) Static pool data, as referenced in Item 1105 of this Regulation AB, such as for the sponsor's and/or servicer's portfolio, prior transactions or the asset pool itself;

(5) Statistical information displaying for a particular class of asset-backed securities the yield, average life, expected maturity, interest rate sensitivity, cash flow characteristics, total rate of return, option adjusted spread or other financial or statistical information relating to the class or classes under specified prepayment, interest rate, loss or other hypothetical scenarios. Examples of such information under the definition include:

Act Form 8-K[85] in accordance with Rules 167 and 426 of the Securities Act.[86] The written materials may constitute a free writing prospectus, as defined in Rule 405 of the Securities Act.[87] In that case, the information that is disclosed must be filed in accordance with Rules 164 and 433 of the Securities Act.[88] Given that the Paragraph (a)(3) Information could constitute offering materials, the Commission believes it is important to explain how the rules under the Securities Act may be relied upon when Paragraph (a)(3) Information is made publicly available.[89]

(i) Statistical results of interest rate sensitivity analyses regarding the impact on yield or other financial characteristics of a class of securities from changes in interest rates at one or more assumed prepayment speeds;
(ii) Statistical information showing the cash flows that would be associated with a particular class of asset-backed securities at a specified prepayment speed; and
(iii) Statistical information reflecting the financial impact of losses based on a variety of loss or default experience, prepayment, interest rate and related assumptions.

(6) The names of underwriters participating in the offering of the securities, and their additional roles, if any, within the underwriting syndicate;
(7) The anticipated schedule for the offering (including the approximate date upon which the proposed sale to the public will begin) and a description of marketing events (including the dates, times, locations, and procedures for attending or otherwise accessing them); and
(8) A description of the procedures by which the underwriters will conduct the offering and the procedures for transactions in connection with the offering with an underwriter or participating dealer (including procedures regarding account-opening and submitting indications of interest and conditional offers to buy). The Commission confirmed in the Asset-Backed Securities Release that loan level information could be included in ABS information and computational materials.

85 17 CFR 249.308.

86 17 CFR 230.167 and 17 CFR 230.426.

87 17 CFR 230.405. The contents of free writing prospectuses are not limited to ABS informational and computational materials.

88 17 CFR 230.164 and 17 CFR 230.433. Rule 433 also provides that a free writing prospectus or portion thereof required to be filed under Rule 433 containing only ABS informational and computational materials may be filed under Rule 433 but within the time frame required for satisfaction of the conditions of Rule 426, and that such filing will satisfy the conditions of Rule 433.

89 Depending on whether the materials constitute a free writing prospectus or ABS informational and computational materials, the liability provisions governing the disclosure may differ. Free writing prospectuses are subject to liability under Section 12(a)(2) and Section 17(a) of the Securities Act. 15 U.S.C. 77l(a)(2) and 15 U.S.C. 77q(a). A free writing prospectus will not be part of a

Most elements of the Paragraph (a)(3) Information would need to be filed in accordance with the rules governing free writing prospectuses or ABS informational and computational materials pursuant to Rules 433 and 426.[90] Currently, the timing or filing requirements under these rules is tied to when the information is provided to specific investors. However, unlike other free writing prospectuses and ABS informational and computational materials that may be provided to specific investors, in a public offering, the Paragraph (a)(3) Information would be required to be disclosed publicly. Therefore, the Commission believes that it is appropriate to clarify when the materials should be filed with the Commission.

Under Rule 426, ABS informational and computational materials are required to be filed by the later of the due date for filing the final prospectus under Rule 424(b) or two days after the date of first use. Under Rule 433, a free writing prospectus must be filed with the Commission no later than the date of first use. However, in order to conform certain asset-backed free writing prospectuses with the filing requirements for ABS informational and computational materials in Rule 426, Rule 433(d)(6) provides that a free writing prospectus containing only ABS information and computational materials may be filed in the time provided by Rule 426(b). Thus, under both rules the information must be filed by the later of the due date for filing the final prospectus under Rule 424(b) or two days after the date of first use.

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registration statement subject to liability under Securities Act Section 11 unless the issuer elects to file it as part of the registration statement. See also Asset-Backed Securities Release at footnote 335. On the other hand, ABS informational and computational materials also are subject to Section 12(a)(2) and Section 17(a) liability, but they must be filed on Form 8-K and therefore, by virtue of incorporation by reference into a registration statement, are subject to Section 11 liability.

90 17 CFR 230.433 and 17 CFR 230.426.

In addition, Rule 433 requires filing by issuers of free writing prospectuses prepared by or on behalf of, or used or referred to by, issuers or, depositors, sponsors, servicers, or affiliated depositors, whether or not the issuer, but not by underwriters or dealers, unless they contain issuer information or are distributed in a manner reasonably designed to lead to its broad dissemination. The Paragraph (a)(3) Information that would be required to be disclosed would not be considered underwriter or dealer information, even if prepared by the underwriter or dealer, given the broad dissemination and thus would need to be filed.

Rules 164 and 167 provide the exemption from Section 5(b)(1) of the Securities Act for the use of free writing prospectuses and ABS informational and computational materials, respectively. For the most part, Rule 164 should be available for the use of the Paragraph (a)(3) Information, even where the issuer is an ineligible issuer,[91] given that the rule provides that ineligible issuers that are asset-backed issuers may use a free writing prospectus as long as the free writing prospectus contains only specified information.[92] Much of the Paragraph (a)(3) Information should contain information that

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91 An "ineligible issuer," as the term is defined in Rule 405 of the Securities Act, includes, in the case of asset-backed issuers, the depositor or any issuing entities previously established, directly or indirectly by the depositor, who are not current in their Exchange Act reports and other materials required to be filed during the prior 12 months (or such shorter period that the issuer was required to file such reports and materials), other than reports on Form 8-K required solely pursuant to an item specified in General Instruction I.A.4 of Form S-3.

92 In asset-backed offerings by ineligible issuers, free writing prospectuses used by ineligible issuers are limited to the following information:
(1) factual information regarding the asset-backed securities being offered and the structure and basic parameters of the securities, such as the number of classes, seniority, payment priorities, terms of payment, the tax, ERISA or other legal conclusions of counsel, and descriptive information relating to each class (e.g., principal amount, coupon, minimum denomination, anticipated price, yield, weighted average life, credit enhancements, anticipated ratings, and other similar information relating to the proposed structure of the offering);
(2) factual information regarding the pool assets underlying the asset-backed securities, including origination, acquisition and pool selection criteria, information regarding any prefunding or revolving period applicable to the offering, information regarding significant obligors, data regarding the contractual

can be included in a free writing prospectus used by an asset-backed issuer pursuant to Rule 164. To the extent that Rule 167 is not available because the offering is registered on Form S-1 rather than Form S-3, and Rule 164 is not available, the information should be filed in an amendment to the registration statement.

In addition, the Commission understands that currently at least some of the information that would constitute Paragraph (a)(3) Information, if not included in a free writing prospectus, is often included as a schedule to pooling and servicing agreements. Those agreements, along with their schedules and exhibits, should be filed by the time of the offering of securities. Therefore they should be filed at the time of the takedown as exhibits to a Form 8-K incorporating them by reference into the Form S-3 registration statement.[93]

The Commission generally requests comment on all aspects of this proposed guidance. In addition, the Commission requests comment on the following questions related to the proposal.

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and related characteristics of the underlying pool assets (e.g., weighted average coupon, weighted average maturity, delinquency and loss information and geographic distribution) and other factual information concerning the parameters of the asset pool appropriate to the nature of the underlying assets, such as the type of assets comprising the pool and the programs under which the loans were originated;
(3) identification of key parties to the transaction, such as servicers, trustees, depositors, sponsors, originators and providers of credit enhancement or other support, including a brief description of each such party's roles, responsibilities, background and experience;
(4) static pool data;
(5) the names of underwriters participating in the offering of the securities, and their additional roles, if any, within the underwriting syndicate;
(6) the anticipated schedule for the offering (including the approximate date upon which the proposed sale to the public will begin) and a description of marketing events (including the dates, times, locations, and procedures for attending or otherwise accessing them); and
(7) a description of the procedures by which the underwriters will conduct the offering and the procedures for transactions in connection with the offering with an underwriter or participating dealer (including procedures regarding account opening and submitting indications of interest and conditional offers to buy).

93 See Form S-3 (17 CFR 239.13), Form 8-K (17 CFR 249.308) and Item 601(b)(4) of Regulation S-K (17 CFR 229.601).

- Do we need to give more guidance on the relationship between the proposed disclosure requirements regarding information about the underlying assets provided to, and used by, the NRSRO to perform ratings surveillance and the requirements of Regulation FD?[94] If commenters believe that the proposed requirements are not consistent with Regulation FD, they should provide a detailed explanation as to why not.
- The proposed disclosure requirements regarding information about the underlying assets provided to, and used by, the NRSRO to perform ratings surveillance may be the same as the information required to be disclosed on Form 10-D for so long as the issuer has an Exchange Act reporting obligation. Given that the Form 10-D reporting obligation is typically suspended for most asset-backed issuers after the first year of reporting, does the proposed disclosure requirement raise any issues regarding Exchange Act reporting?
- ABS informational and computation materials, as defined in Item 1101 of Regulation AB, can include, among other things, factual information regarding the pool assets underlying the asset-backed securities, including origination, acquisition and pool selection criteria, information regarding any prefunding or revolving period applicable to the offering, information regarding significant obligors, data regarding the contractual and related characteristics of the underlying pool assets

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94 17 CFR 243.100 to 103.

(e.g., weighted average coupon, weighted average maturity, delinquency and loss information and geographic distribution) and other factual information concerning the parameters of the asset pool appropriate to the nature of the underlying assets, such as the type of assets comprising the pool and the programs under which the loans were originated.[95] As noted above, the Commission believes that at least some of the proposed Paragraph (a)(3) Information could fall within this category and therefore constitute ABS informational and computational materials. Since there may be a wide variety of information that is provided to an NRSRO, it is not clear that all information provided would fit within the definition of ABS informational and computation materials, or in the various categories of free writing prospectus. Should the Commission provide additional interpretation regarding what types of material that could be provided and would be required to be disclosed to fit within this category? Is there information that is likely to be provided and disclosed that does not appear to fit within these definitions? Should the Commission instead revise the definitions to specifically include the information required to be disclosed?

- Is there any need for the Commission to revise Securities Act Rules 426 or 433 to clarify when the materials need to be filed?
- Are there any additional requirements in Regulation AB or under the Securities Act that are implicated by the proposed amendments? Is

95 See Asset-Backed Securities Release.

there any information that would typically need to be disclosed under this proposed amendment that is not already generally disclosed in filings with the Commission?

- Should the Commission amend Regulation AB to require that the Paragraph (a)(3) Information be disclosed?

ii. Private Offerings

The proposed amendments also would implicate the Securities Act restrictions affecting private offerings. Offerings of securities made in reliance on an exemption from registration contained in Securities Act Section 4(2),[96] the rules promulgated thereunder or pursuant to Regulation D,[97] are offerings that are not made to the public. As a result, general solicitation or advertising is prohibited in these offerings under Securities Act Section 4(2) and the applicable Securities Act rules.[98] As a result of the application of the general solicitation and advertising restrictions, public disclosure of offering or security information pursuant to the proposed rules could cause the private offering exemptions to be unavailable to securities offerings to which the proposed rules apply.

As discussed above, the Commission believes it is likely that much of the information that would need to be disclosed under the proposed amendment would

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96 15 U.S.C. 77d(2).

97 17 CFR 230.501 through 230.508.

98 See Securities Act Section 4(2) (15 U.S.C. 77d(2)) and Securities Act Rules 504, 505 and 506 of Regulation D (17 CFR 230.504, 230.505 and 230.506). An exception to the prohibition against general solicitation applies to some limited offerings under Rule 504(b)(1) (17 CFR 230.504(b)(1)) when an issuer has satisfied state securities laws of specified types. See Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 7644 (February 25, 1999), 64 FR 11090. The restriction on general solicitation or advertising applies to all methods by which the communication can be made, including electronic, paper, mail, radio, television, or in newspapers or magazines.

contain extensive loan level data, and thus anticipates that a common medium for disclosure of this information would be an Internet Web site. The Commission has indicated that the placement of private offering materials on an Internet Web site, without sufficient procedures to limit access only to accredited investors, is inconsistent with the prohibition against general solicitation or advertising in Securities Act Rule 502(c).[99] However, as discussed above, the Commission also believes that to address the conflict of interest inherent in the structured finance product arranger-pay business model it would be beneficial to make this information available to investors and entities meeting the definition of "credit rating agency" in Section 3(a)(61) of the Exchange Act (which would include NRSROs)[100] on the date the placement agent and the issuer or depositor set the offering price of the securities being rated, and to the general public on the first business day after the offering closes.

The Commission believes, therefore, that in a private offering, Paragraph (a)(3) Information would need to be provided to investors, NRSROs, and credit rating agencies by posting the information on a password-protected Internet Web site.[101] On the first business day after the offering closes, however, the Paragraph (a)(3) Information would need to be disclosed publicly. The Commission believes that removing the password protection from the Internet Web site where the Paragraph (a)(3) Information is posted

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99 See Use of Electronic Media, Securities Act Release No. 7856 (April 28, 2000), 65 FR 25843 (the "Electronic Media Release"). The Commission noted in the Electronic Media Release that the federal securities laws apply equally to information contained on an issuer's Web site as they do to other communications made by or attributed to the issuer.

100 15 U.S.C. 78c(a)(61).

101 A password-protected Web site would meet the requirements of an amended Rule 17g-5 in the context of private offerings.

after the offering closes is consistent with the Securities Act restrictions on private offerings while satisfying the requirements of proposed Rule 17g-5(a)(3).

As discussed above, the Commission believes it would be appropriate to allow early access to credit rating agencies other than those hired to issue a rating to provide them with an opportunity to perform independent assessments of the validity of ratings and identify flaws, opportunities for improvement, or compromised procedures in the hired NRSRO's approach. While permitting access to this information to credit rating agencies in addition to accredited investors extends beyond the Commission's previous interpretations on what constitutes a general solicitation or advertising, the Commission believes it balances those issues with the benefits of having other credit rating agencies able to assess the quality of, or provide additional, ratings.[102] This approach is designed to promote competition among NRSROs by providing credit ratings agencies that were not paid by the issuer to rate the issuer's products with information they need to issue unsolicited ratings and allowing other market participants to also have access to the information to allow them to evaluate the ratings. In a private offering, disclosure of this information is undertaken in two steps in order to avoid issues of general solicitation. The Commission is providing the above guidance only in the context of the proposed amendments. Moreover, the guidance expressed in this release is applicable only if the proposed amendments are adopted.

The Commission generally requests comment on all aspects of this proposed guidance. In addition, the Commission requests comment on the following questions related to the proposal.

[102] The Commission noted in Interpretative Release on Regulation D, Securities Act Release No. 6455 (March 3, 1983), 17 CFR 231, that Rule 502(c) relates to the nature of the offering, not the nature of the offerees.

- Are there other parties besides credit rating agencies and investors that should be eligible to access Paragraph (a)(3) Information in the context of a private offering without raising issues of general solicitation?
- Should any of the foregoing guidance regarding the use of Paragraph (a)(3) Information be codified?
- Is expanding the categories of parties who can access the information that would be contained in the proposed Paragraph (a)(3) Information consistent with the purposes of the Securities Act?
- Is there any Paragraph (a)(3) Information that should remain accessible only to credit rating agencies and investors, rather than, as proposed, disclosed to the public on the business day after the offering has closed?
- Should the requirement to publicly disclose the Paragraph (a)(3) Information on the first business day after the offering has closed also permit the NRSRO, depositor, etc. to omit deal-specific information relating to the transaction such that only "generic" information is provided to the public?
- Does disclosure of information provided for purposes of credit rating surveillance raise issues of general solicitation in the context of subsequent offerings of the same asset class? If so, does this vary by asset class?

iii. Offshore Offerings

Similar to private offerings, the proposed amendments would implicate restrictions under Regulation S. Under the General Statement of Regulation S,[103] the provisions of Section 5 of the Securities Act apply to offers and sales of securities that occur in the United States and do not apply to those that occur outside the United States. Regulation S contains various safe harbor procedures that issuers, offering participants and others can follow for unregistered offerings outside the United States. These procedures include restrictions against offers being made to persons in the United States[104] and restrictions against directed selling efforts in the United States by the issuer, distributor, any of their respective affiliates, or persons acting on their behalf.[105]

As noted above, the Commission believes that it is likely that much of the information that would be required to be disclosed would contain extensive loan level data and thus anticipates that a common medium for disclosure of this information would be an Internet Web site. The Commission has provided guidance with respect to the use of Internet Web sites for securities offerings outside the United States.[106] This guidance sets out a general approach that when adequate measures are implemented to prevent U.S. persons from participating in an offshore offer, the Commission would not view the offer as occurring in the United States for registration purposes. The Commission believes that this guidance can be equally applied to the proposed disclosure of the proposed Paragraph (a)(3) Information.

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103 Rule 901 of Regulation S, 17 CFR 230.901.

104 Rule 903(a)(1).

105 Rule 903(a)(2).

106 See Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore, Securities Act Release No. 7516 (March 23, 1998).

Under this guidance, what constitutes adequate measures would depend on all of the facts and circumstances of a particular transaction. As the Commission noted previously:

> "We generally would not consider an offshore Internet offer made by a non-U.S. offeror as targeted at the United States, however, if: (1) the Web site contains a prominent disclaimer making it clear that the offer is directed only to countries other than the United States; . . . and (2) the Web site offeror implements procedures that are reasonably designed to guard against sales to U.S. persons in the offshore offering."[107]

These procedures are not exclusive.

The Commission's prior guidance distinguishes among foreign issuers and U.S. issuers each conducting offshore offerings under Regulation S and U.S. offerings conducted on an exempt basis. The Commission believes it is appropriate to continue this treatment with respect to the proposed disclosure of the Paragraph (a)(3) Information. Under this guidance, a foreign issuer making an offshore offering with no concurrent U.S. private offering is not required to password-protect Internet-based offering communications so long as adequate measures are put in place. Thus, credit rating agencies and other market participants should be able to have ready access to any Paragraph (a)(3) Information that is posted by a foreign issuer. A foreign issuer making an offshore offering concurrently with private offerings in the United States could implement additional other procedures to prevent its offshore Internet communications from being used to solicit participants for its U.S.-based exempt offering, and U.S. issuers conducting an offshore offering should implement procedures similar to those for private placements, such as password-type procedures, under which only non-U.S. persons can obtain access to the materials. Consistent with the procedures for private offerings, there

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107 Id.

could be pricing date disclosure to credit rating agencies that are not purchasers in the offering through a password-protected Internet Web site. As a result, when a foreign issuer is conducting a U.S. private offering under Section 4(2), and when a U.S. issuer is conducting an offshore offering under Regulation S or a private offering under Section 4(2), it would follow the procedures outlined in Section II.A.1.b.ii above with respect to private offerings, including procedures calling for public disclosure of Paragraph (a)(3) Information on the business day after the closing date.

The Commission generally requests comment on all aspects of this proposed guidance. In addition, the Commission requests comment on the following questions related to the proposal.

- Are there other parties besides credit rating agencies that should be eligible to access Paragraph (a)(3) Information in the context of an offshore offering without raising issues of directed selling efforts or offers of securities in the Unites States?
- Should any of the foregoing guidance regarding the use of Paragraph (a)(3) Information be codified?
- Is expanding the categories of parties who can access the information that would be contained in the proposed Paragraph (a)(3) Information consistent with the purposes of the Securities Act?
- Is there any Paragraph (a)(3) Information that should remain accessible only to credit rating agencies and investors, rather than, as proposed, be disclosed to the public on the business day after the offering has closed?

- Should the requirement to publicly disclose the Paragraph (a)(3) Information on the first business day after the offering has closed also permit the NRSRO, depositor, etc. to omit deal-specific information relating to the transaction such that only "generic" information is provided to the public?

2. Rule 17g-5 Prohibition on Conflict of Interest Related to Rating an Obligor or Debt Security where Obligor or Issuer Received Ratings Recommendations from the NRSRO or Person Associated with the NRSRO

The Commission is proposing to amend Rule 17g-5(c) to add a new paragraph (5) that would prohibit an NRSRO from issuing a credit rating with respect to an obligor or security where the NRSRO or a person associated with the NRSRO, as defined in Section 3(a)(63) of the Exchange Act,[108] made recommendations to the obligor or the issuer, underwriter, or sponsor of the security (that is, the parties responsible for structuring the security) about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security. This proposal would prohibit the NRSRO and, in particular, its credit analysts from making recommendations to obligors, issuers, underwriters, and sponsors such as arrangers of structured finance products about how to obtain a desired credit rating during the rating process. It also would prohibit an NRSRO from issuing a credit rating where a person associated with the NRSRO, such as an affiliate, made such recommendations.

The Commission is proposing this amendment to Rule 17g-5, in part, pursuant to the authority in Section 15E(h)(2) of the Exchange Act.[109] The provisions of this section

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108 15 U.S.C. 78c(a)(63).

109 15 U.S.C. 78o-7(h)(2).

of the statute provide the Commission with authority to prohibit, or require the management and disclosure of, any potential conflict of interest relating to the issuance of credit ratings by an NRSRO.[110] The Commission preliminarily believes the proposed amendment is necessary and appropriate in the public interest and for the protection of investors because it would address a potential practice that could impair the objectivity, and, correspondingly, the quality, of a credit rating. It has been suggested that during the process of rating structured finance products the NRSROs have recommended to arrangers how to structure a trust or complete an asset pool to receive a desired credit rating and then rated the securities issued by the trust – in effect, rating their own work.[111] This proposal would prohibit this conduct based on the Commission's preliminary belief that it creates a conflict that cannot be effectively managed insomuch as it would be very difficult for an NRSRO to remain objective when assessing the creditworthiness of an obligor or debt security where the NRSRO or person associated with the NRSRO made recommendations about steps the obligor or issuer of the security could take to obtain a desired credit rating.

The proposal is not intended to prohibit all interaction between the NRSRO and the obligor, issuer, underwriter, or sponsor during the rating process. The Commission preliminarily believes that the transparency of an NRSRO's procedures and methodologies for determining credit ratings is enhanced when the NRSRO explains to obligors and issuers the bases, assumptions, and rationales behind rating decisions. For example, the Commission understands that in the structured finance area, NRSROs may

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110 Id.

111 See e.g., Coffee April 22, 2008 Senate Testimony, pp. 2-3.

provide information to arrangers about the output of expected loss and cash flow models. The information provided by the NRSRO during the rating process allows the arranger to better understand the relationship between model outputs and the NRSRO's decisions with respect to necessary credit enhancement levels to support a particular rating. The arranger then can consider the feedback and determine independently the steps it will take, if any, to adjust the structure, credit enhancement levels, or asset pool. However, if the feedback process turns into recommendations by the NRSRO about changes the arranger could make to the structure or asset pool that would result in a desired credit rating, the NRSRO's role would transition from an objective credit analyst to subjective consultant. In this case, the Commission believes it would be difficult for the NRSRO to remain impartial since the expectation would be that the changes suggested by the NRSRO would result in the credit ratings sought by the arranger.

The prohibition would extend to recommendations by persons associated with the NRSRO to address affiliates. For example, an NRSRO's holding company could establish an affiliate to provide consulting services to issuers about how to obtain desired credit ratings from the NRSRO subsidiary. The Commission believes it would be difficult for the NRSRO to remain objective in this situation since the financial success of the affiliate would depend on issuers getting the ratings they desired after taking any steps recommended by the affiliate. This would create undue pressure on the NRSRO's credit analysts to determine credit ratings that favored the affiliate.

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission requests comment on the following questions related to the proposal.

- Is this type of conflict one that could be addressed through disclosure and procedures to manage it instead of prohibiting it? Should the Commission, rather than prohibiting it, add this type of conflict to the list of conflicts in paragraph (b) of Rule 17g-5, which, under paragraph (a) of the rule, must be addressed through disclosure and procedures to manage them?
- Would there be practical difficulties for an NRSRO that is part of a large conglomerate in monitoring the business activities of persons associated with the NRSRO such as affiliates located in other countries to comply with the proposed requirement? If so, given the greater separation between the NRSRO and these types of persons associated with the NRSRO, should the Commission require instead that, for these types of persons associated with the NRSRO only, the NRSRO disclose this conflict and manage it through information barriers rather than prohibit it?
- The Commission recognizes that the line between providing feedback during the rating process and making recommendations about how to obtain a desired rating may be hard to draw in some cases. Consequently, should the Commission specify the type of interactions between an NRSRO and the person seeking the rating that would and would not constitute recommendations for the purposes of this rule? Commenters that believe the Commission should provide more guidance on this issue should provide suggested definitions.

3. Rule 17g-5 Prohibition on Conflict of Interest Related to the Participation of Certain Personnel in Fee Discussions

The Commission is proposing to amend Rule 17g-5[112] by adding a new paragraph (c)(6) of Rule 17g-5 to address the conflict of interest that arises when a fee paid for a rating is discussed or arranged by a person within the NRSRO who has responsibility for participating in determining credit ratings (including analysts and rating committee members) or for developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models.

The Commission is proposing this amendment to Rule 17g-5, in part, pursuant to the authority in Section 15E(h)(2) of the Exchange Act.[113] The provisions of this section of the statute provide the Commission with authority to prohibit, or require the management and disclosure of, any potential conflict of interest relating to the issuance of credit ratings by an NRSRO.[114] The Commission preliminarily believes the proposed amendment is necessary and appropriate in the public interest or for the protection of investors because it would address a potential practice that could impair the objectivity, and, correspondingly, the quality, of a credit rating. This amendment is designed to effectuate the separation within the NRSRO of persons involved in fee discussions from persons involved in the credit rating analytical process. While the incentives of the persons discussing fees could be based primarily on generating revenues for the NRSRO; the incentives of the persons involved in the analytical process should be based on determining accurate credit ratings. There is a significant potential for these distinct

112 17 CFR 240.17g-5.

113 15 U.S.C. 78o-7(h)(2).

114 Id.

incentive structures to conflict with one another where persons within the NRSRO are engaged in both activities.

The potential consequences are that a credit analyst or person responsible for approving credit ratings or credit rating methodologies could, in the context of negotiating fees, let business considerations undermine the objectivity of rating process. For example, an individual involved in a fee negotiation with an issuer might not be impartial when it comes to rating the issuer's securities. In addition, persons involved in approving the methodologies and processes used to determine credit ratings could be reluctant to adjust a model to make it more conservative if doing so would make it more difficult to negotiate fees with issuers. For these reasons, the Commission preliminarily believes that this conflict should be prohibited.

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission requests comment on the following items related to the proposal.

- Should the proposed prohibition also be extended to cover participation in fee negotiations by NRSRO personnel with supervisory authority over the NRSRO personnel participating in determining credit ratings or developing or approving procedures or methodologies used for determining credit ratings?
- Instead of prohibiting this conflict outright, would disclosure and procedures to manage the conflict adequately address the conflict? If so, what specific disclosures should be required? What other measures should be required in addition to disclosures?

- Would there be practical difficulties in separating analytic and fee discussions for a small NRSRO, including one that has limited staff, that are significant enough that the Commission should consider a different mechanism to address the conflict? If so, what sort of mechanism and with what conditions? Should the Commission adopt an exemption from the prohibition for small NRSROs and, instead, require them to disclose the conflict and establish procedures to manage it? For example, the exemption could apply to NRSROs that have less than 10, 20, or 50 associated persons. Commenters that endorse an exemption for small NRSROs should provide specific details as to how the Commission should define an NRSRO as "small" for purposes of the exemption. For example, for purposes of the Final Regulatory Flexibility Analysis for the Adopting Release the Commission concluded that an NRSRO with total assets of $5 million or less was a "small" entity for purposes of the Regulatory Flexibility Act.[115] Would that be an appropriate way to define a small NRSRO for purposes of this exemption?

4. Rule 17g-5 Prohibition of Conflict of Interest Related to Receipt of Gifts

The Commission is proposing to amend Rule 17g-5[116] by adding a new paragraph (c)(7) that would prohibit an NRSRO from having a conflict of interest relating to the issuance or maintenance of a credit rating where a credit analyst who participated in determining or monitoring the credit rating, or a person responsible for approving the

[115] See Adopting Release, 72 FR at 33618.

[116] 17 CFR 240.17g-5.

credit rating, received gifts, including entertainment, from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities such as meetings that have an aggregate value of no more than $25. Thus, this proposed prohibition would prohibit any gifts to credit analysts and persons on credit rating committees from the obligors, issuers, underwriters, or sponsors with respect to whom they had determined, monitored or approved credit ratings. It also would create an exception for items provided during normal business activities such as meetings to the extent they do not in the aggregate exceed $25 per meeting. For example, the provision of pens, notepads, or minor refreshments, such as soft drinks or coffee, generally are incidental to meetings and other normal course business interactions and not treated as gifts per se. The proposed $25 exception is designed to be high enough to permit these types of exchanges without implicating the prohibition.

The Commission is proposing these amendments to Rule 17g-5, in part, pursuant to the authority in Section 15E(h)(2) of the Exchange Act.[117] The provisions in this section of the statute provide the Commission with authority to prohibit, or require the management and disclosure of, any potential conflict of interest relating to the issuance of credit ratings by an NRSRO as the Commission deems necessary or appropriate in the public interest or for the protection of investors.[118] The Commission preliminarily believes the proposed amendment is necessary and appropriate in the public interest or for the protection of investors because it would address a potential practice that could impair the objectivity, and, correspondingly, the quality, of a credit rating.

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117 15 U.S.C. 78o-7(h)(2).

118 Id.

Persons seeking credit ratings for an obligor or debt security could use gifts to gain favor with the analyst responsible for determining the credit ratings and cause the analyst to be less objective during the rating process. In the case of a substantial gift, the potential to impact the analyst's objectivity could be immediate. With smaller gifts, the danger is that over time the cumulative effect of repeated gifts can impact the analyst's objectivity. Therefore, the proposal would establish an absolute prohibition on gifts with the exception of minor incidentals provided in business meetings.

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission request comment on the following questions related to the proposal.

- Instead of prohibiting this conflict outright, should the Commission require that NRSROs disclose it and establish procedures to manage it? If so, what specific disclosures should be required?
- Instead of prohibiting gifts outright, should the Commission establish a yearly limit on the aggregate value of gifts that would be permitted under the prohibition? For example, the Commission could provide in the rule that the prohibition would not be triggered until the aggregate value of all gifts received from a particular person in a twelve month period exceeded \$100, \$500 or \$1,000 or some other amount.
- Is the proposed \$25 aggregate value an appropriate threshold for incidentals provided at meetings, or should a higher or lower threshold be applied?

- Should the Commission adopt a recordkeeping requirement with respect to the receipt of gifts by analysts and persons responsible for approving credit ratings in addition to the prohibition? For example, the Commission could require an NRSRO to document for each gift the identity of the person providing the gift, the recipient, and the nature of the gift.

B. Amendments to Rule 17g-2

The Commission adopted Rule 17g-2, in part, pursuant to authority in Section 17(a)(1) of the Exchange Act requiring NRSROs to make and keep such records, and make and disseminate such reports, as the Commission prescribes by rule as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the Exchange Act.[119] Rule 17g-2 requires an NRSRO to make and retain certain records relating to its business and to retain certain other business records made in the normal course of business operations. The rule also prescribes the time periods and manner in which all these records are required to be retained. The Commission is proposing to amend this rule to require NRSROs to make and retain certain additional records and to require that some of these proposed new records be made publicly available.

1. A Record of Rating Actions and the Requirement that they be made Publicly Available

The Commission is proposing to amend Exchange Act Rule 17g-2[120] to add a new paragraph (8) to Rule 17g-2 that would require a registered NRSRO to make and retain a record showing all rating actions (initial rating, upgrades, downgrades, and placements on

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119 See Section 5 of the Rating Agency Act and 15 U.S.C 78q(a)(1).

120 17 CFR 240.17g-2.

watch for upgrade or downgrade) and the date of such actions identified by the name of the security or obligor and, if applicable, the CUSIP for the rated security or the Central Index Key (CIK) number for the rated obligor. Furthermore, the Commission is proposing to amend Rule 17g-2(d) to require that this record be made publicly available on the NRSRO's corporate Internet Web site in an interactive data file that uses a machine-readable computer code that presents information in eXtensible Business Reporting Language ("XBRL") in electronic format ("XBRL Interactive Data File"). The purpose of this disclosure is to provide users of credit ratings, investors, and other market participants and observers the raw data with which to compare how the NRSROs initially rated an obligor or security and, subsequently, adjusted those ratings, including the timing of the adjustments. In order to expedite the establishment of a pool of data sufficient to provide a useful basis of comparison, this requirement would apply to all currently rated securities or obligors as well as to all future credit ratings.

The goal of this proposal is to foster greater accountability of the NRSROs with respect to their credit ratings as well as competition among the NRSROs by making it easier for persons to analyze the actual performance of the credit ratings the NRSROs issue in terms of accuracy in assessing creditworthiness. The disclosure of this information on the history of each credit rating would create the opportunity for the marketplace to use the information to develop performance measurement statistics that would supplement those required to be published by the NRSROs themselves in Exhibit 1 to Form NRSRO. The intent is to tap into the expertise and flexibility of credit market observers and participants to create better and more useful means to compare credit ratings. This goal is to make NRSROs more accountable for their ratings by enhancing the transparency of the results of their rating processes for particular securities and obligors and classes of securities and obligors and encourage competition within the industry by making it easier for users of credit ratings to judge the output of the NRSROs.

As noted above, the proposed amendments would require that the record be made publicly available on the NRSRO's corporate Internet Web site in an XBRL Interactive Data File that uses a machine-readable computer code that presents information in XBRL. The Commission is proposing to require that an NRSRO use this format to publicly disclose the ratings action data because it would allow users to dynamically search and analyze the information, thereby facilitating the comparison of information across different NRSROs. In addition, an XBRL Interactive Data File would enable investors, analysts, and the Commission staff to capture and analyze the ratings action data more quickly and at less of a cost than is possible using another format. The Commission further believes that the XBRL Interactive Data File would be compatible with a wide range of open source and proprietary XBRL software applications and that as the ratings action data becomes more widely available, advances in interactive data software, online viewers, search engines, and other Web-based tools may further enhance the accessibility and usability of the data.

The Commission's experience in having certain issuers use XBRL for EDGAR filings has demonstrated the benefits of this format to investors, filers, and Commission staff.[121] Expanding its use to NRSRO ratings history data would be consistent with Commission policy to utilize this format where practical.

The proposed amendment to Rule 17g-2(d) also would provide that the records be made publicly available no later than six months after the date of the rating action. The Commission anticipates that the record required under this amendment would need to be updated frequently as new credit ratings are issued and existing credit ratings are upgraded, downgraded and put on ratings watch. For purposes of the internal record, the NRSRO would need to keep the record current to reflect the complete ratings history of each extant credit rating. However, for purposes of the requirement to make the record publicly available, the NRSRO would be permitted to disclose the record on its Internet Web site six months after the record is updated to reflect a new ratings action. The proposed six-month time lag for publicly disclosing the updated record is designed to accommodate NRSROs that operate using the subscriber-pay model because they are paid for access to their current credit ratings. It also is designed to preserve the revenues that NRSROs operating using the issuer-pay model derive from selling download access to their current credit ratings.[122] The Commission preliminarily believes the six-month time lag would not have any negative effect on the goal of this proposed amendment because the information on credit ratings actions that would be disclosed – perhaps many years worth for some credit ratings – should be sufficient to develop meaningful performance metrics for comparing NRSROs.

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121 See Extension of Interactive Data Voluntarily Reporting Program in the EDGAR System to Include Mutual Fund Risk/Return Summary Information, Securities Act Release No. 8823 (August 20, 2007).

122 The accommodation of subscriber-pay models acknowledges the Rating Agency Act's intent to encourage the subscriber-pays model (see Senate Report, p. 7) while simultaneously ensuring equal treatment for NRSROs operating under an issuer-pays model.

Finally, the proposed amendments also would amend the instructions to Exhibit 1 to Form NRSRO to require the disclosure of the Web address where the XBRL Interactive Data File could be accessed. This is designed to inform persons who use credit ratings where the ratings histories can be obtained.

The Commission is proposing these amendments, in part, under authority to require NRSROs to make and keep for prescribed periods such records as the Commission prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act.[123] The Commission preliminarily believes the proposed new recordkeeping and disclosure requirements are necessary and appropriate in the public interest and for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act. Specifically, by proposing to require NRSROs to make ratings actions publicly available in an XBRL Interactive Data File, market participants would be able to create their own performance measurement metrics, including default and transition matrices, by which to judge the accuracy of NRSRO ratings. In addition, users of credit ratings would be able to compare side-by-side how each NRSRO initially rated a particular security, when the NRSRO took actions to adjust the rating upward or downward, and the degree of those adjustments. Furthermore, users of credit ratings, academics and information venders could use the raw data to perform analyses comparing how the NRSROs differ in their initial ratings and their monitoring for different types of asset classes. This could identify an NRSRO that is an outlier in terms of issuing high or low credit ratings or consistently reassesses ratings on a delayed basis for some or all asset classes when compared to other

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123 See Section 17(a)(1) of the Exchange Act (15 U.S.C. 78q(a)(1)).

NRSROs. It also could help identify NRSROs that are consistently more or less accurate than others. This information also may identify NRSROs whose objectivity may be impaired because of conflicts of interest.

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission requests comment on the following questions related to the proposal.

- Is the six-month delay before publicly disclosing a rating action sufficiently long to address the business concerns of the subscriber-based NRSROs and the issuer-paid NRSROs? Should the delay be for a longer period such as one or two years or even longer? Alternatively, is six months too long and should it be a shorter period of time such as three months or even shorter?
- Should the rule require that a notice be published along with the XBRL Interactive Data File warning that because of the permitted delay in updating the record some of the credit ratings in the record may no longer reflect the NRSRO's current assessment of the creditworthiness of the obligor or debt security? For example, the notice could explain that the information in the record is sixth months old and state that the credit ratings contained in record may not be up-to-date.
- Are there ways in which the NRSROs should be required to sort the credit ratings contained on the record such as by asset class or type of ratings?

- What mechanisms are appropriate for identifying rated securities? Are there other identifiers in addition, or as an alternative, to CUSIP or CIK number that could be used in the rule?
- Should the Commission allow the ratings action data to be provided in a format other than XBRL, such as pipe delimited text data ("PDTD") or eXtensible Markup Language ("XML")? Is there another format that is more widely used or would be more appropriate than XBRL for NRSRO data? What are the advantages/disadvantages of requiring the XBRL format?
- Should the Commission require that the information on the assets underlying a structured finance products discussed in Section II.A.1.a above be provided in a specific format such as PDTD, XML, or XBRL? Again, is there another format that is more widely used or would be more appropriate for such data? What are the advantages/disadvantages of requiring a specific format?
- Should the Commission take the lead in creating the new tags that are needed for the XBRL format or should it allow the tags to be created by another group and then review the tags? How long would it take to create new tags?
- The Commission anticipates that the data provided by NRSROs would be simple and repetitive (i.e., the data would be name, CUSIP, date, rating, date, rating, etc.). Is there a need for more detailed categories of data?

- What would be the costs to an NRSRO to provide data in the XBRL format? Would there be a cost burden on smaller NRSROs? Is there another format that would cost less but still allow investors and analysts to easily download and analyze the data?
- Should the Commission institute a test phase for providing this information in an XBRL format (such as a voluntary pilot program, similar to what it is currently doing for EDGAR filings)? How long should this test phase last?
- Where is the best place to store the data provided by NRSROs? Currently, information that needs to be made publicly available is stored on each NRSRO's Web site. Should the Commission create a central database to store the information? If so, should it use the EDGAR database or should it create a new database?

2. A Record of Material Deviation from Model Output

The Commission is proposing to amend paragraph (a)(2) of Rule 17g-2 to add an additional record that would be required to be made for each current credit rating, namely, if a quantitative model is a substantial component in the process of determining the credit rating, a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued. The NRSRO issuing the rating would be responsible for making the determination of what constituted a "substantial component" of the rating process as well as what constituted a "material" difference between the rating issued and the rating implied by the model.[124] This

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124 The Commission notes that it would consider the RMBS and CDO rating process described above in Section I.C.2 as using a quantitative model as a substantial component in the ratings process.

proposal is designed to enhance the recordkeeping processes of the NRSROs so that Commission examiners (and any internal auditors of the NRSRO) could reconstruct the analytical process by which a credit rating was determined. This would facilitate their review of whether the NRSRO followed its disclosed and internally documented procedures for determining credit ratings.

The requirement to make the record would be triggered in cases where a quantitative model is a substantial component of the credit ratings process for the type of obligor or security being rated and the output of the model would result in a materially different conclusion if the NRSRO relied on it without making an out-of-model adjustment. For example, the Commission preliminarily believes the expected loss and cash flow models used by the NRSROs to rate RMBS and CDOs are substantial components of the rating process. The following hypothetical scenario is intended as an illustrative example of an instance when an out-of-model adjustment would be material to the RMBS rating process thereby triggering the requirement to document the rationale for the adjustment under the proposed rule. A credit analyst uses the NRSRO's expected loss model to analyze a $1 billion (aggregate principal amount) loan pool received from an arranger that is proposed to collateralize an RMBS. The results of the model imply that the senior RMBS tranche would need to have at least 20% subordination in order to receive an AAA rating. However, the NRSRO's methodologies and procedures for rating RMBS allow for the subordination level suggested by the model output to be adjusted based on certain qualitative factors such as the experience and competence of the loan servicer or the recent performance of similar loan pools. Based on the superior competence of the loan servicer, the analyst concludes that the senior tranche only needs

19% subordination and, ultimately, the ratings committee agrees. Consequently, the RMBS is issued with a senior tranche having 19% subordination and receiving an AAA rating from the NRSRO. In this case, under the proposed amendment, the NRSRO would be required to make a record that identified the rationale – the servicer's superior competence – for determining a credit rating that was different from the rating implied by the model.

As the above scenario demonstrates, the failure to make such a record could hamper the ability of the Commission to review whether an NRSRO was following its stated procedures for determining credit ratings. In the above scenario, the analyst could adjust the rating requirements implied by the model by applying qualitative factors with respect to the loan servicer or the performance of similar pools. A record indicating which rationale was applied would make it easier for the Commission to review whether the procedures were followed.

The Commission is proposing this amendment, in part, under authority to require NRSROs to make and keep for prescribed periods such records as the Commission prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act.[125] The Commission preliminarily believes this proposed new recordkeeping requirement is necessary and appropriate in the public interest and for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act. Specifically, as explained above, the Commission preliminarily believes that maintaining records identifying the rationale for material divergences from the ratings implied by qualitative models used as

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125 See Section 17(a)(1) of the Exchange Act (15 U.S.C. 78q(a)(1)).

a substantial component in the ratings process would assist the Commission in evaluating whether an NRSRO is adhering to its disclosed procedures for determining ratings. Further, as the Commission noted in the Adopting Release, "books and records rules have proven integral to the Commission's investor protection function because the preserved records are the primary means of monitoring compliance with applicable securities laws." In the absence of such a recordkeeping requirement, there may be no way to determine whether an analyst modified the requirements for obtaining a certain category of credit rating (e.g. AAA) as indicated by the model results by applying appropriate qualitative factors permitted under the NRSRO's documented procedures or because of undue influence from the person seeking the credit rating or other inappropriate reasons such as those prohibited by Rule 17g-6.[126]

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission requests comment on the following questions related to the proposal.

- Would this proposal have the impermissible effect of regulating the substance of credit ratings in any way?
- Should the Commission define in the rule when the use of a model would be a "substantial component" in the process of determining a credit rating? Commenters endorsing the adoption of such a definition should provide specific proposals.

[126] 17 CFR 240.17g-6. Rule 17g-6 prohibits an NRSRO from engaging in certain unfair, abusive or coercive practices such as issuing a credit rating that is not determined in accordance with the NRSRO's established procedures and methodologies for determining credit ratings based on whether the rated person will purchase the credit rating. See 17 CRF 240.17g-6(a)(2).

- Are there certain types of rated products (e.g., corporate debt, municipal bonds) which generally employ a quantitative model as a substantial component of the ratings process? Commenters should identify the types of bonds and a general description of the models used to rate them.
- Should the Commission define in the rule when the divergence from a model would be "material"? Commenters endorsing the adoption of such a definition should provide specific proposals.
- Is the hypothetical scenario of the RMBS rating process used to illustrate when a divergence would be material for purposes of the proposed amendment reasonable? For example, is the adjustment of the subordination level from 20% to 19% for a $1 billion loan pool a material divergence? Would a lesser adjustment of the subordination level (e.g., 20% to 19.5%) also be material?
- Are there alternative types of records that may be created or retained by an NRSRO that would allow the Commission to understand when and why an NRSRO's final rating differed materially from the rating implied by the model?
- Should the Commission require that the information about material deviations from the rating implied by the model be publicly disclosed by the NRSRO in the presale report or when the rating is issued?

3. Records Concerning Third-Party Analyst Complaints

The Commission is proposing an amendment to Exchange Act Rule 17g-2[127] to add a requirement that an NRSRO retain records of any complaints regarding the performance of a credit analyst in determining credit ratings. Specifically, the proposed amendment would add a new paragraph (b)(8) to Rule 17g-2 to require an NRSRO to retain any communications that contain complaints about the performance of a credit analyst in initiating, determining, maintaining, monitoring, changing, or withdrawing a credit rating.

The Commission is proposing these amendments, in part, under authority to require NRSROs to make and keep for prescribed periods such records as the Commission prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in the furtherance of the Exchange Act.[128] The Commission preliminarily believes the proposed new recordkeeping requirements are necessary and appropriate in the public interest and for the protection of investors, or otherwise in furtherance of the Exchange Act, because they would assist the Commission in reviewing how NRSROs address conflicts interest that could impair the integrity of their credit rating processes. For example, an NRSRO might respond to complaints from issuers that an analyst is too conservative by removing the analyst from the responsibility of rating the securities of those issuers and assigning a new analyst that is more willing to determine credit ratings desired by the issuers. As discussed above with respect to the proposed amendments to Rule 17g-5, the potential for this type of response to complaints about analysts is particularly acute in the structured finance area given that certain

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127 17 CFR 240.17g-2.

128 See Section 17(a)(1) of the Exchange Act (15 U.S.C. 78q(a)(1)).

arrangers of structured finance products repeatedly bring ratings business to the NRSROs.[129] The pressure to maintain the business relationship with these arrangers could cause an NRSRO to remove an analyst responsible for rating the structured finance products these arrangers bring to market if they complained about how the analyst was determining credit ratings and implied that they might take their business to other NRSROs.

The records proposed under these amendments would allow the Commission, in evaluating the integrity of the NRSRO's ratings process, to better assess whether analyst reassignments or terminations were for reasons unconnected to a conflict of interest (e.g., the analyst's poor performance) or as a result of the "arranger-pay" conflict of interest described above. For example, the examiners could review the complaint file that would be established by this proposed amendment and follow-up with the relevant persons within the NRSRO as to how the complaint was addressed. The potential for such a review by Commission examiners could reduce the willingness of an NRSRO to re-assign or terminate a credit analyst for inappropriate business considerations.

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission requests comment on the following questions related to the proposal.

- In addition to the proposed recordkeeping requirement, should the Commission require the NRSROs to publicly disclose when an analyst has been re-assigned from the responsibility to rate an obligor or the securities of an issuer, underwriter, or sponsor?

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129 See e.g., Coffee April 22, 2008 Senate Testimony, pp. 4-6.

- Should the Commission require NRSROs to retain any communications containing a request from an obligor, issuer, underwriter, or sponsor that the NRSRO assign a specific analyst to a transaction in addition to the proposed requirement to retain complaints about analysts?

4. Clarifying Amendment to Rule 17g-2(b)(7)

Paragraph (b)(7) of Rule 17g-2 currently requires an NRSRO to retain all internal and external communications that relate to "initiating, determining, maintaining, changing, or withdrawing a credit rating." The Commission is proposing to add the word "monitoring" to this list. The intent is to clarify that NRSRO recordkeeping rules extend to all aspects of the credit rating surveillance process as well as the initial rating process. This was the intent when the Commission originally adopted the rule as indicated by the use of the term "maintaining." The Commission believes that adding the term "monitoring" – a term of art in the credit rating industry – would better clarify this requirement.

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission requests comment on the following question related to the proposal.

- Should the Commission delete the term "maintaining" from paragraph (b)(7) and proposed new paragraph (b)(8) of Rule 17g-2 as it has the same meaning as "monitoring?"

C. Amendments to the Instructions for Form NRSRO

Form NRSRO is the means by which credit rating agencies apply to be registered with the Commission and registered NRSROs update information they must publicly disclose. Much of the information elicited in Form NRSRO is required to be submitted to the Commission pursuant to the statutory requirements of Section 15E(a)(1)(B) of the Exchange Act.[130] The Commission added certain additional information to be submitted in the Form.[131] As discussed below, the Commission, in part, under its authority pursuant to Section 15E(a)(1)(B)(x), is now proposing to amend Form NRSRO to further enhance the quality and usefulness of the information to be furnished and disclosed by registered NRSROs by requiring specified information in addition to that which is statutorily defined in the Section 15E of the Exchange Act.

1. Enhanced Ratings Performance Measurement Statistics on Form NRSRO

As discussed above, the Commission is proposing to require the disclosure of the historical rating actions relating to each current credit rating of an NRSRO through amendments to Rule 17g-2. The intent is to make available the raw data necessary for the marketplace to develop and apply credit ratings performance metrics. At the same time, the Commission is proposing to amend the instructions to Exhibit 1 to Form NRSRO to enhance the comparability of the performance measurement statistics the NRSROs are required to publicly disclose in the Form. Currently, the instructions require the disclosure of "performance measurement statistics of the credit ratings of the Applicant/NRSRO over short-term, mid-term, and long-term periods (as applicable) through the most recent calendar year-end." The Commission, in adopting this requirement, did not require disclosure of performance statistics in Form NRSRO beyond

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130 15 U.S.C. 78o-7(a)(1)(B).

131 15 U.S.C. 78o-7(a)(1)(B)(x).

those specified in Section 15E(a)(1)(B)(i) of the Exchange Act.[132] In the Adopting Release, the Commission explained that it was not prepared to prescribe standard metrics at that time in light of the varying approaches suggested by some commenters and the opposition of other commenters to having the Commission impose any standards.[133] The Commission also stated that it would continue to consider the issue to determine the feasibility, as well as the potential benefits and limitations, of devising measurements that would allow reliable comparisons of the accuracy of the NRSROs' credit ratings.[134]

The Commission, with the benefit of further consideration of the issue, now preliminarily believes that the instructions to Exhibit 1 can prescribe greater specificity about how the performance statistics must be generated without intruding into the processes and methodologies by which NRSROs determine credit ratings. For example, through the examination process, the Commission has become more familiar with the procedures and methodologies used by the NRSROs to determine credit ratings. Through this experience, the Commission preliminarily believes it can prescribe generic requirements for the performance statistics that would accommodate the different procedures and methodologies used by the NRSROs.

The first proposed amendment would augment the instructions to Exhibit 1 by requiring the disclosure of separate sets of default and transition statistics for each asset class of credit rating for which an applicant is seeking registration as an NRSRO or an NRSRO is registered and any other broad class of credit ratings issued by the NRSRO. This would result in the generation of performance statistics that are specific to each class

132 See 15 U.S.C. 78o-7(a)(1)(B)(i).

133 See Adopting Release, 72 FR at 33574.

134 Id.

of credit ratings for which the NRSRO is registered (or an applicant is seeking registration). This proposal is designed to make it easier for users of credit ratings to compare the accuracy of NRSRO credit ratings on a class-by-class basis.

The proposed amendment also would require an NRSRO registered in the class of credit ratings described in Section 3(a)(62)(B)(iv) of the Rating Agency Act[135] (or an applicant seeking registration in that class) when generating the performance statistics for that class to include credit ratings of any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. This is designed to ensure the inclusion of ratings actions for credit ratings of structured finance products that do not meet the narrower statutory definition of "issuers of asset-backed securities (as that term is defined is section 1101(c) of part 229 of title 17, Code of Federal Regulations)."[136]

The second proposed amendment would require that these class-by-class disclosures be broken out over 1, 3 and 10-year periods. Section 15E(a)(1)(B)(i) of the Exchange Act requires that the performance statistics be over short, mid, and long-term periods.[137] The proposed amendment would define those statutorily prescribed periods in specific years so that the performance statistics generated by the NRSROs cover comparable time periods. The Commission preliminarily believes that 1, 3, and 10 year periods are reasonable definitions of the terms "short-term, mid-term, and long-term periods" as used in Section 15E(a)(1)(B)(i) of the Exchange Act.[138] For example, the 1

135 15 U.S.C. 78c(a)(62)(B)(iv).

136 See Id.

137 15 U.S.C. 78o-7(a)(1)(B)(i).

138 15 U.S.C. 78o-7(a)(1)(B)(i).

year period would provide users with information about how the credit ratings are currently performing. In effect, it could serve as an early warning mechanism if a problem developed in an NRSRO's rating processes due to flaws or conflicts. Similarly, the 3 year period would provide information about the how the ratings were currently performing but, by including more historical data, smooth out spikes in the 1 year statistics to give a better sense of how the ratings perform over time. The 3 year statistics also would serve as a bridge to the longer term 10 year statistics. The 10 year statistics would show users how the ratings in a particular class of securities perform over the long range.

The third proposed amendment would modify what ratings actions are required to be included in these performance measurement statistics by replacing the term "down-grade and default rates" with "ratings transition and default rates." The proposed switch to "ratings transition" rates from "downgrade" rates is designed to clarify that upgrades (as well as downgrades) should be included in the statistics. The fact that an NRSRO upgrades a substantial amount of credit ratings may be just as indicative of a flaw in the initial rating as a large number of downgrades. For example, an NRSRO could try to manipulate its performance statistics by issuing overly conservative ratings.

The final proposed amendment would specify that the default statistics required under the exhibit must show defaults relative to the initial rating and incorporate defaults that occur after a credit rating is withdrawn. This amendment is designed to prevent an NRSRO from manipulating the performance statistics by not including defaults when generating statistics for a category of credit ratings (e.g., AA) because the defaults occur after the rating is downgraded to a lower category (e.g., CC) or withdrawn.

The Commission is proposing these amendments, in part, under authority to require such additional information in the application as it finds necessary or appropriate in the public interest or for the protection of investors.[139] The Commission preliminarily believes the proposed new disclosure requirements for Exhibit 1 are necessary and appropriate and in the public interest or for the protection of investors. Specifically, the information that would be required under the proposed amendments would aid investors by allowing them to evaluate how the credit ratings of an NRSRO perform (i.e., the percentage of credit ratings that migrate to another category of credit rating and the percentage of rated obligors and securities that default) on a class-by-class basis. This would provide better information on how an NRSRO's ratings have performed within the field of financial products relevant to any given user of credit ratings and investor. For example, an investor contemplating the purchase of a highly-rated subprime RMBS would be able to consider the performance of an NRSRO's ratings of structured finance products, which would be more useful than the NRSRO's general performance statistics across all classes of credit ratings. Specifically, an NRSRO may be much better at assessing the creditworthiness of corporate debt securities than of structured finance products. Consequently, performance statistics of such an NRSRO that incorporate all classes of credit ratings (e.g., corporate debt and structured finance products) would be less precise in terms of evaluating the performance of the NRSRO's credit ratings for structured finance products.

Furthermore, by defining "short-term, mid-term, and long-term" periods as 1, 3, and 10-year timeframes, the proposed amendment would provide a better basis for comparing the performance of different NRSROs as the statistics for each NRSRO would

139 See Section 15E(a)(1)(B)(x) of the Exchange Act (15 U.S.C. 78o–7(a)(1)(B)(x)).

cover the same periods. Finally, the replacement of the "down-grade" requirement with a "ratings transition" requirement and the clarification of what default statistics would need to be incorporated into the ratings performance statistics would further enhance investor understanding of NRSRO performance by requiring that similar information be captured in the NRSROs' performance rating statistics and eliminating certain ways that could be used to "pad" statistics.

The Commission generally requests comment on all aspects of these proposed amendments. In addition, the Commission requests comment on the following questions related to the proposals.

- Should the Commission prescribe specific standards for the performance statistics, such as requiring an NRSRO to disclose how its credit ratings performed relative to metrics such as credit spreads? Commenters endorsing such an approach should provide specific details as to how it could be implemented; taking into consideration factors such as the issues related to the difficulty of obtaining timely and consistent pricing information for many debt instruments and the volatility of credit spreads.
- Should the Commission require performance statistics in a more granular form than by class of credit ratings? For example, should the Commission require for structured finance products statistics by more narrowly defined asset classes such as CDOs and RMBS or types of asset-backed securities such as those backed by home loans, credit cards, or commercial real estate? Commenters endorsing greater granularity should provide specific details, including definitions of the credit rating classes.

- Should the Commission prescribe different time periods for the short, medium, and long term statistics than 1, 3, and 10 years, respectively. For example, should the periods be 6 months, 2 years and 7 years or 2, 5, and 15 years or some other set of time periods?

2. Enhanced Disclosure of Ratings Methodologies

The Commission is proposing to amend the instructions for Exhibit 2 to Form NRSRO to require enhanced disclosures about the procedures and methodologies an NRSRO uses to determine credit ratings. Section 15E(a)(1)(B)(ii) of the Exchange Act requires that an application for registration as an NRSRO contain information regarding the procedures and methodologies used by the firm to determine credit ratings.[140] The Commission implemented this requirement by prescribing through the instructions to Form NRSRO that an applicant and NRSRO must provide general descriptions of their procedures and methodologies for determining credit ratings and that the descriptions must be sufficiently detailed to provide users of credit ratings with an understanding of the procedures and methodologies. The instructions also identified various areas that are required to be addressed in Exhibit 2, including, as applicable, descriptions of the NRSRO's policies for determining whether to initiate a credit rating; the public and non-public sources of information used in determining credit ratings, including information and analysis provided by third-party venders; and the quantitative and qualitative models and metrics used to determine credit ratings.

The Commission is proposing to add three additional areas that an applicant and a registered NRSRO would be required to address in the descriptions of its procedures and methodologies in Exhibit 2. The inclusion of these would serve to better disclose the

140 15 U.S.C. 78o-7(a)(1)(B)(ii).

actions an applicant and NRSRO is, or is not taking, in determining credit ratings. The additional areas required to be addressed in the exhibit would be:

- Whether and, if so, how information about verification performed on assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction is relied on in determining credit ratings;
- Whether and, if so, how assessments of the quality of originators of assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction play a part in the determination of credit ratings; and
- How frequently credit ratings are reviewed, whether different models or criteria are used for ratings surveillance than for determining initial ratings, whether changes made to models and criteria for determining initial ratings are applied retroactively to existing ratings, and whether changes made to models and criteria for performing ratings surveillance are incorporated into the models and criteria for determining initial ratings.

The Commission is proposing these amendments, in part, under authority to require such additional information in the application as it finds necessary or appropriate in the public interest or for the protection of investors.[141] The Commission preliminarily believes the proposed new disclosure requirements for Exhibit 2 are necessary and appropriate and in the public interest or for the protection of investors. Specifically, they

141 See Section 15E(a)(1)(B)(x) of the Exchange Act (15 U.S.C. 78o–7(a)(1)(B)(x)).

are designed to provide greater clarity around three areas of the NRSROs' rating processes, particularly for structured finance products, where questions have been raised in the context of the credit market turmoil: namely, the verification performed on information provided in loan documents; the quality of loan originators; and the surveillance of existing ratings and how changes to models are applied to existing ratings. The amendments are designed to enhance the disclosures NRSROs make in these areas and, thereby, allow users of credit ratings to better evaluate the quality of their ratings processes.

The first proposed amendment would require an NRSRO to disclose whether it considers in its rating process for structured finance product steps taken to verify information about the assets in the pool backing the structured finance product. Underwriters and sponsors of structured finance products frequently take some steps to verify information provided by borrowers in loan documentation. Generally, they have been reluctant to provide this information to NRSROs for proprietary reasons. The proposed amendment would not require that the NRSROs incorporate verification (or the lack of verification) into their ratings processes. Rather, it would require an NRSRO to disclose whether and, if so, how information about verification performed on the assets is relied on in determining credit ratings for structured finance products. For example, an NRSRO would need to disclose, as applicable: if it does not consider steps taken to verify the information; if it requires some minimum level of verification to be performed before it will determine a credit rating for a structured finance product; and how it incorporates the level of verification performed into its procedures and methodologies for determining credit ratings (e.g., if it compensates for the lack of verification by requiring greater levels of credit enhancement for the tranche securities).

The Commission preliminarily believes this disclosure would benefit users of credit ratings by providing information about the potential accuracy of an NRSRO's credit ratings. As noted above, the NRSROs determine credit ratings for structured finance products based on assumptions in their models as to how the assets underlying the instruments will perform under varying levels of stress. These assumptions are based on the characteristics of the assets (e.g., value of the property, income of the borrower) as reported by the arranger of the structured finance product. If this information is inaccurate, the capacity of the model to predict the potential future performance of the assets may be significantly impaired. Consequently, information about whether an NRSRO requires that some level of verification be performed or takes other steps to account for the lack of verification or a low level of verification would be useful to users of credit ratings in assessing the potential for an NRSRO's credit ratings to be adversely impacted by bad information about the assets underlying a rated structured finance product.

The second proposed amendment would require an NRSRO to disclose whether it considers qualitative assessments of the originator of assets underlying a structured finance product in the rating process for such products. Certain qualities of an asset originator, such as its experience and underwriting standards, may impact the quality of the loans it originates and the accuracy of the associated loan documentation. This, in turn, could influence how the assets ultimately perform and the ability of the NRSRO's models to predict their performance. Consequently, the failure to perform any assessment of the loan originators could increase the risk that an NRSRO's credit ratings may not be accurate. Therefore, disclosures as to whether the NRSRO performs any qualitative assessments of the originators would be useful in comparing the efficacy of the NRSROs' procedures and methodologies.

The third proposed amendment would require an NRSRO to disclose the frequency of its surveillance efforts and how changes to its quantitative and qualitative ratings models are incorporated into the surveillance process. The Commission believes that users of credit ratings would find information about these matters useful in comparing the ratings methodologies of different NRSROs. For example, how often and with what models an NRSRO monitors its credit ratings would be relevant to assessing the accuracy of the ratings insomuch as ratings based on stale information and outdated models may not be as accurate as ratings of like products determined using newer data and models. Moreover, with respect to new types of rated obligors and debt securities, the NRSROs refine their models as more information about the performance of these obligors and debt securities is observed and incorporated into their assumptions. Consequently, as the models evolve based on more robust performance data, credit ratings of obligors or debt securities determined using older models may be at greater risk for being inaccurate than the newer ratings. Therefore, whether the NRSRO verifies the older ratings using the newer methodologies would be useful to users of credit ratings in assessing the accuracy of the credit ratings.

The Commission generally requests comment on all aspects of the proposed amendments. In addition, the Commission requests comment on the following question related to the proposals.

- Are there other areas of the ratings process where enhanced disclosure on Form NRSRO would benefit investors and other users of credit ratings? Commenters endorsing further disclosures should specifically identify them.

D. Amendment to Rule 17g-3 (Report of Credit Rating Actions)

The Commission adopted Rule 17g-3 pursuant to authority in Section 15E(k)[142] of the Exchange Act, which requires an NRSRO to furnish to the Commission, on a confidential basis[143] and at intervals determined by the Commission, such financial statements and information concerning its financial condition as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. The statute also provides that the Commission may, by rule, require that the financial statements be certified by an independent public accountant.[144] In addition, Section 17(a)(1) of the Exchange Act[145] requires an NRSRO to make and keep such records, and make and disseminate such reports, as the Commission prescribes by rule as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the Exchange Act.[146]

Rule 17g-3 requires an NRSRO to furnish the Commission on an annual basis the following reports: audited financial statements; unaudited consolidated financial

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142 15 U.S.C. 78o-7(k).

143 An applicant can request that the Commission keep this information confidential. See Section 24 of the Exchange Act (15 U.S.C. 78x), 17 CFR 240.24b-2, 17 CFR 200.80 and 17 CFR 200.83.

144 Id.

145 15 U.S.C. 78q(a)(1).

146 See Section 5 of the Rating Agency Act and 15 U.S.C. 78q(a)(1).

statements of the parent of the NRSRO, if applicable; an unaudited report concerning revenue categories of the NRSRO; an unaudited report concerning compensation of the NRSRO's credit analysts; and an unaudited report listing the largest customers of the NRSRO. The rule further requires an NRSRO to furnish the Commission these reports within 90 days of the end of its fiscal year.

The Commission is proposing to amend Rule 17g-3 to require an NRSRO to furnish the Commission with an additional annual report of the number of credit rating actions during the fiscal year in each class of security for which the NRSRO is registered. Specifically, the amendment would add a new paragraph (a)(6) to Rule 17g-3, which would require an NRSRO to provide the Commission with a report of the number of credit rating actions (upgrades, downgrades, and placements on watch for an upgrade or downgrade) during the fiscal year in each class of credit ratings for which the NRSRO is registered with the Commission. A note to paragraph (a)(6) would clarify that for the purposes of reporting credit rating actions in the asset-backed security class of credit ratings described in Section 3(a)(62)(B)(iv) of the Rating Agency Act[147] an NRSRO would need to include credit rating actions on any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. This is designed to ensure the inclusion of information about ratings actions for credit ratings of structured finance products that do not meet the narrower statutory definition of "issuers of asset-backed securities (as that term is defined is section 1101(c) of part 229 of title 17, Code of Federal Regulations)."[148]

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147 15 U.S.C. 78c(a)(62)(B)(iv).

148 See Id.

The Commission is proposing this amendment, in part, under authority to require an NRSRO to "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 Exchange Act]."[149] The Commission preliminarily believes this proposed amendment is necessary and appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act because it would assist the Commission in its examination function of NRSROs. Large spikes in ratings actions within a class of credit ratings could indicate the processes for determining the ratings may be compromised by inappropriate factors. For example, a substantial increase in the number of downgrades in a particular class of credit ratings may be indicative of the fact that the initial ratings were higher than the NRSRO's procedures and methodologies would have implied because the NRSRO sought to gain favor with issuers and underwriters by issuing higher ratings. A substantial increase in upgrades also could be the result of the NRSRO attempting to gain favor with issuers and underwriters.

The Commission recognizes that an increase in the number of ratings actions in a particular class of credit ratings may be the result of macroeconomic factors broadly impacting the rated obligors or securities. In this case, the ratings actions would be the result of appropriate credit analysis and not inappropriate extraneous factors. On the other hand, large numbers of actions could be a signal that the process for rating and monitoring ratings in the impacted class has been compromised by improper practices such as failing to adhere to disclosed and internally documented ratings procedures and methodologies, having prohibited conflicts, failing to establish reasonable procedures to

149 See Section 17(a)(1) of the Exchange Act (15 U.S.C. 78q(a)(1)).

manage conflicts, or engaging in unfair, coercive, or abusive conduct. Consequently, the report would be a valuable tool to improve the focus of examination resources.

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission requests comment on the following questions related to the proposal.

- Could the performance statistics currently required in Exhibit 1 to Form NRSRO, as well as the proposed enhancements to those statistics, be used to target potential problem areas in an NRSRO's credit rating processes in the same manner as this proposed report thereby making the report redundant?
- Should the Commission also require NRSROs to furnish an "early warning" report to the Commission when the number of downgrades in a class of credit ratings passes a certain percentage threshold (e.g., 5%, 10%, 15%, or 20%) within a number of calendar or business days (e.g., 2, 5, 10, or 15 days) after the threshold is passed, similar to the broker-dealer notification rule (See 17 CFR 240.17a-11)?

III. PROPOSED NEW RULE 17g-7 (SPECIAL REPORTING OR USE OF SYMBOLS TO DIFFERENTIATE CREDIT RATINGS FOR STRUCTURED FINANCE PRODUCTS)

The Commission is proposing a new rule, Rule 17g-7, to address concerns that certain investors assumed the risk characteristics for structured finance products, particularly highly rated instruments, were the same as for other types of similarly rated instruments. This proposal also is designed to address concerns that some investors may not have performed internal risk analysis on structured finance products before purchasing them, although at least one survey indicates that many institutional investors asserted that this was not a widespread problem.[150] Specifically, under proposed Rule 17g-7, each time an NRSRO published a credit rating for a structured finance product it also would be required to publish a report describing how the credit ratings procedures and methodologies and credit risk characteristics for structured finance products differ from those of other types of rated instruments such as corporate and municipal debt securities. The objective of this proposal is to alert investors that there are different rating methodologies and risk characteristics associated with structured finance products. As an alternative to publishing the report, an NRSRO would be allowed to use ratings symbols for structured finance products that differentiated them from the credit ratings for other types of debt securities.

More specifically, paragraph (a) of proposed Rule 17g-7 would require an NRSRO to publish a report accompanying every credit rating it publishes for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction that describes the rating methodology used to determine the credit rating and how it differs from a rating for any other type of obligor or debt security and how the risks associated with a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction are different from other types of rated obligors and debt securities. A possible risk associated with this approach is that investors would come to view such reports as "boilerplate" and therefore would not review them.

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150 See Introducing Assumption Volatility Scores and Loss Sensitivities for Structured Finance Securities, Moody's, May 14, 2007, p. 3.

However, the Commission preliminarily believes that requiring an NRSRO to publish such a report along with each publication of a credit rating for a structured finance product likely would provide certain investors with useful information about structured finance products. The goal of the proposal is to spur investors to perform more rigorous internal risk analysis on structure finance products so that they do not overly rely on NRSRO credit ratings in making investment decisions. A possible ancillary benefit of such reports is that they could cause certain investors to seek to better understand risks that are not necessarily addressed in credit ratings of structured products, such as market and liquidity risk.

Because the goal of the rule is to foster greater independent analysis by investors, the Commission preliminarily believes that permitting an NRSRO to comply with the rule by differentiating its structured finance product rating symbols would be an equally effective alternative. The differentiated symbol would alert investors that a structured product was being rated and, therefore, raise the question of how it differs from other types of debt instruments.

The Commission is not proposing to require that specific rating symbols be used to distinguish credit ratings for structured finance products. An NRSRO would be permitted to choose the appropriate symbol. The Commission preliminarily believes that methods for identifying credit ratings for structured finance products could include using a different rating symbol altogether, such as a numerical symbol, or appending identifying characters to existing ratings scales, e.g., "AAA.sf" or "AAA_{SF}."

The Commission is proposing these amendments under authority to require an NRSRO to "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 Exchange Act]."[151] The Commission preliminarily believes these proposed amendments are necessary and appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act because they are designed to encourage investors to perform greater levels of internal risk assessment of structured finance products by putting them on notice that these products have different characteristics than other types of rated debt instruments. The Commission does acknowledge the risks related to these proposals as outlined above.

The Commission generally requests comment on all aspects of this proposed rule. In addition, the Commission request comment on the following questions related to the proposal.

- Would the use of different rating symbols for structured products impact automated securities trading, routing, settlement, clearance, trade confirmation, reporting, processing, and risk management systems and any other systems that are programmed to use standard credit rating symbols across all product classes? Commenters should describe how these systems may be impacted and associated costs to address the impacts on the firm such as costs to change or update the systems. Commenters also should describe how the impacts to these systems could impact trading activity in the markets for structured finance products.
- Is the proposed rule sufficiently clear about the types of securities and money market instruments to which it applies? Are there securities to

151 See Section 17(a)(1) of the Exchange Act (15 U.S.C. 78q(a)(1)).

which the proposal applies that should not be subject to the requirement of a report or a differentiated symbol?

- Would the use of different rating symbols have consequences for investment guidelines and covenants in legal documents that use credit ratings to distinguish finance instruments? Commenters should describe the potential consequences and associated costs to market participants and to the finance markets more broadly.
- Would the use of different rating symbols or reports dissuade purchases of structured finance products?
- Would the reports or differentiated symbols achieve the Commission's stated goal of encouraging investors to perform more internal risk assessments of structured finance products? Could the reports cause investors to ignore other relevant disclosures or lead to confusion?
- Should the rule be expanded to require reports or different ratings symbols for each class of credit ratings identified in Section 3(a)(62)(B) of the Exchange Act (15 U.S.C. 78c(a)(62)(B)); namely: (1) financial institutions, brokers, or dealers; (2) insurance companies; (3) corporate issuers; (4) issuers of asset-backed securities; and (5) issuers of government securities, municipal securities or securities issued by a foreign government? Alternatively, should the rule be expanded to require reports or different ratings symbols for only certain of these classes or subclasses such as for municipal securities?

- Should the rule prohibit an NRSRO from using a common set of symbols (e.g., AAA, AA, A, BBB, BB, B, CCC, CC, C) to rate different types of obligors and debt securities (e.g., corporate debt and municipal debt) where the NRSRO uses different methodologies for determining such ratings? Would such a proposal raise any questions relating to the scope of the Commission's legal authority in this area?
- Should the rule allow the use of a common set of symbols only if the NRSRO determines additional types of ratings to distinguish the different risk characteristics of the different types of obligors and debt securities? For example, the rule could require the determination of ratings to distinguish the potential volatility of the credit ratings of different classes of obligors and debt securities or the differing levels of market and liquidity risk associated with different classes of debt securities. Would such disclosures raise any concerns regarding liability if they were found to be deficient?

IV. PAPERWORK REDUCTION ACT

Certain provisions of the proposed rule amendments contain a "collection of information" within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[152] The Commission is submitting these proposed amendments and proposed rule to the Office of Management and Budget ("OMB") for review in accordance with the PRA. An agency may not conduct or sponsor, and a person is not required to comply with, a collection of information unless it displays a currently valid control number. The titles for the collections of information are:

[152] 44 U.S.C. 3501 et seq.; 5 CFR 1320.11.

(1) Rule 17g-1, Application for registration as a nationally recognized statistical rating agency; Form NRSRO and the Instructions for Form NRSRO (OMB Control Number 3235-0625);

(2) Rule 17g-2, Records to be made and retained by national recognized statistical rating organizations (OMB Control Number 3235-0628) ;

(3) Rule 17g-3, Annual reports to be furnished by nationally recognized statistical rating organizations (OMB Control Number 3235-0626);

(4) Rule 17g-5, Conflicts of interest (a proposed new collection of information); and

(5) Rule 17g-7, Credit rating reports to be furnished by national recognized statistical rating organizations (a proposed new collection of information).

A. Collections of Information under the Proposed Amendments

The Commission is proposing for comment rule amendments to prescribe additional requirements for NRSROs to address concerns that have arisen with respect to their role in the credit market turmoil. These proposed amendments would modify rules the Commission adopted in 2007 to implement registration, recordkeeping, financial reporting, and oversight rules under the Rating Agency Act. Additionally, the Commission is proposing a new rule under authority provided in the Rating Agency Act.[153] Certain of the proposed amendments and the proposed new rule would contain recordkeeping and disclosure requirements that would be subject to the PRA. The collection of information obligations imposed by the proposed amendments and proposed new rule would be mandatory. The proposed amendments and proposed new rule, however, would apply only to credit rating agencies that are registered with the Commission as NRSROs. Such registration is voluntary.[154]

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153 Proposed Rule 17g-7.

154 See Section 15E of the Exchange Act (15 U.S.C. 78o-7).

In summary, the proposed rule amendments and proposed new rule would require: (1) an NRSRO to provide enhanced disclosure of performance measurements statistics and the procedures and methodologies used by the NRSRO in determining credit ratings for structured finance products and other debt securities on Form NRSRO; (2) an NRSRO to make, keep and preserve additional records under Rule 17g-2;[155] (3) an NRSRO to make its rating actions and the date of such actions from the initial credit rating to the current credit rating publicly available in an XBRL Interactive Data File no later than six months after the date of the rating action;[156] (4) an NRSRO to furnish the Commission with an additional annual report;[157] (5) disclosure of certain information about securities being rated beginning on the date the issuer or depositor sets the offering price of the securities being rated;[158] and (6) an NRSRO to attach a report to its credit ratings for structured finance products describing the rating methodology used and how it differs from the determination of ratings for other types of securities or use a symbol that identifies the rated security as a structured finance product.[159]

B. Proposed Use of Information

The proposed amendments and new rule would enhance the framework for Commission oversight of NRSROs in response to the recent credit market turmoil.[160] The collections of information in the proposed amendments and new rule are designed to

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155 17 CFR 240.17g-2.

156 See proposed Rule 17g-2(a)(2)(iv) and (d).

157 See proposed Rule 17g-3(a)(6).

158 See proposed Rule 17g-5(a)(3) and (b)(9).

159 See proposed Rule 17g-7.

160 See 17 CFR 17g-1 through 17g-6, and Form NRSRO.

assist the Commission in effectively monitoring, through its examination function, whether an NRSRO is conducting its activities in accordance with Section 15E of the Exchange Act[161] and the rules thereunder. In addition, these proposed amendments and the new rule are designed to assist users of credit ratings by proposing to require the disclosure of additional information with respect to an NRSRO that could be used to compare the credit ratings quality of different NRSROs, particularly with respect to structured finance products. The Commission believes that the information that NRSROs would have to make public as a result of the proposed amendments would advance one of the primary objectives of the Rating Agency Act, as noted in the accompanying Senate Report, to "facilitate informed decisions by giving investors the opportunity to compare ratings quality of different firms."[162]

C. Respondents

In adopting the final rules under the Rating Agency Act, the Commission estimated that approximately 30 credit rating agencies would be registered as NRSROs.[163] The Commission believes that this estimate continues to be appropriate for identifying the number of respondents for purposes of the proposed amendments and for proposed new Rule 17g-7. Since the initial set of rules under the Rating Agency Act became effective in June 2007, nine credit rating agencies have registered with the Commission as NRSROs.[164] The registration program has been in effect for less than a

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161 15 U.S.C. 78o-7.

162 See Senate Report, p. 8.

163 See Adopting Release, 72 FR at 33606-33607.

164 A.M. Best Company, Inc.; DBRS Ltd.; Fitch.; Japan Credit Rating Agency, Ltd.; Moody's; Rating and Investment Information, Inc.; S&P; LACE Financial Corp.; and Egan-Jones Rating Company.

year; consequently, the Commission expects additional entities will register. While 20 more entities may not ultimately register, the Commission believes the estimate is within reasonable bounds and appropriate given that it adds an element of conservatism as it increases paperwork burden estimates as well as cost estimates.

In addition, proposed Rule 17g-5(a)(3)[165] would require the disclosure of certain information provided to, and used by, an NRSRO in determining an initial rating for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction and for monitoring those ratings. The rule would not specify which party would disclose such information: the NRSRO, sponsor, issuer, depositor, trustee or some other person. The Commission believes that the most likely persons to disclose this information would be structured finance product arrangers, managers, or trustees as they are the entities that generate the information and provide it to the NRSROs. For purposes of the PRA estimate for proposed Rule 17g-5(a)(3), based on staff information gained from the NRSRO examination process, the Commission estimates that there would be approximately 200 respondents. As noted throughout the release, the number of arrangers bringing structured finance products to market is small relative to the number of deals.

The Commission generally requests comment on all aspects of these proposed estimates for the number of respondents. In addition, the Commission requests specific comment on the following items related to these estimates.

- Should the Commission use the number of credit rating agencies currently registered as NRSROs rather the estimated number of 30 ultimate registrants? Alternatively, is there a basis to estimate a different number of likely registrants?

165 See proposed Rule 17g-5(a)(3)(i) and (iii).

- Is the Commission correct in believing that structured product arrangers, managers, and trustees would be the entities that disclose the information required under the proposed amendments to Rule 17g-5(a)?
- Are there sources that could provide credible information that could be used to determine the number of credit rating agencies and other NRSROs that would be subject to the proposed paperwork burdens? Commenters should identify any such sources and explain how a given source could be used to either support the Commission's estimate or arrive at a different estimate.

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

D. Total Annual Recordkeeping and Reporting Burden

As discussed in further detail below, the Commission estimates the total recordkeeping burden resulting from the proposed amendments and proposed new rule would be approximately 1,434,690 hours on an annual basis[166] and 64,500 hours on a one-time basis.[167]

The total annual and one-time hour burden estimates described below are averages across all types of NRSROs expected to be affected by the proposed amendment and new rule. The size and complexity of NRSROs range from small entities to entities that are part of complex global organizations employing thousands of credit analysts. Consequently, the burden hour estimates represent the average time across all NRSROs. The Commission further notes that, given the significant variance in size between the

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166 This total is derived from the total annual hours set forth in the order that the totals appear in the text: 390 + 300 + 4,000 + 150,000 + 1,280,000 = 1,434,690.

167 This total is derived from the total one-time hours set forth in the order that the totals appear in the text: 900 + 900 + 60,000 + 1,500 + 300 + 900 = 64,500.

largest NRSROs and the smallest NRSROs, the burden estimates, as averages across all NRSROs, are skewed higher because the largest firms currently predominate in the industry.

1. Amendments to Form NRSRO

The proposed amendments to Form NRSRO would change the instructions for the Form to require that NRSROs provide more detailed credit ratings performance statistics in Exhibit 1 and disclose with greater specificity information about the procedures and methodologies used to determine structured finance and other credit ratings in Exhibit 2.[168] The Commission expects these proposed amendments would not have a material effect on the respondents' hour burden. The Commission believes that the total annual burden hours of 2,100 currently approved by OMB would not change for Rule 17g-1 and Form NRSRO materially because the additional disclosures would be included within the overall preparation of the initial Form NRSRO for new applicants. Additionally, the Commission believes that the nine currently registered NRSROs could be required to prepare and furnish an amended Form NRSRO to update their registration applications if the Commission were to adopt the proposed amendments (i.e., nine amended Form NRSROs). However, the Commission believes these potential nine furnishings of Form NRSRO are accounted for in the currently approved PRA collection for Rule 17g-1, which includes an estimate that each NRSRO would file two amendments to Form NRSRO per year.[169]

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[168] 17 CFR 240.17g-1 and Form NRSRO.

[169] See Adopting Release, 72 FR at 33609. To date, only one of the seven NRSROs that have been registered with the Commission since September 2007 has furnished the Commission with an amended Form NRSRO since registering with the Commission.

The Commission generally requests comment on all aspects of these proposed burden estimates for Rule 17g-1 and Form NRSRO, proposed to be amended. In addition, the Commission requests specific comment on the following items related to these estimates:

- Would the proposed additional disclosure requirements increase the burden hours from the amount currently budgeted for Rule 17g-1 and Form NRSRO?

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

2. Amendments to Rule 17g-2

Rule 17g-2 requires an NRSRO to make and keep current certain records relating to its business and requires an NRSRO to preserve those and other records for certain prescribed time periods.[170] The Commission's current estimate for the average one-time burden of implementing a recordkeeping system to comply with Rule 17g-2 is 300 hours.[171] Additionally, the total annual burden currently approved by OMB for Rule 17g-2 is 7,620 hours, which represents the average annual amount of time an NRSRO will spend to make and maintain these records (254 hours per year) multiplied by 30 respondents.[172]

The proposed amendments to Rule 17g-2 would require an NRSRO to make and retain two additional records and retain a third type of record. The records to be made

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170 17 CFR 240.17g-2.

171 See Adopting Release, 72 FR at 33608.

172 See Adopting Release, 72 FR at 33610.

and retained would be: (1) a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued, if a quantitative model is a substantial component in the process of determining a credit rating;[173] and (2) a record showing the history and dates of all previous rating actions with respect to each current credit rating.[174] The proposed amendments to Rule 17g-2 would require an NRSRO to make the second set of records – rating actions related to current ratings – publicly available in an XBRL Interactive Data File.[175] In addition, the proposed amendments would require an NRSRO to retain communications that contain any complaints by an obligor, issuer, underwriter, or sponsor about the performance of a credit analyst.[176]

With respect to the proposed amendments to Rule 17g-2, the Commission estimates, based on staff information gained from the NRSRO examination process, that the total one-time and annual record recordkeeping burdens would increase approximately 10% and 5%, respectively.[177] Thus, the Commission estimates that the one-time burden that each NRSRO would spend implementing a recordkeeping system to comply with Rule 17g-2 as proposed to be amended would be approximately 330

173 Proposed paragraph (a)(2)(iii) of Rule 17g-2.

174 Proposed paragraph (a)(8) of Rule 17g-2.

175 Proposed amendment to Rule 17g-2(d).

176 Proposed paragraph (b)(8) of Rule 17g-2.

177 The Commission believes that the one-time burden to set up and/or modify a recordkeeping system to comply with the proposed amendments would be greater than the ongoing annual burden. Once an NRSRO has set up or modified its recordkeeping system to comply with the proposed amendments, its annual hour burden would be increased only to the extent it would be required to make and retain additional records.

hours,[178] for a total one-time burden of 9,900 hours for 30 NRSROs.[179] The Commission estimates that an NRSRO would spend an average of 267 hours per year[180] to make and retain records under Rule 17g-2 as proposed to be amended, for a total annual hour burden under Rule 17g-2 of 8,010 hours.[181] This estimate would result in an increase in the currently approved PRA burden under Rule 17g-2 of 390 annual burden hours.[182] As discussed above, the increase in annual burden hours would result from the increase in the number of records an NRSRO would be required to make and retain under the proposed amendments to Rule 17g-2.

In addition, the proposed amendments to Rule 17g-2 would require an NRSRO to make the records of its rating actions publicly available in an XBRL Interactive Data File.[183]

The Commission believes that an NRSRO would choose to make this information available through its Internet Web site and that each NRSRO already has, or would have, an Internet Web site. Therefore, based on staff information gained from the NRSRO examination process, the Commission estimates that, on average, an NRSRO would spend approximately 30 hours to publicly disclose the history of its rating actions for each credit rating in an XBRL Interactive Data File and, thereafter, 10 hours per year to

178 300 hours x 1.10 = 330 hours. This would result in an increase of approximately 30 hours per NRSRO for the one-time hour burden.

179 330 hours x 30 respondents = 9,900 hours. The proposed amendments would result in an increase of 900 total one-time burden hours.

180 254 hours x 1.05 = 267 hours. The proposed amendments would result in an increase of approximately 13 annual burden hours per NRSRO for Rule 17g-2.

181 267 hours x 30 respondents = 8,010 hours.

182 8,010 hours – 7,620 hours = 390 hours.

183 See proposed amendment to Rule 17g-2(d).

update this information.[184] Accordingly, the total aggregate one-time burden to the industry to make the history of rating actions publicly available in an XBRL Interactive Data File would be 900 hours,[185] and the total aggregate annual burden hours would be 300 hours.[186]

Under the currently approved PRA collection for Rule 17g-2, the Commission estimated that an NRSRO may need to purchase recordkeeping system software to establish a recordkeeping system in conformance with Rule 17g-2.[187] The Commission estimated that the cost of the software would vary based on the size and complexity of the NRSRO. Also, the Commission estimated that some NRSROs would not need such software because they already have adequate recordkeeping systems or, given their small size, such software would not be necessary. Based on these estimates, the Commission estimated that the average cost for recordkeeping software across all NRSROs would be approximately $1,000 per firm, with an aggregate one-time cost to the industry of $30,000. The Commission estimates that the proposed amendments to Rule 17g-2 would not alter this estimate or that any increases in the cost would be de minimis.

The Commission generally requests comment on all aspects of these proposed burden estimates for Rule 17g-2. In addition, the Commission requests specific comment on the following items related to these burden estimates:

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184 The Commission also bases this estimate on the current one-time and annual burden hours for an NRSRO to publicly disclose its Form NRSRO. No alternatives to these estimates as proposed were suggested by commenters. See Adopting Release, 72 FR at 33609.

185 30 hours x 30 NRSROs = 900 hours.

186 10 hours x 30 NRSROs = 300 hours.

187 See Adopting Release, 72 FR at 33609, 33610.

- Are there publicly available reports or other data sources the Commission should consider in arriving at these burden estimates?
- Are the estimates that these amendments would result in an increase to the current total one-time and annual recordkeeping burdens of approximately 10% and 5% accurate? If not, should they be higher or lower?
- Are the estimates that the requirement to make records of rating actions publicly available in an XBRL Interactive Data File would result in an increased one-time burden for each NRSRO of approximately 30 hours to publicly disclose the history of its rating actions for each credit rating in an XBRL Interactive Data File and, thereafter, 10 hours per year to update this information accurate? If not, should they be higher or lower?
- Is the estimate that the NRSROs would incur no additional costs (or that any additional costs would be de minimis) to update recordkeeping systems to comply with the proposed new recordkeeping requirements accurate? If not, what would the additional costs be?

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

3. Proposed Amendment to Rule 17g-3

Rule 17g-3 requires an NRSRO to furnish certain financial reports to the Commission on an annual basis, including audited financial statements as well as other financial reports.[188] The Commission is proposing to amend Rule 17g-3 to require an NRSRO to furnish the Commission with an additional report: an unaudited report of the

[188] 17 CFR 240.17g-3.

number of credit ratings that were changed during the fiscal year in each class of credit ratings for which the NRSRO is registered with the Commission.[189]

The total annual burden currently approved by OMB for Rule 17g-3 is 6,000 hours, based on the fact that it would take an NRSRO, on average, approximately 200 hours to prepare for and file the annual reports.[190] In addition, the total annual cost burden currently approved by OMB is $450,000 to engage the services of an independent public accountant to conduct the annual audit as part of the preparation of the first report required by Rule 17g-3.[191] This estimate is based on 30 NRSROs hiring an independent public accountant on an annual basis for an average of $15,000.[192]

The Commission believes that the proposed amendment to Rule 17g-3 that would require a report on an NRSRO's rating changes during a fiscal year would have a de minimis effect on the annual hour burden for the current PRA collection for Rule 17g-3. The Commission preliminarily believes that an NRSRO already would have this information with respect to each class of credit ratings for which it is registered. In addition, the proposed amendment does not prescribe a format for the report. Consequently, the Commission estimates that proposed Rule 17g-3(a)(6) would not have a significant effect on the total annual hour burden currently approved for the PRA for Rule 17g-3.

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189 See proposed Rule 17g-3(a)(6).

190 200 hours x 30 NRSROs = 6,000 hours. See Adopting Release, 72 FR at 33610.

191 Rule 17g-3 currently requires five reports. Only the first report – financial statements – need be audited. The two new reports proposed to be required by the amendments would not need to be audited.

192 $15,000 x 30 NRSROs = $450,000. See Adopting Release, 72 FR at 33610.

The Commission generally requests comment on all aspects of these proposed burden estimates for Rule 17g-3. In addition, the Commission requests specific comment on the following items related to these burden estimates:

- Are there publicly available reports or other data sources the Commission should consider in arriving at these burden estimates?

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

4. Amendments to Rule 17g-5

Rules 17g-5 requires an NRSRO to manage and disclose certain conflicts of interest.[193] The rule also prohibits specific types of conflicts of interest.[194] The proposed amendments to Rule 17g-5 would add an additional conflict to paragraph (b) of Rule 17g-5. This proposed conflict of interest would be issuing or maintaining a credit rating for a security or money market instrument issued by an asset pool or as part of an asset-backed or mortgage-backed securities transaction that was paid for by the issuer, sponsor, or underwriter of the security or money market instrument.[195] Under the proposal, an NRSRO would be prohibited from issuing a credit rating for a structured finance product, unless certain information about the transaction and the assets underlying the structured finance product are disclosed.[196] Specifically, the following information would need to be made publicly available beginning on the date the underwriter, issuer or depositor set the offering price of the securities being rated: (1) all information provided to the

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193 17 CFR 240.17g-5.

194 17 CFR 240.17g-5(c).

195 See proposed Rule 17g-5(b)(9). The current paragraph (b)(9) would be renumbered as (b)(10).

196 See proposed Rule 17g-5(a)(3).

NRSRO that is used in determining the initial credit rating, including information about the characteristics of the assets underlying or referenced by the security or money market instrument, and the legal structure; and (2) all information provided to the NRSRO by the issuer, underwriter, sponsor, depositor or trustee that is used by the NRSRO in undertaking credit rating surveillance on the security or money market instrument.[197] In a private offering, the above information would need to be made available on the date the underwriter and the issuer or depositor set the offering price of the securities being rated only to credit rating agencies and investors; it would need to be made publicly available, however, no later than one business day after the offering closes.

The proposed rule would not specify which party would disclose the information: the NRSRO, sponsor, issuer, depositor or trustee. The Commission preliminarily believes that in order to avoid conflicts with Securities Act prohibitions on general solicitations as well as to avoid making the NRSRO liable for the accuracy of information that would originally be supplied by the arrangers and trustees of structured products, this information would likely be disclosed by those arrangers and trustees. The Commission estimates that there would be approximately 200 such entities. For purposes of this PRA, the Commission estimates that it would take a respondent approximately 300 hours to develop a system, as well as policies and procedures, for the disclosures required by the proposed rule. This estimate is based on the Commission's experience with, and burden estimates for, the recordkeeping requirements for NRSROs.[198] Accordingly, the Commission believes, based on staff experience, that a respondent would take

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197 See proposed Rule 17g-5(a)(3)(i)-(iii).

198 See Adopting Release, 72 FR at 33609.

approximately 300 hours on a one-time basis to implement a disclosure system to comply with the proposal in that a respondent would need a set of policies and procedures for disclosing the information, as well as a system for making the information publicly available. This would result in a total one-time hour burden of 60,000 hours for 200 respondents.[199]

In addition to the one-time hour burden, disclosure would also be required under the proposed rule on a transaction by transaction basis when an initial rating is determined. Based on staff experience, the Commission estimates that each respondent would disclose information with respect to approximately 20 new transactions per year and that it would take approximately 1 hour per transaction to make the information publicly available. This estimate is based on the Commission's expectation that the respondent will have already implemented the system and policies and procedures for disclosure. The Commission estimates that a large NRSRO would have rated approximately 2,000 new RMBS and CDO transactions in a given year. The Commission is basing this estimate on the number of new RMBS and CDO deals rated in 2006 by two of the largest NRSROs which rated structured finance transactions. The Commission adjusted this number to approximately 4,000 transactions in order to include other types of structured finance products, including commercial MBS and other consumer assets. Therefore, the Commission estimates for purposes of the PRA that each respondent would arrange approximately 20 new transactions per year: 4,000 new transactions/200 arrangers = 20 new transactions. The Commission notes that the number of new transactions arranged per year would vary by the size of arranger and that this estimate would be an average across all respondents. Larger respondents may

[199] 300 hours x 200 respondents = 60,000 hours.

arrange in excess of 20 new deals per year, while a smaller entity may only arrange one or two new deals on an annual basis. Based on this analysis, the Commission estimates that it would take a respondent approximately 20 hours[200] to disclose this information under the proposed rule, on an annual basis, for a total aggregate annual hour burden of 4,000 hours.[201]

In addition, proposed Rule 17g-5(a)(ii) would require disclosure of information provided to an NRSRO that is used by an NRSRO in undertaking credit rating surveillance on a security or money market instrument. Because surveillance would cover more than just initial ratings, the Commission estimates based on staff information gained from the NRSRO examination process that monthly disclosure would be required with respect to approximately 125 transactions on an ongoing basis. Also based on staff information gained from the NRSRO examination process, the Commission estimates that it would take a respondent approximately 0.5 hours per transaction to disclose the information. Therefore, the Commission estimates that each respondent would spend approximately 750 hours[202] on an annual basis disclosing information under proposed Rule 17g-5, for a total aggregate annual burden hours of 150,000 hours.[203]

The Commission generally requests comment on all aspects of these proposed burden estimates for Rule 17g-5. In addition, the Commission requests specific comment on the following items related to these estimates:

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[200] 20 transactions x 1 hour = 20 hours.

[201] 20 hours x 200 respondents = 4,000 hours.

[202] 125 transactions x 30 minutes x 12 months = 45,000 minutes/60 minutes = 750 hours.

[203] 750 hours x 200 respondents = 150,000 hours.

- Are there publicly available reports or other data sources the Commission should consider in arriving at these burden estimates?
- Are the estimates of the one-time and recurring burdens of the proposed additional disclosures accurate? If not, should they be higher or lower?

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

5. Proposed Rule 17g-7

The Commission is proposing a new rule – Rule 17g-7 – which would address concerns that investors believe that the risk characteristics for a structured finance product are the same as for other types of obligors or debt securities. Proposed Rule 17g-7 would require an NRSRO to attach a report each time it publishes a credit rating for a structured finance product describing how the ratings procedures and methodologies differ from those for other types of obligors or debt securities.[204] Proposed Rule 17g-7 would include an exemption to this requirement, however, if the NRSRO used credit rating symbols for structured finance products that identify the product as such as distinct from any other type of obligor or debt security. The Commission believes that proposed Rule 17g-7[205] would provide users of credit ratings with useful information either through the report or the differentiated symbol upon which to base their investment decisions.

The Commission expects that most NRSROs already have documented their methodologies and procedures in place to determine credit ratings for structured finance products and corporate debt securities, and have disclosed such policies and procedures if

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204 See proposed Rule 17g-7.

205 See proposed Rule 17g-7.

they have registered with the Commission as an NRSRO. The Commission expects, however, that an NRSRO would have to compile and/or modify these documents to comply with the specific reporting requirements that would be mandated by the proposed rule. Based on staff information gained from the NRSRO examination process, the Commission estimates that it would take an NRSRO approximately 50 hours[206] to draft the report required under the proposed rule for a total one-time hour burden of 1,500 hours.[207]

The Commission also estimates that it would take an NRSRO additional time to publish the report each time a credit rating for a structured finance product is published and to monitor the publications of structured finance credit ratings to ensure compliance with the proposed rule. Based on the average number of credit ratings of asset-backed securities outstanding as of the latest fiscal year of the three largest NRSROs, the Commission estimates that an NRSRO would publish approximately 128,000 asset-backed credit ratings per year.[208] The Commission notes that this number may not include all structured finance ratings, since some may not fit within the statutory definition of asset-backed security. However, the Commission also notes that the issuance of RMBS has dropped dramatically off recent highs. Accordingly, the Commission believes the number of asset-backed ratings reported in Form NRSRO is a

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206 The Commission based this estimate on the estimated number of hours it would take an NRSRO to comply with Rule 17g-4 to develop policies and procedures to prevent the misuse of material nonpublic information. See Adopting Release, 72 FR at 33611.

207 50 hours x 30 NRSROs = 1,500 hours.

208 This estimate uses the average of the approximate number of credit ratings for asset-based securities as defined in 17 CFR 229.1101(c) that S&P, Moody's and Fitch had outstanding as of the most recent calendar year end as reported in their annual certifications. (S&P: 197,700; Moody's: 110,000; and Fitch: 75,278).

reasonable proxy for the number of structured finance ratings. The Commission also notes that, as discussed below, the burden estimate identifies 30 respondents. However, most of the structured finance ratings are concentrated in the largest 3 or 4 NRSROs. Accordingly, the average number of structured finance ratings issued per NRSRO each year may be considerably lower than 128,000. For these reasons, the Commission believes the estimate is fairly conservative.

The Commission estimates that an NRSRO would publish a rating action with respect to a particular structured finance rating approximately 4 times per year for a total of 512,000 publications.[209] The Commission notes that this estimate would include publication of an initial rating, upgrades, downgrades and any affirmations published in a given year. Based on staff experience, the Commission estimates that an NRSRO would spend approximately 5 minutes ensuring that the required report was published along with the credit rating, for a total of 42,667 annual burden hours[210] per respondent, and a total of 1,280,000 hours[211] across 30 NRSROs. Finally, the Commission estimates, based on staff experience, that it would take an NRSRO approximately 10 hours per year to review and update the report to ensure that the disclosure was accurate and up-to-date for a total aggregate annual hour burden to the industry of 300 hours.[212] The Commission

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209 128,000 x 4 = 512,000 ratings publications.

210 512,000 x 5 minutes per report = 2,560,000 minutes/60 minutes per hour = 42,667 hours.

211 42,667 hours x 30 NRSROs = 1,280,000 hours.

212 This estimate is based on the number of hours it would take an NRSRO to complete an annual certification on Form NRSRO. See Adopting Release, 72 FR at 33609. 10 hours x 30 NRSROs = 300 hours.

believes, therefore, that the aggregate one-time and annual burden hours under proposed Rule 17g-7(a) would be 1,280,000 and 1,800 hours,[213] respectively.

The Commission believes, however, that most, if not all, NRSROs would opt to differentiate their ratings under paragraph (b) of proposed Rule 17g-7,[214] rather than publish a report. The Commission believes that an NRSRO would likely choose to use a specific credit rating symbol to indicate that the particular credit rating relates to structured product as distinct from a credit rating for any other category of security or issuer. The Commission believes that an NRSRO would choose to employ this symbology approach because it would be more efficient and less burdensome than ensuring that the appropriate report was published along with the credit rating. The Commission believes that the implementation of a different rating symbol would entail a one-time burden of approximately 30 hours to develop the symbol for a total aggregate one-time burden to the industry of 900 hours.[215]

Because the Commission believes that NRSROs will choose to differentiate their ratings under paragraph (b) of proposed Rule 17g-7 rather than publish a report under paragraph (a) of the proposed new rule, the Commission believes that the appropriate estimate for the aggregate one-time burden to the industry under proposed Rule 17g-7 is 900 hours. The Commission generally requests comment on all aspects of these proposed burden estimates for Rule 17g-7. In addition, the Commission requests specific comment on the following items related to these burden estimates:

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213 1,500 + 300 hours.

214 See proposed Rule 17g-7(b).

215 30 hours x 30 NRSROs.

- Is the Commission incorrect in its belief that NRSROs would opt to use a different rating symbol rather than to publish a report with each structured product rating? If so, what percentage of NRSROs would be likely to opt to publish a report?

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

E. Collection of Information Is Mandatory

The recordkeeping and notice requirements for the proposed amendment and the proposed new rule would be mandatory.

F. Confidentiality

The disclosures proposed to be required under the amendments to Rule 17g-1 and Form NRSRO would be made publicly available on Form NRSRO. The books and records information proposed to be collected under the proposed amendments to Rule 17g-2 would be stored by the NRSRO and made available to the Commission and its representatives as required in connection with examinations, investigations, and enforcement proceedings. However, an NRSRO would be required to make the record of rating actions under proposed Rule 17g-2(a)(8) publicly available in an XBRL Interactive Data File no later than six months after the date of the rating action.[216] The information proposed to be collected under the proposed amendment to Rule 17g-3 would be generated from the internal records of the NRSRO and would be furnished to the Commission on a confidential basis, to the extent permitted by law.[217] The information

216 See proposed Rule 17g-2(a)(8) and (d).

217 15 U.S.C. 78o-7(k).

under Rule 17g-5(a)(3) would be made publicly available or available to certain permitted persons. The information proposed to be required under proposed new Rule 17g-7 would be made publicly available.

G. Record Retention Period

The records required under the proposed amendments to Rule 17g-1 and Form NRSRO, Rule 17g-2, and 17g-3 would need to be retained by the NRSRO for at least three years.[218]

H. Request for Comment

The Commission requests comment on the proposed collections of information in order to: (1) evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information would have practical utility; (2) evaluate the accuracy of the Commission's estimates of the burden of the proposed collections of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; (4) evaluate whether there are ways to minimize the burden of the collection of information on those who respond, including through the use of automated collection techniques or other forms of information technology; and (5) evaluate whether the proposed rules would have any effects on any other collection of information not previously identified in this section.

Persons who desire to submit comments on the collection of information requirements should direct their comments to the OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Secretary,

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218 17 CFR 240.17g-2(c).

Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, and refer to File No. S7-13-08. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this document in the Federal Register; therefore, comments to OMB are best assured of having full effect if OMB receives them within 30 days of this publication. Requests for the materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-13-08, and be submitted to the Securities and Exchange Commission, Records Management Office, 100 F Street, NE, Washington, DC 20549-1110.

V. COSTS AND BENEFITS OF THE PROPOSED RULES

The Commission is sensitive to the costs and benefits that result from its rules. The Commission has identified certain costs and benefits of the proposed amendments and the proposed new rule and requests comment on all aspects of this cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in the analysis.[219] The Commission seeks comment and data on the value of the benefits identified. The Commission also welcomes comments on the accuracy of its cost estimates in each section of this cost-benefit analysis, and requests those commenters to

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219 For the purposes of this cost/benefit analysis, the Commission is using salary data from the Securities Industry and Financial Markets Association ("SIFMA") Report on Management and Professional Earnings in the Securities Industry 2007, which provides base salary and bonus information for middle-management and professional positions within the securities industry. The Commission believes that the salaries for these securities industry positions would be comparable to the salaries of similar positions in the credit rating industry. Finally, the salary costs derived from the report and referenced in this cost benefit section, are modified to account for an 1800-hour work year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. The Commission used comparable assumptions in adopting the final rules implementing the Rating Agency Act in 2007, requested comments on such assumptions, and received no comments in response to its request. See Adopting Release, 72 FR at 33611, note 576. Hereinafter, references to data derived from the report as modified in the manner described above will be cited as "SIFMA 2007 Report as Modified."

provide data so the Commission can improve the cost estimates, including identification of statistics relied on by commenters to reach conclusions on cost estimates. Finally, the Commission seeks estimates and views regarding these costs and benefits for particular types of market participants, as well as any other costs or benefits that may result from the adoption of these proposed rule amendments.

A. Benefits

The purposes of the Rating Agency Act, as stated in the accompanying Senate Report, are to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry.[220] As the Senate Report states, the Rating Agency Act establishes "fundamental reform and improvement of the designation process" to further the belief that "eliminating the artificial barrier to entry will enhance competition and provide investors with more choices, higher quality ratings, and lower costs."[221]

The proposed amendments and new rule would be issued pursuant to specific grants of rulemaking authority in the Rating Agency Act as well as the Commission's authority under the Exchange Act. The amendments are designed to further the goals of the Rating Agency Act and to enhance the Commission's oversight of NRSROs, in light of the recent credit market turmoil. Since the adoption of the final rules implementing the Rating Agency Act in 2007,[222] and in response to the recent concerns about the role of credit rating agencies in the credit market turmoil, the Commission has identified a

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220 Senate Report, p. 2.

221 Id, p. 7.

222 See Adopting Release.

number of areas where it would be appropriate to enhance the current regulatory program for NRSROs.

Consequently, the Commission is proposing amendments and a new rule that are designed to address concerns raised about the role NRSROs played in the credit turmoil by proposing to enhance the disclosure of credit ratings performance measurement statistics; increase the disclosure of information about the assets underlying structured finance products; require more information about the procedures and methodologies used to determine structured finance ratings; and address conflicts of interest arising from the structured finance rating process. As discussed below, the Commission believes that these proposed amendments and proposed new rule would further the purpose of the Rating Agency Act to improve the quality of credit ratings by fostering accountability, transparency, and competition in the credit rating industry, particularly with respect to credit ratings for structured finance products.[223]

Rule 17g-1 prescribes a process for a credit rating agency to register with the Commission as an NRSRO using Form NRSRO,[224] and requires that a credit rating agency provide information required under Section 15E(a)(1)(B) of the Exchange Act and certain additional information.[225] Form NRSRO is also the means by which NRSROs update the information they must publicly disclose. The proposed amendments to the instructions to Exhibit 1 to Form NRSRO would require NRSROs to provide more detailed performance statistics and, thereby, make it easier for users of credit ratings to

223 See Senate Report, p. 2.

224 See Rule 17g-1.

225 See Section 15E(a)(1)(B) of the Exchange Act. 15 U.S.C. 78o-7(a)(1)(B).

compare the ratings performance of the NRSROs.[226] In addition, these proposed amendments could make it easier for an NRSRO to demonstrate that it has a superior ratings methodology or competence and, thereby, attract clients.

The proposed amendments to the instructions to Exhibit 2 of Form NRSRO are designed to provide greater clarity around three areas of the NRSROs' rating processes for structured finance products that have raised concerns in the context of the recent credit market turmoil: the level of verification performed on information provided in loan documents; the quality of loan originators; and the on-going surveillance of existing ratings and how changes made to a model used for initial ratings are applied to existing ratings. The additional information provided by the proposed amendments would assist users of credit ratings in making more informed decisions about the quality of an NRSRO's ratings processes, particularly with regard to structured finance products.

The Commission preliminarily believes that these proposed enhanced disclosures in the Exhibits to Form NRSRO could make it easier for market participants to select the NRSROs that are performing best and have the highest quality processes for determining credit ratings. The potential result could be increased competition and the promotion of capital formation through a restoration of confidence in credit ratings.

The proposed amendments to Rule 17g-2 are designed to assist the Commission in its examination function and provide greater information to users of credit ratings about the performance of an NRSRO's credit ratings. The additional records would be: (1) a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued, if a quantitative model is a substantial

226 17 CFR 240.17g-1 and Form NRSRO.

component in the process of determining a credit rating;[227] (2) a record showing the history and dates of all previous rating actions with respect to each current credit rating;[228] and (3) any complaints regarding the performance of a credit analyst in determining credit ratings.[229] These proposed records would assist the Commission in monitoring whether an NRSRO is complying with provisions of Section 15E of the Exchange Act and the rules thereunder. This would include monitoring whether an NRSRO is operating consistently with the methodologies and procedures it establishes (and discloses) to determine credit ratings and its policies and procedures designed to ensure the impartiality of its credit ratings, including its ratings of structured finance products.

In addition, the proposed amendments to Rule 17g-2, which would require an NRSRO to make its rating actions history publicly available in an XBRL Interactive Data File, would allow the marketplace to develop performance measurement statistics that would supplement those already required to be published by NRSROs in Exhibit 1 to Form NRSRO. This proposed amendment is designed to leverage the expertise of the marketplace and, thereby, provide users of credit ratings with innovative and potentially more useful metrics with which to compare NRSROs. This could make NRSROs more accountable for their ratings by enhancing the transparency of their ratings performance. By proposing to require an XBRL Interactive Data File the Commission also believes the proposed amendment would allow investors, analysts, and the Commission staff to

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227 Proposed paragraph (a)(2)(iii) of Rule 17g-2.

228 Proposed paragraph (a)(8) of Rule 17g-2.

229 Proposed paragraph (b)(8) of Rule 17g-2.

capture and analyze the ratings action data more quickly and at less of a cost than is possible using another format.

The Commission preliminarily believes that the proposed amendments to Rule 17g-2 would enhance the Commission's oversight of NRSROs and, with respect to the public disclosure of ratings history, provide the marketplace with the raw materials to develop metrics for comparing the ratings performance of NRSROs. This could, in turn, help in restoring confidence in credit ratings and, thereby, promote capital formation. Increased disclosure of ratings history could make the ratings performance of the NRSROs more transparent to the marketplace and, thereby, highlight those firms that do a better job analyzing credit risk. This could benefit smaller NRSROs to the extent they have performed better than others by alerting the market to their superior competence.

The proposed amendment to Rule 17g-3 would require an NRSRO to furnish an additional annual report to the Commission: an unaudited report of the number of credit ratings that were changed during the fiscal year in each class of credit ratings for which the NRSRO is registered with the Commission.[230] The proposed new report is designed to enhance the Commission's oversight of NRSROs by providing the Commission with additional information to assist in the monitoring of NRSROs for compliance with their stated policies and procedures. For example, the proposed new report would allow examiners to target potential problem areas in an NRSRO's rating processes by highlighting spikes in rating actions within a particular class of credit rating.

The proposed amendments to Rule 17g-5 would prohibit an NRSRO from issuing a rating for a structured product unless information about the assets underlying the rated

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[230] See proposed Rule 17g-3(a)(6).

security is made available to certain persons.[231] These proposed rule amendments would prohibit an NRSRO from issuing or maintaining a credit rating where the NRSRO or an affiliate provided recommendations on the structure of the transaction being rated; a credit analyst or person involved in the ratings process participated in fee negotiations; or a credit analyst or a person responsible for approving a credit rating received gifts from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities such as meetings that have an aggregate value of no more than $25.[232] The Commission believes that the proposed amendments to Rule 17g-5 would promote the disclosure and management of conflicts of interest and mitigate potential undue influences on an NRSRO's credit rating process, particularly with respect to credit ratings for structured finance products.[233] This would in turn increase confidence in the integrity of NRSRO ratings and, thereby, promote capital formation. In addition, the proposed disclosure of additional information regarding the assets underlying a structured finance transaction[234] would allow for unsolicited ratings that could help address ratings shopping by exposing an NRSRO whose ratings methodologies are less conservative in order to gain business. It also could mitigate the impact of rating shopping, since NRSROs not hired to rate a deal could nonetheless issue a credit rating. These potential impacts of the rule proposal could help to restore confidence in credit ratings and, thereby, promote capital formation. Also, by creating a mechanism for determining unsolicited ratings, they could increase

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231 See proposed Rule 17g-5(a)(3) and (b)(9).

232 See proposed Rule 17 CFR 240.17g-5(c)(5)-(7).

233 See 15 U.S.C. 78o-7(a)(1)(B)(vi) and (h).

234 See proposed Rule 17 CFR 240.17g-5(a)(3).

competition by allowing smaller NRSROs to demonstrate proficiency in rating structured products.

Proposed Rule 17g-7 would address concerns that investors may believe that the risk characteristics for a structured finance product are the same as for other types of obligors or debt securities by requiring an NRSRO to attach a report each time it publishes a credit rating for a structured finance product describing how the ratings procedures and methodologies differ from those ratings for other types of obligors or debt securities.[235] Alternatively, an NRSRO would be permitted to use rating symbols for structured finance products that differentiate them from its other credit ratings. The Commission believes this proposed rule would address potential confusion by investors as to the different characteristics of structured finance products when compared to other types of obligors or debt securities and help them in assessing the risks involved with different types of securities and promote better informed investment decisions.

The Commission generally requests comment on all aspects of these proposed benefits. In addition, the Commission requests specific comment on the following items related to these benefits.

- Are there metrics available to quantify these benefits and any other benefits the commenter may identify, including the identification of sources of empirical data that could be used for such metrics.

Commenters should provide specific data and analysis to support any comments they submit with respect to these benefit estimates.

B. Costs

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[235] See proposed Rule 17g-7.

The cost of compliance with the proposed amendments and new rule to a given NRSRO would depend on its size and the complexity of its business activities. The size and complexity of NRSROs vary significantly. Therefore, the cost could vary significantly across NRSROs. Instead, the Commission is providing estimates of the average cost per NRSRO, as a result of the proposed amendments, taking into consideration the range in size and complexity of NRSROs and the fact that many already may have established policies, procedures and recordkeeping systems and processes that would comply substantially with the proposed amendments. Additionally, the Commission notes that nine credit rating agencies are currently registered with the Commission as NRSROs and subject to the Act and its implementing regulations. The cost of compliance would also vary depending on which classes of credit ratings an NRSRO issues. NRSROs which issue credit ratings for structured finance products would incur higher compliance costs than those NRSROs which do not issue such credit ratings or issue very few credit ratings in that class.

For these reasons, the cost estimates represent the average cost across all NRSROs and take into account that some firms would only need to augment existing policies, procedures and recordkeeping systems and processes to come into compliance with the proposed amendments.

1. Proposed Amendments to Form NRSRO

As discussed above, the Commission is proposing to amend the instructions to Exhibit 1 to Form NRSRO to provide more detailed performance statistics. Currently, the instructions require the disclosure of performance measurement statistics of the credit ratings of the "Applicant/NRSRO over the short-term, mid-term and long-term periods (as applicable) through the most recent calendar year end." The proposed amendments would augment these instructions to require the disclosure of separate sets of default and transition statistics for each class of credit ratings. In addition, the class-by-class disclosures would need to be broken out over 1, 3 and 10 year periods.[236]

The proposed amendments would also amend the instructions to Exhibit 2 to Form NRSRO to require enhanced disclosures about the procedures and methodologies an NRSRO uses to determine credit ratings, including whether and, if so, how information about verification performed on assets underlying a structured finance transaction is relied on in determining credit ratings; whether and, if so, how assessments of the quality of originators of assets underlying a structured finance transaction factor into the determination of credit ratings; and how frequently credit ratings are reviewed, whether different models are used for ratings surveillance than for determining credit ratings, and whether changes made to models and criteria for determining initial ratings are applied retroactively to existing ratings. As discussed above, the Commission estimates that for PRA purposes the total one-time and annual hour burdens and the cost would have a neutral effect, resulting in no overall change in hours or cost for the currently approved PRA collection.

The Commission preliminarily believes, however, NRSROs may incur a cost of compliance in updating their performance metric statistics to conform to the new requirements set forth in the proposed rule amendments. Under the current instructions to Exhibit 1 to Form NRSRO, an NRSRO must disclose its performance metrics over short, mid, and long-term periods. Thus, the current Form NRSRO instructions to Exhibit 1 allow an NRSRO to use its own definitions of "short, mid, and long-term

[236] See proposed instructions to Exhibit 1, Form NRSRO.

periods" and to include all credit ratings, regardless of class of rating, in one set of metrics. Under the proposed amendments, an NRSRO would be required to break out on a class-by-class basis performance statistics over 1, 3 and 10-year periods. The Commission believes that existing NRSROs would incur costs to conform their current performance statistics with the requirements of this proposed amendment to Exhibit 1.

The Commission estimates that it would take each NRSRO currently registered with the Commission approximately 50 hours to review its performance measurement statistics and to develop and implement any changes necessary to comply with the proposed amendment. The Commission is basing this estimate on the amount of time the Commission estimated that it would take an NRSRO to establish procedures in conformance with Rule 17g-4 and on information gained from the NRSRO examination process.[237] For these reasons, the Commission estimates that the average one-time cost to an NRSRO would be $12,740[238] and the total aggregate cost to the currently registered NRSROs would be $114,660.[239]

The Commission generally requests comment on all aspects of these proposed cost estimates for the proposed amendments to Form NRSRO. In addition, the Commission requests specific comment on the following items related to these cost estimates:

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237 See 17 CFR 240.17g-4; Adopting Release, 72 FR at 33616.

238 The Commission estimates that a Compliance Attorney (40 hours) and a Programmer Analyst (10 hours) would perform these responsibilities. The SIFMA 2007 Report as Modified indicates that the average hourly rates for a Compliance Attorney and a Programmer Analyst are $270 and $194 per hour, respectively. Therefore, the average one-time cost to an NRSRO would be $12,740 [(40 hours x $270) + (10 hours x $194)].

239 $12,740 x 9 NRSROs = $114,660.

- Would these proposals impose costs on other market participants, including persons who use credit ratings to make investment decisions or for regulatory purposes, and persons who purchase services and products from NRSROs?

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

2. Proposed Amendments to Rule 17g-2

Rule 17g-2 requires an NRSRO to make and preserve specified records related to its credit rating business.[240] As discussed above, the proposed amendments to Rule 17g-2 would require an NRSRO to make and retain two additional records and retain a third type of record. The records to be made and retained would be: (1) a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued, if a quantitative model is a substantial component in the process of determining a credit rating;[241] and (2) a record showing the history and dates of all previous rating actions with respect to each current credit rating.[242] The proposed amendments to Rule 17g-2 would require an NRSRO to make the second record – rating actions related to current ratings – publicly available in an XBRL Interactive Data File.[243] In addition, the proposed amendments would require an NRSRO to retain communications that contain any complaints by an obligor, issuer, underwriter, or sponsor about the performance of a credit analyst.[244]

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[240] 17 CFR 240.17g-2.

[241] Proposed paragraph (a)(2)(iii) of Rule 17g-2.

[242] Proposed paragraph (a)(8) of Rule 17g-2.

[243] Proposed amendment to Rule 17g-2(d).

[244] Proposed paragraph (b)(8) of Rule 17g-2.

As discussed with respect to the PRA, the Commission estimates that, based on staff experience, that the total one-time and annual recordkeeping burdens would increase approximately 10% and 5%, respectively. Thus, the Commission estimates that the one-time hour burden that each NRSRO would spend implementing a recordkeeping system to comply with Rule 17g-2 would be approximately 330 hours (an increase of 30 hours)[245] for a total one-time burden of 9,900 hours (an increase of 900 hours).[246]

The Commission estimates that an NRSRO would spend an average of 267 hours per year (an increase of 13 hours)[247] to make and maintain records under Rule 17g-2, for a total annual hour burden of 8,010 hours.[248] This estimate would increase the currently approved PRA burden under Rule 17g-2 by 390 hours.[249] For these reasons, the Commission estimates that an NRSRO would incur an average one-time cost of $7,350 and the average annual cost of $3,185, as a result of the proposed amendments.[250] Consequently, the total aggregate one-time cost attributable to the proposed amendments would be $220,500[251] and the total aggregate annual cost to the industry would be $95,550.[252]

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245 300 hours x 1.10 = 330 hours.

246 330 hours x 30 respondents = 9,900 hours.

247 254 hours x 1.05 = 267 hours.

248 267 hours x 30 respondents = 8,010 hours.

249 8,010 hours – 7,620 hours = 390 hours.

250 The Commission estimates that an NRSRO will have a Compliance Manager perform these responsibilities. Based on the average hourly rate for a Compliance Manager of $245, the average one time cost will be $7,350 (30 hours x $245 per hour) and the average annual cost will be $3,185 (13 hours x $245 per hour).

251 $7,350 x 30 NRSROs = $220,500.

252 $3,185 x 30 NRSROs = $95,550.

In addition, the proposed amendments to Rule 17g-2 would require an NRSRO to make the records of its rating actions publicly available in an XBRL Interactive Data File.[253] As discussed with respect to the PRA, the Commission estimates that, on average, an NRSRO would spend approximately 30 hours to publicly disclose this ratings history information in an XBRL Interactive Data File and, thereafter, 10 hours per year to update its rating action history.[254] Accordingly, the total aggregate one-time burden to the industry to make the history of its rating actions publicly available in an XBRL Interactive Data File would be 900 hours[255] and the total aggregate annual burden hours would be 300 hours.[256] Furthermore, as discussed in the PRA the Commission estimates there will be 30 NRSROs. For these reasons, the Commission estimates that an NRSRO would incur an average one-time cost of $8,670 and an average annual cost of $2,890, as a result of the proposed amendment.[257] Consequently, the total aggregate one-time cost to the industry would be $260,100[258] and the total aggregate annual cost to the industry would be $86,700.[259]

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[253] See proposed amendment to Rule 17g-2(d).

[254] The Commission also bases this estimate on the estimated one time and annual burden hours it would take an NRSRO to publicly disclose its Form NRSRO on its Web site. No comments were received on these estimates in the final rule release. See Adopting Release, 72 FR at 33609.

[255] 30 hours x 30 NRSROs = 900 hours.

[256] 10 hours x 30 NRSROs = 300 hours.

[257] The Commission estimates that an NRSRO would have a Senior Programmer perform these responsibilities. The SIFMA 2007 Report as Modified indicates that the average hourly cost for a Senior Programmer is $289. Therefore, the average one-time cost would be $8,670 [(30 hours) x ($289 per hour)] and the average annual cost would be $2,890 [(10 hours per year) x ($289 per hour)].

[258] 900 hours x $289 per hour.

[259] 300 hours x $289 per hour.

As discussed with respect to the PRA, the Commission estimated that an NRSRO may have to purchase recordkeeping software to establish a recordkeeping system in conformance with Rule 17g-2. The Commission estimated that the cost of the software will vary based on the size and complexity of the NRSRO. Also, the Commission estimated that some NRSROs would not need such software because they already have adequate recordkeeping systems or, given their small size, such software would not be necessary. Based on these estimates, the Commission estimated that the average cost for recordkeeping software across all NRSROs would be approximately $1,000 per firm. Therefore, the estimated one-time cost to the industry would be $30,000. The Commission estimates that the proposed amendments to Rule 17g-2 would not alter this estimate or that any increases in the cost would be de minimis.

Finally, proposed paragraph (a)(8) to Rule 17g-2 would require an NRSRO to create and maintain a record showing all rating actions and the date of such actions from the initial rating to the current rating identified by the name or rated security or obligor, and, if applicable, the CUSIP of the rated security or the Central Index Key (CIK) number of the rated obligor.[260] The Commission estimates that an NRSRO could be required to purchase a license from the CUSIP Service Bureau in order to access CUSIP numbers for the securities it rates. The CUSIP Service Bureau's operations are covered

260 See proposed Rule 17g-2(a)(8). The Central Index Key (CIK) is used on the Commission's computer systems to identify corporations and individual people who have filed disclosure with the Commission. Anyone may search www.edgarcompany.sec.gov for a company, fund, or individual CIK. There is no fee for this service. CUSIP stands for Committee on Uniform Securities Identification Procedures. A CUSIP number identifies most securities, including: stocks of all registered U.S. and Canadian companies, U.S. government and municipal bonds, as well as structured finance issuances. The CUSIP system—owned by the American Bankers Association and operated by Standard & Poor's—facilitates the clearing and settlement process of securities. The CUSIP number consists of nine characters (including letters and numbers) that uniquely identify a company or issuer and the type of security.

by fees paid by issuers and licensees of the CUSIP Service Bureau's data. Issuers pay a one-time fee for each new CUSIP assigned, and licensees pay a renewable subscription or a license fee for access and use of the CUSIP Service Bureau's various database services. The CUSIP Service Bureau's license fees vary based on usage, i.e., how many securities or by type of security or business line.[261] The Commission estimates that the license fees incurred by an NRSRO would vary depending on the size of the NRSRO and the number of credit ratings it issues. For purposes of this cost estimate, the Commission estimates that an NRSRO would incur a fee of $100,000 to obtain access to the CUSIP numbers for the securities it rates. Consequently, the estimated total one-time cost to the industry would be $3,000,000.[262]

The Commission generally requests comment on all aspects of these cost estimates for the proposed amendments to Rule 17g-2. In addition, the Commission requests specific comment on the following items related to these cost estimates:

- Would these proposals impose costs on other market participants, including persons who use credit ratings to make investment decisions or for regulatory purposes, and persons who purchase services and products from NRSROs?

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

3. Proposed Amendment to Rule 17g-3

261 See https://www.cusip.com/static/html/webpage/service_fees.html#lic_fees.

262 $100,000 x 30 NRSROs = $3,000,000.

Rule 17g-3 requires an NRSRO to furnish audited annual financial statements to the Commission, including certain specified schedules.[263] The proposed amendment to Rule 17g-3 would require an NRSRO to furnish the Commission with an additional annual report: an unaudited report of the number of credit ratings that were changed during the fiscal year in each class of credit ratings for which the NRSRO is registered with the Commission. The Commission believes that the annual costs to NRSROs to comply with the proposed amendment to Rule 17g-3 would be de minimis, as the Commission preliminarily believes that a credit rating agency already would have this information with respect to each class of credit ratings for which it is registered. In addition, the proposed amendment does not prescribe a format for the report. Consequently, the Commission estimates that proposed Rule 17g-3(a)(6) would not have a significant effect on the total average annual cost burden currently estimated for Rule 17g-3.

The Commission generally requests comment on all aspects of these cost estimates for the proposed amendment to Rule 17g-3. In addition, the Commission requests specific comment on the following items related to these cost estimates:

- Would this proposal impose costs on other market participants, including persons who use credit ratings to make investment decisions or for regulatory purposes, and persons who purchase services and products from NRSROs?

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

4. Proposed Amendments to Rule 17g-5

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263 17 CFR 240.17g-3.

Rules 17g-5 requires an NRSRO to manage and disclose certain conflicts of interest.[264] The proposed amendments would add an additional conflict to paragraph (b) of Rule 17g-5. This proposed conflict of interest would be issuing or maintaining a credit rating for a security or money market instrument issued by an asset pool or as part of an asset-backed or mortgage-backed securities transaction that was paid for by the issuer, sponsor, or underwriter of the security or money market instrument.[265] Unlike the other conflicts of interest in paragraph (b) of Rule 17g-5, NRSROs would be prohibited from issuing a rating, unless certain information about the transaction and the assets underlying the structured product being rated were disclosed, pursuant to proposed Rule 17g-5(a)(3)(i) and (ii).[266]

Specifically, proposed Rule 17g-5(a)(3)(i) and (ii) would require the disclosure of certain information about the assets underlying a structured product that is provided to an NRSRO and used in determining an initial rating and monitoring the rating. While the proposed rule would require disclosure of certain information, the rule would not specify which party would disclose the information. For purposes of this PRA, the Commission estimates that it would take a respondent approximately 300 hours to develop a system, as well as policies and procedures to disclose the information as required under the proposed rule. This would result in a total one-time hour burden of 60,000 hours for 200 respondents.[267] For these reasons, the Commission estimates that the average one-time

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264 17 CFR 240. 17g-5.

265 See proposed Rule 17g-5(b)(9). The current paragraph (b)(9) would be renumbered as (b)(10).

266 See proposed Rule 17g-5(a)(3).

267 300 hours x 200 respondents = 60,000 hours.

cost to each respondent would be $65,850[268] and the total aggregate one-time cost to the industry would be $13,116,000.[269]

As discussed with respect to the PRA, in addition to the one-time hour burden, respondents also would be required to disclose the required information under proposed Rule 17g-5(a)(3)(i) on a transaction by transaction basis. Based on staff information gained from the NRSRO examination process, the Commission estimates that the proposed amendments would require each respondent to disclose information with respect to approximately 20 new transactions per year and that it would take approximately 1 hour per transaction to make the information publicly available.[270] Therefore, as discussed with respect to the PRA, the Commission estimates that it would take a respondent approximately 20 hours[271] to disclose this information under proposed Rule 17g-5(a)(i) and (ii), on an annual basis, for a total aggregate annual hour burden of 4,000.[272] For these reasons, the Commission estimates that the average annual cost to a

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268 The Commission estimates an NRSRO would have a Compliance Manager and a Programmer Analyst perform these responsibilities, and that each would spend 50% of the estimated hours performing these responsibilities. The SIFMA 2007 Report as Modified indicates that the average hourly cost for a Compliance Manager is $245 and the average hourly cost for a Programmer Analyst is 194. Therefore, the average one-time cost to an NRSRO would be $[150 hours x $245) + (150 hours x $194)] = $65,850.

269 $65,580 x 200 respondents = $13,116,000.

270 This estimate assumes the respondent has already implemented the system and policies and procedures for disclosure. The Commission cannot estimate the number of initial transactions per year with certainty. The Commission believes that the number of deals that each respondent will disclose information on will vary widely based on the size of the entity. In addition, the Commission preliminarily believes that the number of asset-backed or mortgaged-backed issuances being rated by NRSROs in the next few years would be difficult to predict given the recent credit market turmoil.

271 20 transactions x 1 hour = 20 hours.

272 20 hours x 200 respondents = 4,000 hours.

respondent would be $4,100[273] and the total annual cost to the industry would be $820,000.[274]

Proposed Rule 17g-5(a)(ii) would require respondents to disclose information provided to an NRSRO that is used by an NRSRO in undertaking credit rating surveillance on a structured product. Because surveillance would cover more than just initial ratings, the Commission estimates that a respondent would be required to disclose information with respect to approximately 125 transactions on an ongoing basis and that the information would be provided to the NRSRO on a monthly basis. As discussed with respect to the PRA, the Commission estimates that each respondent would spend approximately 750 hours[275] on an annual basis disclosing the information for a total aggregate annual burden hours of 150,000 hours.[276] For these reasons, the Commission estimates that the average annual cost to a respondent would be $153,750[277] and the total annual cost to the industry would be $30,750,000.[278]

The Commission is also proposing to amend paragraph (c) to Rule 17g-5 to add three additional prohibited conflicts of interest.[279] The Commission estimates that the amendments to paragraph (c) to Rule 17g-5 generally would impose de minimis costs on

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273 The Commission estimates an NRSRO would have a Webmaster perform these responsibilities. The SIFMA 2007 Report as Modified indicates that the average hourly cost for a Webmaster is $205. Therefore, the average one-time cost to a respondent would be 20 hours x $205 = $4,100.

274 $4,100 x 200 respondents = $820,000.

275 125 transactions x 30 minutes x 12 months = 45,000 minutes/60 minutes = 750 hours.

276 750 hours x 200 respondents = 150,000 hours.

277 The Commission estimates an NRSRO would have a Webmaster perform these responsibilities. The SIFMA 2007 Report as Modified indicates that the average hourly cost for a Webmaster is $205. Therefore, the average one-time cost to a respondent would be 750 hours x 205 = $153,750.

278 $153,750 x 200 respondents = $30,750,000.

279 See proposed Rule 17g-5(c)(5)-(7).

an NRSRO. However, the Commission recognizes that an NRSRO may incur costs related to training employees about the requirements with respect to these proposed amendments. It also is possible that the proposed amendments could require some NRSROs to restructure their business models or activities, in particular with respect to their consulting services.

The Commission generally requests comment on all aspects of these cost estimates for the proposed amendments to Rule 17g-5. In addition, the Commission requests specific comment on the following items related to these cost estimates:

- Would the proposals for additional disclosure impose costs on issuers, underwriters, sponsors, depositors, or trustees?
- Would these proposals impose costs on other market participants, including persons who use credit ratings to make investment decisions or for regulatory purposes, and persons who purchase services and products from NRSROs?
- Would there be costs in addition to those identified above, such as costs arising from systems changes and restructuring business practices to account for the new reporting requirement?
- Would the proposed amendments to paragraph (c) of Rule 17g-5 impose training and restructuring costs?
- Would the proposed amendments to paragraph (c) of Rule 17g-5 impose personnel costs?
- Would the proposed amendments to paragraph (c) of Rule 17g-5 impose any additional costs on an NRSRO that is part of a large conglomerate related to

monitoring the business activities of persons associated with the NRSRO, such as affiliates located in other countries, to comply with the proposed requirement? Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

5. Proposed Rule 17g-7

The Commission is proposing a new rule – proposed Rule 17g-7 – which would require an NRSRO to attach a report each time it publishes a credit rating for a structured finance product describing how the ratings procedures and methodologies differ from those for corporate debt.[280] Alternatively, an NRSRO would be permitted to use rating symbols for structured finance products that differentiate them from its other credit ratings. The Commission expects that most NRSROs already have methodologies in place to determine credit ratings for structured finance products and corporate debt securities, and disclosed such policies and procedures if they have registered as an NRSRO. The Commission expects, however, that an NRSRO would have to conform these disclosures into a report to comply with the specific requirements in the proposed rule. As discussed above with respect to PRA, the Commission estimates that it would take approximately 50 hours for an NRSRO to compile and write disclosures to comply with the proposed rule and that there would be 30 NRSROs. For these reasons, the

280 See proposed Rule 17g-3A.

Commission estimates that the average one-time cost to an NRSRO would be $12,250[281] and the total aggregate one-time cost to the industry would be $367,500.[282]

As discussed above with respect to the PRA, the Commission also estimates that it would take an NRSRO additional time to attach the report to each credit rating for a structured finance product and to monitor the report on an ongoing basis to ensure that the disclosure was accurate. Based on staff experience staff information gained from the NRSRO examination process, the Commission estimates that an NRSRO would spend approximately 5 minutes to attach each proposed report to the estimated 128,000 asset-backed credit ratings per NRSRO, four times per year, as discussed above, for a total of 42,667 annual burden hours[283] per respondent, and a total of 1,280,010 annual burden hours[284] for 30 NRSROs. For these reasons, the Commission estimates that the average annual cost to an NRSRO would be $4,373,265[285] and the total aggregate annual cost to the industry would be $131,197,950.[286]

Finally, as discussed with respect to the PRA, the Commission estimates, based on staff experience, that it would take an NRSRO approximately 10 hours per year to

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281 The Commission estimates an NRSRO would have a Compliance Manager perform these responsibilities. The SIFMA 2007 Report as Modified indicates that the average hourly cost for a Compliance Manager is $245. Therefore, the average one-time cost to an NRSRO would be $12,250 (50 hours x $245).

282 30 NRSROs x $12,250 = $367,500.

283 128,000 x 4 = 512,000 reports x 5 minutes per report = 2,560,000 minutes/60 minutes per hour = 42,667 hours.

284 42,667 hours x 30 NRSROs = 1,280,010 hours.

285 The Commission estimates an NRSRO would have a Webmaster perform these responsibilities. The SIFMA 2007 Report as Modified indicates that the average hourly cost for a Webmaster is $205. Therefore, the average one-time cost to an NRSRO would be $4,373,265 (21,333 hours x $205).

286 $4,373,265 x 30 NRSROs = $131,197,950.

review and update the report to ensure the disclosure was accurate and up-to-date for a total aggregate annual hour burden to the industry of 300 hours.[287] For these reasons, the Commission estimates that the average annual cost to an NRSRO would be $2,700[288] and the total aggregate annual cost to the industry would be $81,000.[289]

The Commission generally requests comment on all aspects of these cost estimates for the proposed amendments to Rule 17g-7. In addition, the Commission requests specific comment on the following items related to these cost estimates:

- Would the use of different rating symbols for structured products impact automated securities trading, routing, settlement, clearance, trade confirmation, reporting, processing, and risk management systems and any other systems that are programmed to use standard credit rating symbols across all product classes?
- Would the use of different rating symbols have consequences for investment guidelines and covenants in legal documents that use credit ratings to distinguish finance instruments?
- Would these proposals impose costs on other market participants, including persons who use credit ratings to make investment decisions or for regulatory purposes, and persons who purchase services and products from NRSROs?

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287 This estimate is based on the number of hours it would take an NRSRO to complete an annual certification on Form NRSRO. See Exchange Act Release No. 55857 (June 5, 2007), 72 FR 33564, 33609 (June 18, 2007). 10 hours x 30 NRSROs = 300 hours.

288 The Commission estimates an NRSRO would have a Compliance Attorney perform these responsibilities. The SIFMA 2007 Report as Modified indicates that the average hourly cost for a Compliance Attorney is $270. Therefore, the average one-time cost to an NRSRO would be $2,700 (10 hours x $270).

289 $2,700 x 30 NRSROs = $81,000.

- Would there be costs in addition to those identified above, such as costs arising from systems changes and restructuring business practices to account for the new reporting requirement?

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

C. Total Estimated Costs and Benefits of this Rulemaking

As discussed above, the proposed amendments and new rules are expected to have both benefits and costs for investors and the credit rating industry as a whole. The Commission believes the benefits to investors and other users of credit ratings, especially with respect to investments in structured finance products would be quite substantial, but are difficult to quantify. Similarly difficult to quantify are the expected benefits to the Commission's oversight over NRSROs due to the enhanced recordkeeping, disclosure and reporting requirements. Moreover, not all the costs the Commission anticipates would result from this rulemaking are quantifiable. Based on the figures discussed above, however, the Commission estimates that the first year quantifiable costs related to this proposed rulemaking would be approximately $180,175,810.[290]

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

Under Section 3(f) of the Exchange Act,[291] the Commission shall, when engaging in rulemaking that requires the Commission to consider or determine if an action is necessary or appropriate in the public interest, consider whether the action will promote

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290 $17,078,760 (total one-time costs) + $163,097,810 (total annual costs) = $180,175,810.

291 15 U.S.C. 78c(f).

efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act[292] requires the Commission to consider the anticompetitive effects of any rules the Commission adopts under the 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. As discussed below, the Commission's preliminary view is that the proposed amendments and new rules should promote efficiency, competition, and capital formation.

The proposed amendments to the Instructions to Exhibit 1 to Form NRSRO would require NRSROs to make more comparable disclosures about the performance of their credit ratings. These could make it easier for an NRSRO to demonstrate that it has a superior ratings methodology or competence and, thereby, attract clients. In addition, the proposed amendments to the instructions to Exhibit 2 are designed to enhance the disclosures NRSROs make with respect to their methodologies for determining credit ratings. The Commission believes these enhanced disclosures would make it easier for users of credit ratings to compare the quality of the NRSRO's procedures and methodologies for determining credit ratings. The greater transparency that would result from all these enhanced disclosures could make it easier for market participants to select the NRSROs that are performing best and have the highest quality processes for determining credit ratings. This could increase competition and promote capital formation by restoring confidence in the credit ratings, which are an integral part of the capital formation process.

The proposed amendments to Rule 17g-2 are designed to enhance the Commission's oversight of NRSROs and, with respect to the public disclosure of ratings

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292 15 U.S.C. 78w(a)(2).

history, provide the marketplace with the raw materials to develop metrics for comparing the ratings performance of NRSROs. Enhancing the Commission's oversight could help in restoring confidence in credit ratings and, thereby, promote capital formation. Increased disclosure of ratings history could make the ratings performance of the NRSROs more transparent to the marketplace and, thereby, highlight those firms that do a better job analyzing credit risk. This could benefit smaller NRSROs to the extent they have performed better than others by alerting the market to their superior competence.

The proposed amendment to Rule 17g-3 is designed to enhance the Commission's oversight of NRSROs. Enhancing the Commission's oversight could help in restoring confidence in credit ratings and, thereby, promote capital formation.

The proposed amendments to paragraphs (a) and (b) of Rule 17g-5 would enhance the disclosures made about assets underlying structured finance products. The goal of these proposals is to provide a mechanism for NRSROs to determine unsolicited credit ratings and other market participants and observers to independently assess the creditworthiness of structured finance products. This could expose NRSROs whose procedures and methodologies for determining credit ratings are less conservative in order to gain business. It also could mitigate the impact of rating shopping, since NRSROs not hired to rate a deal could nonetheless issue a credit rating. These potential impacts of the rule proposal could help to restore confidence in credit ratings and, thereby, promote capital formation. Also, by creating a mechanism for determining unsolicited ratings, they could increase competition by allowing smaller NRSROs to demonstrate proficiency in rating structured products.

The proposed amendments to paragraph (c) of Rule 17g-5 would prohibit NRSROs and their affiliates from providing consulting or advisory services, prohibit analysts from participating in fee negotiations, and prohibit credit analysts or persons responsible for approving a credit rating receiving gifts from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities such as meetings that have an aggregate value of no more than $25. These proposals could increase confidence in the integrity of NRSROs and the credit ratings they issue. This could help to restore confidence in credit ratings and, thereby, promote capital formation.

Proposed new Rule 17g-7 would provide users of credit ratings with useful information about structured product ratings. This could help them in assessing the risk of securities and promote better informed investment decisions. This could increase the efficiency of the capital markets by making structured finance ratings more transparent.

The Commission generally requests comment on all aspects of this analysis of the burden on competition and promotion of efficiency, competition, and capital formation. In addition, the Commission requests specific comment on the following items related to this analysis:

- Would the proposed amendments have an adverse effect on efficiency, competition, and capital formation that is neither necessary nor appropriate in furtherance of the purposes of the Exchange Act?

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

VII. CONSIDERATION OF IMPACT ON THE ECONOMY

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[293] the Commission must advise OMB whether a proposed regulation constitutes a major rule. Under SBREFA, a rule is "major" if it has resulted in, or is likely to result in:

- an annual effect on the economy of $100 million or more;
- a major increase in costs or prices for consumers or individual industries; or
- a significant adverse effect on competition, investment, or innovation.

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

VIII. INITIAL REGULATORY FLEXIBILITY ANALYSIS

The Commission has prepared the following Initial Regulatory Flexibility Analysis ("IRFA"), in accordance with the provisions of the Regulatory Flexibility Act,[294] regarding proposed amendments to Form NRSRO, Rule 17g-2, Rule 17g-3, and Rule 17g-5 and regarding proposed Rule 17g-7 under the Exchange Act.

The Commission encourages comments with respect to any aspect of this IRFA, including comments with respect to the number of small entities that may be affected by the proposed amendments. Comments should specify the costs of compliance with the proposed amendments and suggest alternatives that would accomplish the goals of the

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293 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).

294 5 U.S.C. 603.

amendments. Comments will be considered in determining whether a Final Regulatory Flexibility Analysis is required 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.

A. Reasons for the Proposed Action

The proposed amendments would prescribe additional requirements for NRSROs to address concerns raised about the role of credit rating agencies in the recent credit market turmoil. The proposed amendments are designed to enhance and strengthen the rules the Commission adopted in 2007 to implement specific provisions of the Rating Agency Act.[295] The Rating Agency Act defines the term "nationally recognized statistical rating organization" as a credit rating agency registered with the Commission, provides authority for the Commission to implement registration, recordkeeping, financial reporting, and oversight rules with respect to registered NRSROs.

B. Objectives

The proposed amendments and new rules would enhance and strengthen the rules the Commission adopted in 2007 to implement specific provisions of the Rating Agency Act. The objectives of the Rating Agency Act are "to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry."[296] The proposed amendments and new rules are designed to further enhance these objectives and assist the Commission in monitoring whether an NRSRO complies with the provisions of the Rating Agency Act

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295 Pub. L. No. 109-291 (2006); see also Exchange Act Release No. 55857 (June 5, 2007), 72 FR 33564, 33609 (June 18, 2007).

296 See Senate Report.

and rules thereunder, consistent with the Commission's statutory mandate to adopt rules to implement the NRSRO regulatory program, and provide information regarding NRSROs to the public and to users of credit ratings. These proposed amendments would also prescribe additional requirements for NRSROs to address concerns raised about the role of credit rating agencies in the recent credit market turmoil, including concerns with respect to the determination of credit ratings for structured finance products.

C. Legal Basis

Pursuant to the Sections 3(b), 15E, 17(a), 23(a) and 36 of the Exchange Act.[297]

D. Small Entities Subject to the Rule

Paragraph (a) of Rule 0-10 provides that for purposes of the Regulatory Flexibility Act, a small entity "[w]hen used with reference to an 'issuer' or a 'person' other than an investment company" means "an 'issuer' or 'person' that, on the last day of its most recent fiscal year, had total assets of $5 million or less."[298] The Commission believes that an NRSRO with total assets of $5 million or less would qualify as a "small" entity for purposes of the Regulatory Flexibility Act.

As noted in the Adopting Release,[299] the Commission believes that approximately 30 credit rating agencies ultimately would be registered as an NRSRO. Of the approximately 30 credit rating agencies estimated to be registered with the Commission, the Commission estimates that approximately 20 may be "small" entities for purposes of the Regulatory Flexibility Act.[300]

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297 15 U.S.C. 78c(b), 78o-7, 78q(a), and 78w.

298 17 CFR 240.0-10(a).

299 Adopting Release, 72 FR at 33618.

300 See 17 CFR 240.0-10(a).

E. Reporting, Recordkeeping, and Other Compliance Requirements

The proposals would amend Form NRSRO to elicit certain additional information regarding the performance data for the credit ratings and the methods used by a credit rating agency for issuing credit ratings.[301]

The proposals would amend Rule 17g-2 to establish additional recordkeeping requirements.[302] The proposed amendments would require an NRSRO to make and retain two additional records and retain a third type of record. The records would be: (1) a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued, if a quantitative model is a substantial component in the process of determining a credit rating;[303] (2) a record showing the history and dates of all previous rating actions with respect to each current credit rating;[304] and (3) any complaints about the performance of a credit analyst.[305] These records would assist the Commission, through its examination process, in monitoring whether the NRSRO continues to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity (as required under the Rating Agency Act) and whether the NRSRO was complying with the provisions of the Exchange Act including the provisions of the Rating Agency Act, the rules adopted thereunder, and the NRSRO's disclosed policies and procedures.

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301 See proposed amendments to Form NRSRO.

302 See proposed amendments to Rule 17g-2.

303 Proposed paragraph (a)(2)(iii) of Rule 17g-2.

304 Proposed paragraph (a)(8) of Rule 17g-2.

305 Proposed paragraph (b)(8) of Rule 17g-2.

The proposals would amend Rule 17g-3 to require an NRSRO to furnish the Commission with an additional annual report: the number of downgrades in each class of credit ratings for which it is registered and the description of the findings from an independent review.[306] This requirement is designed to assist the Commission in its examination function and to require an NRSRO to assess the integrity of its rating process. It also is designed to assist the Commission in monitoring whether the NRSRO is complying with provisions of the Rating Agency Act and the rules adopted thereunder.

The proposals would amend paragraphs (a) and (b) of Rule 17g-5 to prohibit an NRSRO from issuing a credit rating for a structured product unless certain information about the assets underlying the product are disclosed. The proposals would amend paragraph (c) of Rule 17g-5 to prohibit NRSROs and their affiliates from providing consulting or advisory services, prohibit analysts from participating in fee negotiations, and prohibit credit analysts or persons responsible for approving a credit rating received gifts from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities such as meetings that have an aggregate value of no more than $25.[307]

The proposals would amend Rule 17g-7 to require an NRSRO to attach a report each time it publishes a credit rating for a structured finance product describing how the ratings procedures and methodologies and credit risk characteristics for structured products differ from those for other types of obligors and debt securities. An NRSRO

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306 See proposed amendment to Rule 17g-3.

307 See proposed amendment to Rule 17g-5.

could avoid having to attach the report if it used ratings symbols for structured products that differentiate them from its other types of credit ratings.[308]

F. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no federal rules that duplicate, overlap, or conflict with the proposed amendments or new rule.

G. Significant Alternatives

Pursuant to Section 3(a) of the RFA,[309] the Commission must consider certain types of alternatives, including: (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the rule, or any part of the rule, for small entities.

The Commission is considering whether it is necessary or appropriate to establish different compliance or reporting requirements or timetables; or clarify, consolidate, or simplify compliance and reporting requirements under the rule for small entities. Because the proposed amendments and proposed new rule are designed to improve the overall quality of ratings and enhance the Commission's oversight, the Commission is not proposing to exempt small entities from coverage of the rule, or any part of the rule. The proposed amendments and new rules allow NRSROs the flexibility to develop procedures tailored to their specific organizational structure and business models. The Commission also does not believe that it is necessary at this time to consider whether

308 See proposed Rule 17g-7.

309 5 U.S.C. 603(c).

small entities should be permitted to use performance rather than design standards to comply with the proposed amendments as the amendments already propose performance standards and do not dictate for entities of any size any particular design standards that must be employed to achieve the Act's objectives.

H. Request for Comments

The Commission encourages the submission of comments to any aspect of this portion of the IRFA. Comments should specify costs of compliance with the proposed amendments and suggest alternatives that would accomplish the objective of the proposed amendments

IX. STATUTORY AUTHORITY

The Commission is proposing amendments to Form NRSRO and Rules 17g–2, 17g–3, and 17g–5 and is proposing new rule 17g–7 pursuant to the authority conferred by the Exchange Act, including Sections 3(b), 15E, 17, 23(a) and 36.[310]

Text of Proposed Rules

List of Subjects in 17 CFR Parts 240 and 249b

Brokers, Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, the Commission proposes to amend Title 17, Chapter II of the Code of Federal Regulations as follows.

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

1. The authority citation for part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p,

[310] 15 U.S.C. 78c(b), 78o–7, 78q, 78w, and 78mm.

78q, 78s, 78u5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

2. Section 240.17g–2 is amended by:

a. Removing paragraph (a)(2)(iv);

b. Redesignating paragraph (a)(2)(iii) as paragraph (a)(2)(iv);

c. In newly redesignated paragraph (a)(2)(iv), removing "; and" and in its place adding a period;

d. Adding new paragraph (a)(2)(iii);

e. Adding paragraph (a)(8);

f. In paragraph (b)(7), revising the phrase "maintaining, changing," to read "maintaining, monitoring, changing,";

g. Redesignating paragraphs (b)(8), (b)(9), and (b)(10) as paragraphs (b)(9), (b)(10), and (b)(11), respectively;

h. Adding new paragraph (b)(8); and

i. In paragraph (d), adding a sentence to the end of the paragraph.

The additions read as follows:

§ 240.17g–2 Records to be made and retained by nationally recognized statistical rating organizations.

(a) * * *

(2) * * *

(iii) If a quantitative model was a substantial component in the process of determining the credit rating, a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued; and

* * * * *

(8) A record showing all rating actions and the date of such actions from the initial credit rating to the current credit rating identified by the name of the rated security or obligor and, if applicable, the CUSIP of the rated security or the Central Index Key (CIK) number of the rated obligor.

(b) * * *

(8) Any communications that contain complaints about the performance of a credit analyst in initiating, determining, maintaining, monitoring, changing, or withdrawing a credit rating.

* * * * *

(d) * * * In addition, the records required to be retained pursuant to paragraph (a)(8) of this section must be made publicly available on the corporate Web site of the NRSRO in an XBRL Interactive Data File that uses a machine-readable computer code that presents information in eXtensible Business Reporting Language in electronic format no later than six months after the date of the rating action.

* * * * *

3. Section 240.17g–3 is amended by:

a. Adding paragraph (a)(6); and

b. Revising paragraph (b).

The additions and revision read as follows:

§ 240.17g-3 Annual financial reports to be furnished by nationally recognized statistical rating organizations.

(a) * * *

(6) The number of credit ratings actions taken during the fiscal year in each class of credit ratings identified in section 3(a)(62)(B) of the Act (15 U.S.C. 78c(a)(62)(B)) for which the nationally recognized statistical rating organization is registered with the Commission.

Note to paragraph (a)(6): A nationally recognized statistical rating organization registered in the class of credit ratings described in section 3(a)(62)(B)(iv) of the Act (15 U.S.C. 78c(a)(62)(B)(iv)) must include credit ratings actions taken on credit ratings of any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction for purposes of reporting the number of credit ratings actions in this class.

(b) The nationally recognized statistical rating organization must attach to the financial reports furnished pursuant to paragraphs (a)(1) through (a)(6) of this section a signed statement by a duly authorized person associated with the nationally recognized statistical rating organization stating that the person has responsibility for the financial reports and, to the best knowledge of the person, the financial reports fairly present, in all material respects, the financial condition, results of operations, cash flows, revenues, analyst compensation, and credit rating actions of the nationally recognized statistical rating organization for the period presented.

* * * * *

4. Section 240.17g–5 is amended by:

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

b. Removing the period at the end of paragraph (a)(2) and in its place adding "; and";

c. Adding paragraph (a)(3);

d. Redesignating paragraph (b)(9) as paragraph (b)(10);

e. Adding new paragraph (b)(9);

f. Removing the word "or" at the end of paragraph (c)(3);

g. Removing the period at the end of paragraph (c)(4) and in its place adding a semi-colon; and

h. Adding paragraphs (c)(5), (c)(6), and (c)(7).

The additions read as follows:

§ 240.17g-5 Conflicts of interest.

(a) * * *

(3) In the case of the conflict of interest identified in paragraph (b)(9) of this section, the following information is disclosed through a means designed to provide reasonably broad dissemination:

(i) (A) All information provided to the nationally recognized statistical rating organization by the issuer, underwriter, sponsor, depositor, or trustee that is used in determining the initial credit rating for the security or money market instrument, including information about the characteristics of the assets underlying or referenced by the security or money market instrument, and the legal structure of the security or money market instrument, with such information to disclosed publicly in an offering registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.) on the date the underwriter and the issuer or depositor set the offering price of the securities being rated;

(B) In offerings that are not registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.), the information in paragraph (a)(3)(i)(A) of this section must be disclosed to investors and credit rating agencies on the date the underwriter and the issuer or depositor set the offering price of the securities being rated, and disclosed publicly on the first business day after the transaction closes; and

(ii) All information provided to the nationally recognized statistical rating organization by the issuer, underwriter, sponsor, depositor, or trustee that is used by the nationally recognized statistical rating organization in undertaking credit rating surveillance on the security or money market instrument, including information about the characteristics and performance of the assets underlying or referenced by the security or money market instrument, with such information to be disclosed publicly at the time such information is provided to the nationally recognized statistical rating organization.

(b) * * *

(9) Issuing or maintaining a credit rating for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction that was paid for by the issuer, sponsor, or underwriter of the security or money market instrument.

* * * * *

(c) * * *

(5) The nationally recognized statistical rating organization issues or maintains a credit rating with respect to an obligor or security where the nationally recognized statistical rating organization or a person associated with the nationally recognized statistical rating organization made recommendations to the obligor or the issuer, underwriter, or sponsor of the security about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security;

(6) The nationally recognized statistical rating organization issues or maintains a credit rating where the fee paid for the rating was negotiated, discussed, or arranged by a person within the nationally recognized statistical rating organization who has responsibility for participating in determining credit ratings or for developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models; or

(7) The nationally recognized statistical rating organization issues or maintains a credit rating where a credit analyst who participated in determining or monitoring the credit rating, or a person responsible for approving the credit rating received gifts, including entertainment, from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities such as meetings that have an aggregate value of no more than $25.

* * * * *

5. Section 240.17g–7 is added to read as follows:

§ 240.17g-7 Credit rating reports to be furnished by nationally recognized statistical rating organizations.

(a) A nationally recognized statistical rating organization must attach a report each time it publishes a credit rating for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction that describes the rating methodology used to determine such credit rating and how it differs from the determination of ratings for any other type of obligor or debt security and how the credit risk characteristics associated with a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction differ from those of any other type of obligor or debt security.

(b) Exemption from attaching report. A nationally recognized statistical rating organization is not required to attach the report each time it publishes a credit rating as prescribed by paragraph (a) of this section if the credit rating symbol used by the nationally recognized statistical rating organization to indicate the credit rating identifies the credit rating as relating to a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction as distinct from a credit rating for any other type of obligor or debt security.

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

6. The authority citation for part 249b continues to read in part as follows:

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

* * * * *

7. Form NRSRO (referenced in § 249b.300) is amended by revising Exhibits 1 and 2 in section H, Item 9 of the Form NRSRO Instructions to read as follows:

Note: The text of Form NRSRO and this amendment does not appear in the Code of Federal Regulations.

Form NRSRO

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Form NRSRO Instructions

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H. INSTRUCTIONS FOR SPECIFIC LINE ITEMS

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Item 9. Exhibits. * * *

Exhibit 1. Provide in this Exhibit performance measurement statistics of the credit ratings of the Applicant/NRSRO, including performance measurement statistics of

the credit ratings seperately for each class of credit rating for which the Applicant/NRSRO is seeking registration or is registered (as indicated in Item 6 and/or 7 of Form NRSRO) and any other broad class of credit rating issued by the Applicant/NRSRO. For the purposes of this Exhibit, an Applicant/NRSRO registered in the class of credit ratings described in Section 3(a)(62)(B)(iv) of the Act (15 U.S.C. 78c(a)(62)(B)(iv)) must include credit ratings of any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction for purposes of reporting the performance measurement statistics for this class. The performance measurement statistics must at a minimum show the performance of credit ratings in each class over 1 year, 3 year, and 10 year periods (as applicable) through the most recent calendar year-end, including, as applicable: historical ratings transition and default rates within each of the credit rating categories, notches, grades, or rankings used by the Applicant/NRSRO as an indicator of the assessment of the creditworthiness of an obligor, security, or money market instrument in each class of credit rating. The default statistics must include defaults relative to the initial rating and must incorporate defaults that occur after a credit rating is withdrawn. As part of this Exhibit, define the credit rating categories, notches, grades, and rankings used by the Applicant/NRSRO and explain the performance measurement statistics, including the inputs, time horizons, and metrics used to determine the statistics. Also provide in this Exhibit the Web site address where the records of credit rating actions required under 17 CFR 240.17g-2(a)(8) are, or will be, made publicly available in an XBRL Interactive Data File pursuant to the requirements of 17 CFR 240.17g-2(d).

Exhibit 2. Provide in this Exhibit a general description of the procedures and methodologies used by the Applicant/NRSRO to determine credit ratings, including unsolicited credit ratings within the classes of credit ratings for which the Applicant/NRSRO is seeking registration or is registered. The description must be sufficiently detailed to provide users of credit ratings with an understanding of the processes employed by the Applicant/NRSRO in determining credit ratings, including, as applicable, descriptions of: policies for determining whether to initiate a credit rating; a description of the public and non-public sources of information used in determining credit ratings, including information and analysis provided by third-party vendors; whether and, if so, how information about verification performed on assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction is relied on in determining credit ratings; the quantitative and qualitative models and metrics used to determine credit ratings, including whether and, if so, how assessments of the quality of originators of assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction factor into the determination of credit ratings; the methodologies by which credit ratings of other credit rating agencies are treated to determine credit ratings for securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgaged-backed securities transaction; the procedures for interacting with the management of a rated obligor or issuer of rated securities or money market instruments; the structure and voting process of committees that review or approve credit ratings; procedures for informing rated obligors or issuers of rated securities or money market instruments about

credit rating decisions and for appeals of final or pending credit rating decisions; procedures for monitoring, reviewing, and updating credit ratings, including how frequently credit ratings are reviewed, whether different models or criteria are used for ratings surveillance than for determining initial ratings, whether changes made to models and criteria for determining initial ratings are applied retroactively to existing ratings, and whether changes made to models and criteria for performing ratings surveillance are incorporated into the models and criteria for determining initial ratings; and procedures to withdraw, or suspend the maintenance of, a credit rating. An Applicant/NRSRO may provide in Exhibit 2 the location on its Web site where additional information about the procedures and methodologies is located.

* * * * *

By the Commission.

Florence E. Harmon
Acting Secretary

Dated: June 16, 2008

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

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-57966; File No. SR-NYSE-2007-04)

June 16, 2008

Self-Regulatory Organizations; New York Stock Exchange LLC; Notice of Filing of Amendment Nos. 1 and 2 and Order Granting Accelerated Approval to Proposed Rule Change, as Modified by Amendment Nos. 1 and 2 Thereto, Relating to Approval of Fee for NYSE Real-Time Reference Prices

I. Introduction

On January 12, 2007, the New York Stock Exchange LLC ("NYSE" or "Exchange") filed with the Securities and Exchange Commission ("Commission" or "SEC"), 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 to establish a flat monthly fee for the receipt and use of real-time last sale prices of transactions that take place on the Exchange ("Last Sale Proposal"). The proposal was published for comment in the Federal Register on March 5, 2007.[3] On March 30, 2007, NYSE filed Amendment No. 1 to the Last Sale Proposal.[4] The Commission received six comment letters regarding the proposal.[5] On November 30, 2007, NYSE responded to the comment

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

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 55354 (February 26, 2007), 72 FR 9817 ("Notice").

4 In Amendment No. 1, the Exchange submitted a copy of the Exhibit C that the Exchange described in the Notice. As described below, the contractual terms of this Exhibit C would govern how vendors receive and redistribute the NYSE last sale market data.

5 See letters from Alan Davidson, Senior Policy Counsel, Google Inc., to the Honorable Christopher Cox, Chairman, SEC, dated June 12, 2007 ("Google Letter"); Chuck Thompson, President, eSignal, to Nancy M. Morris, Secretary, SEC, dated March 27, 2007 ("eSignal Letter"); Gregory Babyak and Christopher Gilkerson, Co-Chairs of the Market Data Subcommittee of the Technology and Regulation Committee, the Securities Industry and Financial Markets Association ("SIFMA"), to Nancy M. Morris, Secretary, SEC, dated March 26, 2007 ("SIFMA Letter"); Scott Drake, Vice President, Digital Products, CNBC, to Nancy M. Morris, Secretary, SEC, dated February 16, 2007 ("CNBC Letter"); David Keith, Vice President, The Globe and Mail, to the Honorable Christopher

Document 20 of 48

letters.[6] On June 11, 2008, NYSE filed Amendment No. 2 to the Last Sale Proposal. In Amendment No. 2, NYSE proposed to impose fees for the Last Sale Proposal only for a four-month pilot period beginning July 1, 2008.[7]

The Commission is publishing this notice to solicit comments on the proposed rule change as modified by Amendment Nos. 1 and 2 and is simultaneously approving the proposed rule change, as modified by Amendment Nos. 1 and 2, on an accelerated basis.

II. Description of the Last Sale Proposal

The Exchange proposes to establish a four-month pilot program beginning on July 1, 2008, called NYSE Real-Time Reference Prices ("NYSE RTRP")[8] that would allow vendors to receive and redistribute, on a real-time basis, last sale prices of transactions that take place on the Exchange ("NYSE Trade Prices") and to establish a flat monthly fee for this service. The NYSE RTRP would only include pricing information for the securities transactions. The Exchange intends to make the NYSE RTRP available to internet service providers, traditional market data vendors, and others ("NYSE-Only Vendors"). The Exchange has represented that it would not permit any NYSE-Only Vendor to provide NYSE Trade Prices in a context in which a trading or order-routing decision can be implemented unless the NYSE-Only Vendor also provides consolidated displays of Network A last sale prices in accordance with Rule 603(c)(1) of

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Cox, Chairman, SEC, dated January 17, 2007 ("Globe and Mail Letter"); and Clem Chambers, CEO, ADVFN, to Nancy Morris, Secretary, SEC, dated January 16, 2007 ("ADVFN Letter").

6 See letter from Mary Yeager, Assistant Secretary, NYSE, to Nancy M. Morris, Secretary, SEC, dated November 30, 2007.

7 In Amendment No. 2, the Exchange removed language regarding syndication of the NYSE RTRP and stated that the Exchange may provide NYSE RTRP without charge upon Commission approval prior to July 1, 2008.

8 In Amendment No. 2, the Exchange also changed the name of the service from NYSE Real-Time Trade Prices to NYSE Real-Time Reference Prices.

Regulation NMS.

The Exchange proposes to establish a flat monthly fee of $100,000 for NYSE-Only Vendors to receive access to the NYSE RTRP data feed. The NYSE-Only Vendor may use that access to provide unlimited NYSE Trade Prices to an unlimited number of the NYSE-Only Vendor's subscribers and customers. The Exchange will not impose any device or end-user fee for the NYSE-Only Vendors' distribution of NYSE Trade Prices. The Exchange would also require the NYSE-Only Vendor to identify the NYSE trade price by placing the text "NYSE Data" in close proximity to the display of each NYSE Trade Price or series of NYSE Trade Prices.

The Exchange proposes to allow NYSE-Only Vendors to provide NYSE Trade Prices to their subscribers and customers without requiring the end-users to enter into contracts for the benefit of the Exchange. Instead, the Exchange will require NYSE-Only Vendors to provide a readily visible hyperlink that will send the end-user to a warning notice about the end-user's receipt and use of market data.

The Exchange also proposes to use the existing CTA and CQ Plan vendor contracts ("Network A Vendor Form") to govern the distribution of the NYSE Trade Prices to the NYSE-Only Vendors. The Exchange proposes supplementing the Network A Vendor Form with an Exhibit C that would include terms that will govern such things as (i) the restriction against providing the service in the context of a trading or order-routing service, (ii) the replacement of end-user agreements with a hyperlink to a notice, (iii) the substance of the notice, and (iv) the "NYSE Data" labeling requirement. In addition, Exhibit C will specify that the NYSE-Only Vendor's authorization to provide the service will terminate at the expiration date of the pilot program unless the Exchange submits a proposed rule change to extend the program or to make it permanent and the Commission approves that proposed rule change. Lastly, Exhibit C would require NYSE-Only Vendors to share with the Exchange any research they may conduct regarding the pilot program or the results of their experience with the program and to consult with the Exchange regarding their views of NYSE RTRP.

III. Discussion

The Commission finds that the proposed rule change, to be implemented on a four-month pilot basis, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.[9] In particular, it is consistent with Section 6(b)(4) of the Act,[10] which requires that the rules of a national securities exchange provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other parties using its facilities, and Section 6(b)(5) of the Act,[11] which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, 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, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

The Commission also finds that the proposed rule change is consistent with the provisions of Section 6(b)(8) of the Act,[12] which requires that the rules of an exchange not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. Finally, the Commission finds that the proposed rule change is consistent with Rule

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9 In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

10 15 U.S.C. 78f(b)(4).

11 15 U.S.C. 78f(b)(5).

12 15 U.S.C. 78f(b)(8).

603(a) of Regulation NMS,[13] adopted under Section 11A(c)(1) of the Act, which requires an exclusive processor that distributes information with respect to quotations for or transactions in an NMS stock to do so on terms that are fair and reasonable and that are not unreasonably discriminatory.[14]

The Commission received four comment letters expressing concern over the proposed rule change and two comment letters supporting the proposed rule change. Generally, SIFMA, Globe and Mail, eSignal, and ADVFN each suggested that NYSE did not adequately demonstrate that the proposed rule change was consistent with the Act.[15] SIFMA asserted that NYSE had failed to demonstrate that its proposal met the relevant requirements of the Act, including that its market data fees be fair and reasonable and not unreasonably discriminatory.[16] SIFMA, Globe and Mail, eSignal, and ADVFN each asserted that the NYSE proposal would unreasonably discriminate against smaller market data distributors.[17] Google and CNBC, however, expressed strong support for the proposal and noted their enthusiasm regarding the opportunity to give more of their users access to real-time financial information online.[18]

The Commission notes that NYSE amended the proposed rule change so that its fees would be imposed only for a four-month pilot period. On June 4, 2008, the Commission published for public comment a draft approval order that sets forth a market-based approach for analyzing proposals by self-regulatory organizations to impose fees for "non-core" market data

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13 17 CFR 242.603(a).

14 NYSE is an exclusive processor of its last sale data under Section 3(a)(22)(B) of the Act, 15 U.S.C. 78c(a)(22)(B), which defines an exclusive processor as, among other things, an exchange that distributes data on an exclusive basis on its own behalf.

15 See SIFMA Letter, Globe and Mail Letter, eSignal Letter and ADVFN Letter.

16 See SIFMA Letter.

17 See SIFMA Letter, Globe and Mail Letter, eSignal Letter and ADVFN Letter.

18 See Goggle Letter and CNBC Letter.

products that would encompass the NYSE RTRP.[19] The Commission believes that NYSE's proposal is consistent with the Act for the reasons noted preliminarily in the Draft Approval Order. Pending review by the Commission of comments received on the Draft Approval Order, and final Commission action thereon, the Commission believes that approving NYSE's proposal on a pilot basis would be beneficial to investors and in the public interest, in that it should result in broad public dissemination of real-time pricing information. Therefore, the Commission is approving NYSE's proposed fees for a four-month pilot beginning July 1, 2008. The broader approach ultimately taken by the Commission with respect to non-core market data fees will necessarily guide Commission action regarding fees for the NYSE RTRP beyond the four-month pilot period.

The Commission finds good cause for approving the proposed rule change, as modified by Amendment Nos. 1 and 2 thereto, before the thirtieth day after the date of publication of notice of filing thereof in the Federal Register. As noted above, accelerating approval of this proposal should benefit investors by facilitating their prompt access to widespread, free, real-time pricing information contained in the NYSE Trade Prices. In addition, the Commission notes that the proposal is approved only on a four-month pilot period while the Commission analyzes comments on the Draft Approval Order. Therefore, the Commission finds good cause, consistent with Section 19(b)(2) of the Act,[20] to approve the proposed rule change, as modified by Amendment Nos. 1 and 2, on an accelerated basis.

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[19] See Securities Exchange Act Release No. 57917 (June 4, 2008), 73 FR 32751 (June 10, 2008) (Notice of Proposed Order Approving Proposal by NYSE Arca, Inc. to Establish Fees for Certain Market Data and Request for Comment) ("Draft Approval Order").

[20] 15 U.S.C. 78s(b)(2).

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment Nos. 1 and 2 to the Last Sale Proposal, including whether Amendment Nos. 1 and 2 to the Last Sale Proposal are 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 No. SR-NYSE-2007-04 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-NYSE-2007-04. 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 NYSE. 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-NYSE-2007-04 and should be submitted on or before [insert date 21 days from the date of publication in the Federal Register].

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[21] that the proposed rule change (SR-NYSE-2007-04), as modified by Amendment Nos. 1 and 2, be, and it hereby is, approved on an accelerated basis until October 31, 2008.

By the Commission.

Florence E. Harmon
Acting Secretary

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[21] 15 U.S.C. 78s(b)(2).

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 57974 / June 17, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2839 / June 17, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13071

In the Matter of **NEC CORPORATION,** **Respondent.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 12(j) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, REVOKING REGISTRATION OF SECURITIES, AND IMPOSING A CEASE-AND-DESIST ORDER**

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 Sections 12(j) and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against NEC Corporation ("NEC" 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 Public Administrative and Cease-and-Desist Proceedings Pursuant to Sections 12(j) and 21C of the Securities Exchange Act of 1934, Making Findings, Revoking Registration of Securities, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

Document 21 of 48

III.

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

Respondent

NEC Corporation ("NEC") is a Japanese corporation with its headquarters in Tokyo, Japan. NEC is a foreign private issuer that is required to file annual reports on Form 20-F with the Commission. As a foreign private issuer, NEC elected to prepare its financial statements in accordance with Generally Accepted Accounting Principles in the United States ("GAAP"). At all relevant times, NEC's common stock, in the form of American Depository Receipts ("ADRs"),[2] has been registered with the Commission pursuant to Exchange Act Section 12, and was traded on the NASDAQ National Market under the symbol "NIPNY" until September 27, 2007, when NASDAQ suspended trading.[3]

Summary

For fiscal years 2000 through 2005, NEC filed annual reports with the Commission that misstated revenues, net income, or net loss. Specifically, NEC improperly recognized revenues from contracts with customers that included the provision of hardware, software, and customer support. In accordance with GAAP, NEC should have deferred a substantial portion of these revenues pending future performance. From 2000 through 2006, NEC also did not maintain accurate books and records, and had deficient internal accounting controls. As a result of these deficiencies, NEC is unable to restate prior financial statements and to file with the Commission annual reports on Form 20-F for the fiscal years ended March 31, 2006 and March 31, 2007. Accordingly, NEC violated Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rule 13a-1 thereunder.

Accounting For Certain Software Arrangements Under GAAP

When an issuer enters into a multi-element arrangement to provide hardware, software, and customer support, GAAP requires the issuer to allocate the revenue from the entire arrangement to the individual elements based upon evidence of the fair value of each of those elements.[4] This evidence is referred to as vendor-specific objective evidence of

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

2 ADRs are stocks of foreign companies that trade in the U.S. markets. Each ADR represents one or more shares of foreign stock or a fraction of a share.

3 Currently, NEC's ADRs are quoted on the Pink Sheets under the symbol, "NIPNY."

4 American Institute of Certified Public Accountants ("AICPA") Statement of Position 97-2 *Software Revenue Recognition* ("SOP 97-2") ¶10.

fair value ("VSOE").[5] Under GAAP, VSOE is not established by relying solely on the prices stated in the contract.[6] Instead, VSOE is determined by the price the issuer would ordinarily charge for each particular element if the issuer had sold that element separately.[7] If the issuer cannot establish VSOE, then revenue should be recognized over the entire term of the customer support element of the arrangement.[8]

NEC Failed to File Annual Reports with the Commission

NEC has not filed an annual report with the Commission since it filed its Form 20-F for fiscal year 2005 and, therefore, is delinquent in filing annual reports for fiscal years 2006 and 2007. NEC's inability to make these or other annual reports stems from NEC's violations of GAAP, as well as certain record keeping and internal accounting control deficiencies.

From 2000 through 2006, NEC routinely entered into multi-element arrangements with its customers to provide hardware, software, and customer support.[9] During the relevant period, NEC's practice was to recognize revenue from multi-element arrangements with customers in the following manner: for the hardware and software elements, NEC recognized revenue, upon delivery, in an amount equal to the prices stated in the hardware and software contracts; and as to the customer support element, NEC recognized revenue over the term of that agreement, in an amount equal to the price stated in that contract.

In violation of GAAP, NEC recorded revenue from these contracts without establishing VSOE for any of the elements in those arrangements. By failing to establish VSOE for any of the elements in these arrangements, NEC was required to recognize revenue for *each* element - including hardware and software, in addition to customer support-over the term of the customer support contract. Because NEC did not properly recognize revenue for these multi-element arrangements, NEC filed annual reports with the

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5 *Id.*

6 SOP 97-2 ¶10 and ¶12.

7 SOP 97-2 ¶10.

8 SOP 97-2 ¶12 and ¶58.

9 During this period, NEC's practice was to enter into separate contracts with its customers for each element of a multi-element arrangement (*e.g.*, separate contracts for the hardware, software, and customer support components) and record them as stand-alone contracts. NEC, however, should have recorded these contracts as part of a multi-element arrangement. As a result of this recordkeeping deficiency, NEC cannot identify which of its contracts originated as part of a multi-element arrangement. Further, NEC has been unable to determine the number of multi-element arrangements that it executed, the timing and terms of those arrangements, and the prices that it charged for each element of those arrangements during the relevant period. This deficiency contributed to NEC's inability to establish VSOE.

Commission for fiscal years 2000 through 2005 that misstated revenues, net income, or net loss.

These deficiencies contributed to NEC's inability to restate prior financial statements and to file annual reports for fiscal years 2006 and 2007.

NEC's Violations

NEC's Violations of the Reporting Provisions

Section 13(a) of the Exchange Act and Rule 13a-1 thereunder require issuers whose securities are registered with the Commission pursuant to Section 12 of the Exchange Act to file annual reports with the Commission. NEC violated Section 13(a) of the Exchange Act and Rule 13a-1 thereunder since it has not filed with the Commission annual reports on Form 20-F for the fiscal years ended March 31, 2006 and March 31, 2007.

NEC's Violations of the Books and Records and Internal Control Provisions

Section 13(b)(2)(A) of the Exchange Act requires issuers to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets. Section 13(b)(2)(B) of the Exchange Act requires issuers to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP.

From 2000 through 2006, NEC did not maintain accurate books and records because NEC improperly recorded revenue on certain transactions involving multi-element arrangements. NEC's books and records did not identify which of its contracts originated as a part of a multi-element arrangement, which contributed to NEC's inability to establish VSOE for those contracts. As a result, NEC's books and records also did not accurately reflect the company's revenues, net income, or net loss for these years. In addition, NEC failed to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that it recognized revenue from multi-element arrangements in accordance with GAAP.

Based on the foregoing, the Commission finds that Respondent violated Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rule 13a-1 thereunder.

IV.

Revocation of Securities' Registration Pursuant to Section 12(j) of the Exchange Act

Section 12(j) of the Exchange Act provides that:

> The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if

> the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means of instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

As discussed above, NEC has not filed with the Commission annual reports on Form 20-F for the years ended March 31, 2006 and March 31, 2007, and, therefore the Commission finds that it is necessary and appropriate for the protection of investors to revoke the registration of NEC's securities.

V.

NEC's Undertakings

Respondent has undertaken that, in connection with this action and any related Commission investigation, or judicial or administrative proceeding commenced by the Commission or to which the Commission is a party, Respondent (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 the Commission for documents or testimony at investigative testimony, depositions, hearings, or trials; (iii) appoints Respondent's attorney in this matter as agent to receive service of such notices and subpoenas; (iv) with respect to such notices and subpoenas (excluding ones relating to a Commission investigation), 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's travel, lodging, and subsistence expenses at the then-prevailing U.S. Government per diem rates; (v) consents to personal jurisdiction over Respondent in any United States District Court for purposes of enforcing any such subpoena; and (vi) consents to the production by any third party of any documents, records, or other information in the third party's possession, custody, or control that the Commission seeks from the third party, by subpoena or otherwise. In determining whether to accept the Offer, the Commission has considered these undertakings.

VI.

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

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, that Respondent NEC cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rule 13a-1 thereunder.

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

By the Commission.

Florence E. Harmon
Acting 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. 8930 / June 17, 2008

SECURITIES EXCHANGE ACT OF 1934
Release No. 57978 / June 17, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2840 / June 17, 2008

Administrative Proceeding
File No. 3-13072

In the Matter of **Preston D. Hopper, CPA** **Respondent.**	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS AND IMPOSING A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 (the "Securities Act") and Section 21C of the Securities Exchange Act of 1934 (the "Exchange Act") against Preston D. Hopper ("Hopper" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings contained herein, except that Respondent admits the Commission's jurisdiction over him and over the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and

Document 22 of 48

Section 21C of the Securities Exchange Act of 1934, Making Findings and Imposing a Cease-and-Desist Order.

III.
FINDINGS

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

A. RESPONDENT

Preston D. Hopper, 57, resides in Michigan and, during the relevant period, was Chief Accounting Officer of CMS Energy Corp. ("CMS"). Hopper was formerly licensed as a CPA in Michigan, but his license lapsed. CMS is a Michigan corporation with its principal place of business in Jackson, Michigan. CMS's shares are registered with the Commission under Section 12(b) of the Exchange Act and trade on the New York Stock Exchange under the symbol "CMS." During the relevant period, CMS's energy-trading division, CMS Marketing Services & Trading ("MS&T"), was active in retail marketing of gas and wholesale trading of electricity and natural gas.

B. FACTS

1. Overview of Round Trip Trades.

The round trip trades[2] were transactions conducted by CMS and counterparties including Reliant Energy Services, Inc. ("Reliant") whereby the parties essentially agreed to simultaneously both purchase and sell electric power or natural gas for the same volume and at the same price, with no delivery contemplated and with neither party making any profit. The transactions were intended solely to improve each company's standing in industry publications that ranked energy marketing companies based on volumes reported to the Federal Energy Regulatory Commission ("FERC"). However, the trades also had the effect of causing the companies to overstate the revenues and expenses reported in each company's respective Commission filings as the transactions were reported on a gross basis in each company's financial statements.

2. Round Trip Trades at CMS.

CMS materially overstated its revenues and expenses in 2000 and 2001 as a result of round trip energy transactions conducted by its Houston-based energy-trading subsidiary, MS&T. These overstatements appeared in certain 10-Qs and 10-Ks filed with the Commission.

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

[2] Round trip trades at CMS and Reliant were referred to variously as "Brag-a-Watts," "volumetric" deals, "back-to-back" trades, "net-zero" trades, "no margin" trades and "zero-margin" trades. The press coined the term "round trip" to describe the trades in articles reporting on the practice first published in May 2002 and it will be used in this Order.

During the relevant period, CMS also filed with the Commission several registration statements in connection with offerings of its securities.[3] The registration statements incorporated by reference the materially misleading Forms 10-Q and the 2000 Form 10-K, including the financial statements incorporated in the filings. The round trip trades had no impact on CMS's net earnings.

CMS's sole purpose for engaging in the round trip trades was to elevate MS&T's standing in certain industry publications that ranked energy marketing companies based on total FERC-reported volumes. Specifically, CMS sought to be among the top 20 tier ("Top 20") in such industry publications in order to attract requests for proposals from municipalities that considered such industry rankings as a useful means of identifying which companies should receive requests for proposals.

Although the purpose of the round trip trades was to boost CMS's rankings, the trades also had the effect of artificially inflating CMS's revenues and expenses. CMS reported all trades on a gross basis, which meant that its reported revenue figures were not netted against offsetting expenses. As a result, the round trip transactions conveyed an inaccurate picture of the company's revenues and expenses.

For example, on July 12, 2000, MS&T and Reliant entered into a round trip trade with a September 2000 term involving 10,000,000 MWH of power and $380 million in revenue and expense. Before its execution, this transaction was reviewed by MS&T's Director of Credit Management, CMS's Chief Risk Officer, and CMS's Chief Financial Officer who approved the practice. On or before October 20, 2000, CMS's outside auditor learned about the transaction from its audit team in Houston responsible for MS&T. During this same period, Respondent and CMS's Audit Committee Chairman discussed the accounting for the $380-million dollar round trip trade in a conference call on October 25, 2000 with CMS's outside auditor who advised that accounting for the trade on a gross basis was appropriate. The $380-million dollar round trip trade also came to the attention of the CMS Director of Financial Reporting in connection with the preparation of the MS&T Results of Operations for the CMS 2000 third quarter 10-Q.[4]

Separately, MS&T staff informed CMS's accounting department that the $380-million dollar round trip trade was the source of a substantial increase in current assets and liabilities for CMS for the month ended September 30, 2000. CMS's accounting staff, in turn, prepared an internal variance report for that same month that was distributed to CMS's executive officers (including CMS's Chief Executive Officer, Chief Financial Officer, Chief Operating Officer,

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[3] CMS filed the following registration statements during the relevant period: a Form S-3 on December 15, 2000, December 22, 2000, and December 12, 2001, and a Form S-8 on April 11, 2001.

[4] The initial draft of the MS&T Results of Operations for the CMS 2000 third quarter 10-Q prepared by MS&T staff did not include references to gross revenues or volumes. CMS's financial reporting staff subsequently revised the proposed draft to include references to total volumes and volume percentage increases. In response, MS&T staff specifically disclosed to the CMS Director of Financial Reporting that the trades generating the increased volumes did not contemplate physical delivery, made no margin, and were being done only for the purpose of "puffing up the volumes" and specifically suggested that he delete the volume references. Nevertheless, CMS included volume references in the MS&T Results of Operations for the CMS 2000 third quarter 10-Q and every 10-Q thereafter during the relevant time period.

General Counsel, and Vice President in Charge of Investor Relations) and the entire CMS Board of Directors that attributed CMS's increase in receivables and payables to MS&T's "electric wholesale activities with Reliant Energy." Thereafter, through July 2001, every time MS&T did round trip trades, MS&T staff would identify the round trip trades by dollar amounts as the source of the corresponding increases in current assets and liabilities and CMS's accounting staff would then attribute those increases to "buy/sale" "deals" with Reliant in the monthly variance reports given to the CMS executive officers and Board.

During its audit of the 2001 first quarter financial statements, MS&T disclosed to CMS's outside auditor three "no-margin" transactions with Reliant with revenues and corresponding expenses of $1.2 billion. CMS's outside auditor, in turn, brought the round trip trades to the attention of CMS's Audit Committee Chairman who discussed the trades first with MS&T's Chief Executive Officer and CMS's Chief Executive Officer[5] and then with CMS's outside auditor and Respondent. At the request of the CMS Audit Committee Chairman, MS&T's Chief Executive Officer explained to the CMS Board of Directors what MS&T's round trip trades were, their purpose, and how they worked and answered the questions asked by the Board.

The outside auditor's review of the round trip trades continued into the second quarter of 2001.[6] At that time, a member of the MS&T audit team concluded that revenues and expenses from the round trip trades should be recorded on a net basis – contrary to MS&T's (and CMS's) practice and the audit team's prior guidance. Neither Respondent, others at CMS, nor the CMS audit team, however, were apprised of this conclusion.

A few days prior to October 2001 (prior to the filing of CMS's third quarter Form 10-Q), CMS's outside auditor recommended to CMS that it record the revenues and expenses from round trip trades only if:

- The parties to the trade bear both credit and performance risk;
- Title to the related commodity transfers to the buyer; and
- Settlement is for the gross proceeds (checks must be exchanged and cashed for the gross amount of the transaction).

The round trip trades – which involved no risk, no net transfer of title and no exchange of cash – could not satisfy these criteria. On or about October 2, 2001, Respondent informed MS&T's Chief Executive Officer and MS&T's Controller that CMS had decided to change the way it accounted for the round-trip trades in the financial statements it filed with the SEC. Nevertheless, CMS reported in the third quarter of 2001 the revenues and expenses from MS&T's third quarter round trip trades, resulting in material financial misstatements.

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[5] CMS's Audit Committee Chairman asked CMS's Chief Executive Officer and MS&T's Chief Executive Officer about the "zero-margin" trades. CMS's Chief Executive Officer responded that the trades were: (i) commonly done in the industry, (ii) done to establish MS&T on league tables as a means of showing MS&T as a viable commodities trader, and (iii) that such trading did not affect earnings, cash flow or the balance sheet/shareholders' equity. MS&T's Chief Executive Officer told the CMS Audit Committee Chairman that the trades were ongoing, arranged transactions with RES that represented "more than half" of MS&T's volume.

[6] This review included round trip trades that MS&T had done for that quarter that were disclosed by MS&T to the outside auditors.

By recording revenues and expenses from the round trip trades, CMS overstated its revenues and expenses by a total of $5.2 billion over a one-year period: $1.0 billion (10%) in 2000, and $4.2 billion (36%) for the first three quarters of 2001. On March 24, 2002, CMS's auditors advised CMS that the financial results of the round trip trades conducted in 2001 would have to be reclassified to record them all on a net basis, which CMS did in its annual report for 2001.[7] However, CMS did not reclassify the financial results of the round trip trades conducted in 2000 until May 29, 2002.

On March 17, 2004, the Commission issued a settled cease-and-desist order against CMS Energy Corp. and MS&T's Controller, finding that each had violated Section 17(a) of the Securities Act and Sections 10(b), 13(a) and 13(b)(2) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1 and 13a-13 thereunder. *In the Matter of CMS Energy Corp. and Terry Woolley*, Administrative Proceeding File No. 3-11436.

Respondent's Conduct

In his role as Chief Accounting Officer of CMS, Hopper maintained oversight responsibility for recording MS&T's commodities transactions. The inclusion of those transactions caused CMS's financial statements to present a materially misleading picture of CMS's actual business activity. Additionally, after CMS's auditors determined that the round trip trades should be recorded on a net basis in October 2001, Hopper did not ensure that CMS's quarterly report, which was filed with the Commission, omitted these transactions. Finally, Hopper had responsibility for properly disclosing the nature and extent of CMS's restatement of earnings to exclude the round trip trades in the explanation included in its March 29, 2002 Form 10-K, which failed adequately to disclose the facts and circumstances of MS&T's round trip trades.

Respondent's conduct with respect to the round trip trades was negligent and, as such, he was a cause of CMS' filing of reports, including offering materials, that included revenues and expenses related to round trip trades. Respondent was also a cause of CMS's misstatement of the company's transactions in its books, records, and accounts.

As a result of the conduct described above, Respondent Hopper was a cause of CMS's violations of Sections 17(a)(2) and (3) of the Securities Act, Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder.[8]

IV.

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

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[7] MS&T conducted additional round trip trades in November and December of 2001. However, the revenues and expenses from those trades were not included in Commission filings.

[8] *KPMG, LLP. v. SEC*, 289 F.3d 109, 120 (D.C. Cir. 2002) (negligence alone is sufficient to establish causing liability for non-scienter violations under Section 21C of the Exchange Act).

Accordingly, IT IS HEREBY ORDERED, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, that

Respondent Hopper cease and desist from committing or causing any violation and any future violation of Sections 17(a)(2) and (3) of the Securities Act, and cease and desist from causing any violation or future violation of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder.

By the Commission.

Florence E. Harmon
Acting 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. 8931 / June 17, 2008

SECURITIES EXCHANGE ACT OF 1934
Release No. 57979 / June 17, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2841 / June 17, 2008

Administrative Proceeding
File No. 3-13073

In the Matter of **Tamela Pallas,** **Respondent.**	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS AND IMPOSING A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 (the "Securities Act") and Section 21C of the Securities Exchange Act of 1934 (the "Exchange Act") against Tamela Pallas ("Pallas" or "Respondent").

II.

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

Document 23 of 48

III.
FINDINGS

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

A. RESPONDENT

Tamela Pallas, 50, resides in Texas and, during the relevant period, was Chief Operating Officer and later Chief Executive Officer of CMS Marketing Services & Trading ("MS&T"), a subsidiary of CMS Energy Corp. ("CMS"). CMS is a Michigan corporation with its principal place of business in Jackson, Michigan. CMS's shares are registered with the Commission under Section 12(b) of the Exchange Act and trade on the New York Stock Exchange under the symbol "CMS." During the relevant period, MS&T was active in retail marketing of gas and wholesale trading of electricity and natural gas. Pallas is no longer employed at MS&T.

Prior to joining MS&T on November 1, 1999, Pallas served as an officer of Reliant Energy Services, Inc. ("RES"), a subsidiary of Reliant Energy, Inc., that was a part of Reliant's Wholesale Group and that, among other things, traded in and marketed power, natural gas, and other energy-related commodities. Until August 31, 2002, Reliant was an electric and gas public utility holding company exempt from registration under Section 3(a)(2) of the Public Utility Holding Company Act of 1935 (the "1935 Act"). Reliant's common stock was registered with the Commission under Section 12(b) of the Exchange Act, and traded on the New York Stock Exchange under the symbol REI until October 1, 2002.

B. FACTS

1. Overview of Round Trip Trades.

The round trip trades[2] were transactions conducted by Reliant and CMS (among others) whereby Reliant and CMS essentially agreed with one another (or with other counterparties) to simultaneously both purchase and sell electric power or natural gas for the same volume and at the same price, with no delivery contemplated and with neither party making any profit.[3] At both Reliant and CMS, the transactions were intended solely to improve each company's standing in industry publications that ranked energy marketing companies based on volumes reported to the Federal Energy Regulatory Commission ("FERC"). However, in both cases, the trades also had the effect of causing the companies to overstate the revenues and expenses reported in each company's respective Commission filings as the transactions were reported on a gross basis in each company's financial statements.

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

[2] Round trip trades at CMS and Reliant were referred to variously as "Brag-a-Watts," "volumetric" deals, "back-to-back" trades, "net-zero" trades, "no margin" trades and "zero-margin" trades. The press coined the term "round trip" to describe the trades in articles reporting on the practice first published in May 2002 and will be used in this Order.

[3] Typically, the round trip trades had no impact on CMS's net earnings. However, in at least one instance, RES paid a counterparty a nominal accommodation fee as part of the transaction.

2. Round Trip Trades at Reliant.

In late 1998 or early 1999 a series of informal strategy meetings were held within the Wholesale Group of Reliant to find ways to increase trading volume. One option considered was to do frequent day trades in and out of power or gas positions. The Wholesale Group rejected this sort of transactional churning, however, after receiving an estimate of the transaction costs associated with each trade. Ultimately, Reliant officials decided to arrange a smaller number of offsetting large volume trades with willing counterparties.

Reliant officials initially considered booking the round trip trades at a price of zero, but rejected the idea because it would skew the market prices reported to FERC. Instead, the company booked the round trip trades at market prices. Based on Reliant's practice at the time of recording all trades on a gross basis, the revenues and expenses associated with the round trip trades were recorded in Reliant's books and records. Recording all trades on a gross basis meant that Reliant's reported revenue figures were not netted against offsetting expenses. As a result, the round trip transactions conveyed an inaccurate picture of the company's revenues and expenses.

In 1999 Reliant entered into five power round trip trades totaling 29.75 million megawatt hours with three counterparties: PanCanadian Energy Services, Inc. ("PanCanadian"), Merchant Energy Group of the Americas, Inc. ("MEGA"), and Public Service Company of Colorado. MEGA requested and Reliant paid an accommodation fee of $50,000 for its trade. Reliant also entered into a series of round trip gas trades that year for 182 billion cubic feet, valued at $364 million, with Cokinos Energy. In total, the 1999 power and gas round trip trades added over $1.4 billion in offsetting gross revenue and expenses to Reliant's books.

Reliant's first series of round trip trades was with Cokinos Energy for an aggregate $364 million in natural gas to be delivered from April to June 1999. The trades were not initially entered into Reliant's computerized trading system or its accounting and general ledger system. In July 1999, the RES Senior Vice President of Gas Trading, who reported to Respondent, brought the trades to the attention of Reliant's Chief Risk Officer. As a result of discussions involving, at various times, Reliant's Chief Risk Officer, Manager of SEC Reporting, Director of Financial Reporting, and Controller, the trades were brought to the attention of Reliant's Chief Accounting Officer. These discussions involved, among other things, the structure of the trades, their purpose, and whether and how to account for the trades. Thereafter, Reliant entered the round trip trades into its books after the close of the second quarter of 1999 using a post-closing adjustment.[4] Respondent did not participate in these or any other discussions or decisions at Reliant regarding how to account for the round trip trades.

In the fourth quarter of 1999 an individual in Reliant's credit group brought to the attention of the RES Vice President of Risk Control a round trip trade that exceeded the counterparty's credit limit. The RES Vice President of Risk Control brought the trade to the

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[4] Reliant also provided documentation concerning the $364 million post-closing adjustment to its outside auditor as part of the SEC reporting binders for the second quarter of 1999. In February 2000, Reliant's outside auditor reviewed and approved the post-closing adjustment as part of their annual audit.

attention of Reliant's Chief Risk Officer later that same afternoon. Reliant's Chief Risk Officer told this individual that the trade was approvable so long as it did not create a margin or credit risk to Reliant. Because round trip trades had exactly offsetting buy and sell positions, they did not give rise to margin or credit risk to the company. Following this discussion, Reliant's credit department did not generate exception reports for subsequent round trip trades.

These round trip trades continued at Reliant in 2000 and through the third quarter of 2001 when they were discontinued. However, Reliant did not restate its financial statements for the affected years until May 2002, after press reports of round trip trading at Dynegy and CMS led to the disclosure that Reliant had also done the trades.

On May 12, 2003, the Commission issued a settled cease-and-desist order against Reliant Resources, Inc. and Reliant Energy, Inc. finding that each had violated Section 17(a) of the Securities Act and Sections 10(b), 13(a), and 13(b)(2) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1 and 13a-13 thereunder. *In the Matter of Reliant Resources, Inc. and Reliant Energy, Inc.*, Administrative Proceeding File No. 3-11110 (May 12, 2003).

3. Round Trip Trades at CMS.

As with Reliant, CMS materially overstated its revenues and expenses in 2000 and 2001 as a result of round trip energy transactions conducted by its Houston-based energy-trading subsidiary, MS&T. These overstatements appeared in certain 10-Qs and 10-Ks filed with the Commission. During the relevant period, CMS also filed with the Commission several registration statements in connection with offerings of its securities.[5] The registration statements incorporated by reference the materially misleading Forms 10-Q and the 2000 Form 10-K, including the financial statements incorporated in the filings.

CMS's sole purpose for engaging in the round trip trades was to elevate MS&T's standing in certain industry publications that ranked energy marketing companies based on total FERC-reported volumes. Specifically, CMS sought to be among the top 20 tier ("Top 20") in such industry publications in order to attract requests for proposals from municipalities that considered such industry rankings as a useful means of identifying which companies should receive requests for proposals.

Although the purpose of the round trip trades was to boost CMS's rankings, the trades also had the effect of artificially inflating CMS's revenues and expenses. CMS reported all trades on a gross basis, which meant that its reported revenue figures were not netted against offsetting expenses. As a result, the round trip transactions conveyed an inaccurate picture of the company's revenues and expenses.

On July 12, 2000, MS&T and RES entered into a round trip trade with a September 2000 term involving 10,000,000 MWH of power and $380 million in revenue and expense. As at Reliant, Respondent and her staff at MS&T communicated the structure, magnitude and purpose of the transactions to CMS. Before its execution, this transaction was reviewed by MS&T's

[5] CMS filed the following registration statements during the relevant period: a Form S-3 on December 15, 2000, December 22, 2000, and December 12, 2001, and a Form S-8 on April 11, 2001.

Director of Credit Management, CMS's Chief Risk Officer, and CMS's Chief Financial Officer who approved the practice.[6] On or before October 20, 2000, CMS's outside auditor learned about the transaction from its audit team in Houston responsible for MS&T. During this same period, CMS's Chief Accounting Officer and CMS's Audit Committee Chairman discussed the accounting for the $380-million dollar round trip trade in a conference call on October 25, 2000 with CMS's outside auditor who advised that accounting for the trade on a gross basis was appropriate. Respondent did not participate in such discussions or decisions on how to account for the trades. The $380-million dollar round trip trade also came to the attention of the CMS Director of Financial Reporting in connection with the preparation of the MS&T Results of Operations for the CMS 2000 third quarter 10-Q.[7]

Separately, Respondent's staff informed CMS's accounting department that the $380-million dollar round trip trade was the source of a substantial increase in current assets and liabilities for CMS for the month ended September 30, 2000. CMS's accounting staff, in turn, prepared an internal variance report for that same month that was distributed to CMS's executive officers (including CMS's Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, General Counsel, and Vice President in Charge of Investor Relations) and the entire CMS Board of Directors that attributed CMS's increase in receivables and payables to MS&T's "electric wholesale activities with Reliant Energy." Thereafter, through July 2001, every time MS&T did round trip trades, Respondent's staff would identify the round trip trades by dollar amounts as the source of the corresponding increases in current assets and liabilities and CMS's accounting staff would then attribute those increases to "buy/sale" "deals" with Reliant in the monthly variance reports given to the CMS executive officers and Board.

During its audit of the 2001 first quarter financial statements, MS&T disclosed to CMS's outside auditor three "no-margin" transactions with RES with revenues and corresponding expenses of $1.2 billion. CMS's outside auditor, in turn, brought the round trip trades to the attention of CMS's Audit Committee Chairman who discussed the trades first with Respondent and CMS's Chief Executive Officer[8] and then with CMS's outside auditor and Chief Accounting

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[6] Respondent also discussed the proposed marketing strategy with MS&T's Vice President of Power Trading & Marketing and MS&T's Vice President of Wholesale Power Trading, both of whom supported the strategy.

[7] The initial draft of the MS&T Results of Operations for the CMS 2000 third quarter 10Q prepared by Respondent's staff did not include references to gross revenues or volumes. CMS's financial reporting staff subsequently revised the proposed draft to include references to total volumes and volume percentage increases. In response, Respondent's staff specifically disclosed to the CMS Director of Financial Reporting that the trades generating the increased volumes did not contemplate physical delivery, made no margin, and were being done only for the purpose of "puffing up the volumes" and specifically suggested that he delete the volume references. Nevertheless, CMS included volume references in the MS&T Results of Operations for the CMS 2000 third quarter 10Q and every 10Q thereafter during the relevant time period. Respondent did not participate in drafting CMS's third quarter earnings release or any subsequent earnings release or Commission filing. Later, after reading a published press release or Commission filing, Respondent asked CMS's Chief Financial Officer why CMS used the phrase "lower margin" to explain certain revenue increases when the transactions contributing significantly to the revenue increases were "zero margin." CMS's Chief Financial Officer dismissed Respondent's concern.

[8] CMS's Audit Committee Chairman asked CMS's Chief Executive Officer and Respondent about the "zero-margin" trades. CMS's Chief Executive Officer responded that the trades were: (i) commonly done in the industry, (ii) done to establish MS&T on league tables as a means of showing MS&T as a viable commodities trader, and (iii) that such trading did not affect earnings, cash flow or the balance sheet/shareholders' equity. Respondent told the

Officer. At the request of the CMS Audit Committee Chairman, Respondent explained to the CMS Board of Directors what MS&T's round trip trades were, their purpose, and how they worked and answered the questions asked by the Board.

The outside auditor's review of the round trip trades continued into the second quarter of 2001.[9] At that time, a member of the MS&T audit team concluded that revenues and expenses from the round trip trades should be recorded on a net basis – contrary to MS&T's (and CMS's) practice and the audit team's prior guidance. Neither Respondent, others at CMS, nor the CMS audit team, however, were apprised of this conclusion.

A few days prior to October 2001 (prior to the filing of CMS's third quarter Form 10-Q), CMS's outside auditor recommended to CMS that it record the revenues and expenses from round trip trades only if:

- The parties to the trade bear both credit and performance risk;
- Title to the related commodity transfers to the buyer; and
- Settlement is for the gross proceeds (checks must be exchanged and cashed for the gross amount of the transaction).

The round trip trades – which involved no risk, no net transfer of title and no exchange of cash – could not satisfy these criteria. Respondent first learned of this guidance on or about October 2, 2001 when CMS's Chief Accounting Officer informed Respondent and MS&T's Controller that CMS had decided to change the way it accounted for the round-trip trades in the financial statements it filed with the SEC. Thereafter, Respondent was advised on several occasions both before and after the filing of the CMS third quarter earnings release and Form 10-Q that revenues and expenses for the round trip trades were not included "in the numbers being reported for the financial/SEC reporting purposes." Nevertheless, CMS reported in the third quarter of 2001 the revenues and expenses from MS&T's third quarter round trip trades, resulting in material financial misstatements.

By recording revenues and expenses from the round trip trades, CMS overstated its revenues and expenses by a total of $5.2 billion over a one-year period: $1.0 billion (10%) in 2000, and $4.2 billion (36%) for the first three quarters of 2001. On March 24, 2002, CMS's auditors advised CMS that the financial results of the round trip trades conducted in 2001 would have to be reclassified to record them all on a net basis, which CMS did in its annual report for 2001.[10] However, CMS did not reclassify the financial results of the round trip trades conducted in 2000 until May 29, 2002.

On March 17, 2004, the Commission issued a settled cease-and-desist order against CMS Energy Corp. and MS&T's Controller, finding that each had violated Section 17(a) of the

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CMS Audit Committee Chairman that the trades were ongoing, arranged transactions with RES that represented "more than half" of MS&T's volume.

[9] This review included round trip trades that MS&T had done for that quarter that were disclosed by MS&T to the outside auditors.

[10] MS&T conducted additional round trip trades in November and December of 2001. However, the revenues and expenses from those trades were not included in Commission filings.

Securities Act and Sections 10(b), 13(a) and 13(b)(2) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1 and 13a-13 thereunder. *In the Matter of CMS Energy Corp. and Terry Woolley*, Administrative Proceeding File No. 3-11436.

Respondent's Conduct

Respondent participated in and approved of the decision to do the round trip trades while she was Senior Vice President of Reliant's Wholesale Group and as the Chief Operating Officer and later Chief Executive Officer of MS&T. Before her resignation in October 1999, Reliant completed a total of six round trip trades. After Respondent joined CMS, she agreed at the request of Reliant's Senior Vice President of Power Trading to do round trip trades with Reliant. Thereafter, traders at MS&T under Respondent's supervision executed round trip trades beginning with the third quarter of 2000 and ending with the fourth quarter of 2001, the sole purpose of which was at all times to raise MS&T's profile in industry league tables by improving MS&T's FERC-reported volumes.[11] Although Respondent neither participated in discussions or decisions regarding how to account for the transactions nor participated in drafting earnings releases or Commission filings at either Reliant or CMS,[12] Respondent should have known that the revenues and expenses associated with the round trip trades would be included in each company's financial statements, including filings made with the Commission.

Respondent's conduct with respect to the round trip trades was negligent and, as such, was a cause of the filing of reports, including offering materials, which included revenues and expenses related to round trip trades. Respondent's negligent conduct was also therefore a cause of the related misstatement of the transactions in each company's books, records and accounts.

C.

As a result of the conduct described above, Respondent Pallas was a cause of Reliant's and CMS's violations of Sections 17(a)(2) and (3) of the Securities Act, Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder.[13]

IV.

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

Accordingly, IT IS HEREBY ORDERED, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, that

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[11] Respondent and others at CMS believed that MS&T remained relatively unknown outside Michigan and that some of CMS's municipal customers considered industry rankings of FERC-reported volume as a useful means of identifying which companies should receive requests for proposals and, therefore, round trip trades could improve MS&T's industry profile.

[12] Respondent and her respective staffs did communicate the structure, magnitude and purpose of the transactions to their respective parent companies and to the persons responsible for financial reporting at those companies, as early as the first round trip trades conducted at each company.

[13] *KPMG, LLP. v. SEC*, 289 F.3d 109, 120 (D.C. Cir. 2002) (negligence alone is sufficient to establish causing liability for non-scienter violations under Section 21C of the Exchange Act).

Respondent Pallas cease and desist from committing or causing any violation and any future violation of Section 17(a)(2) and (3) of the Securities Act, and cease and desist from causing any violation and any future violation of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

June 18, 2008

IN THE MATTER OF CERTAIN COMPANIES QUOTED ON THE PINK SHEETS: **Greenstone Holdings, 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 Greenstone Holdings, Inc. ("Greenstone").

Greenstone is incorporated under the laws of Florida and has its primary headquarters in New York, New York. Questions have arisen regarding the adequacy and accuracy of press releases, financial statements, and statements on the company's website concerning the company's current financial condition, business and operations, and stock promoting activity.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in Greenstone's securities.

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the above listed company is suspended for the period from 9:30 a.m. EDT on June 18, 2008, through 11:59 p.m. EDT, on July 1, 2008.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Document 24 of 48

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
June 19, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13075

In the Matter of **K-2 Logistics.Com, Inc.,** **Kafus Industries, Ltd.,** **Kakkimon Acquisitions Corp.,** **Kevco, Inc.,** **Kings Road Entertainment, Inc., and** **Kingsfield Capital Corp. (n/k/a Kingsfield Entertainment Corp.),** **Respondents.**	**ORDER INSTITUTING PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate 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 K-2 Logistics.Com, Inc., Kafus Industries, Ltd., Kakkimon Acquisitions Corp., Kevco, Inc., Kings Road Entertainment, Inc., and Kingsfield Capital Corp. (n/k/a Kingsfield Entertainment Corp.).

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. K-2 Logistics.Com, Inc. ("K-2") (CIK No. 1121189) is a revoked Nevada corporation located in West Vancouver, British Columbia, Canada with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). K-2 is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended February 28, 2002, which reported no assets and a net loss of $9,397 from inception on June 1, 1999.

Document 25 of 48

2. Kafus Industries, Ltd. ("Kafus") (CIK No. 793762) is a British Columbia corporation located in Vancouver, British Columbia, Canada with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Kafus is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended December 31, 1999, which reported a net loss of over $37 million for the year ended December 31, 1999. As of May 16, 2008, the company's common stock (symbol "KSEVQ") was quoted on the Pink Sheets, had five market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

3. Kakkimon Acquisitions Corp. ("Kakkimon") (CIK No. 821211) is a Delaware corporation located in Toronto, Ontario, Canada with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Kakkimon is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-SB for the period ended June 12, 2002, which reported a net loss of $74,075 from its inception on January 29, 1987 to March 31, 2002.

4. Kevco, Inc. ("Kevco") (CIK No. 1021706) is a dissolved Texas corporation located in Fort Worth, Texas with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Kevco is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2000, which reported a net loss of over $16 million for the prior nine months. On February 5, 2001, Keith Group filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Northern District of Texas, a reorganization plan was confirmed on November 24, 2002, and the case was terminated on September 17, 2007. As of May 16, 2008, the company's stock (symbol "KVCOQ") was quoted on the Pink Sheets, had two market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

5. Kings Road Entertainment, Inc. ("Kings Road") (CIK No. 773588) is a Delaware corporation located in Beverly Hills, California with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Kings Road is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the period ended April 30, 2005, which reported a net loss of over $495,590 for the prior year. As of May 16, 2008, the company's stock (symbol "KREN") was quoted on the Pink Sheets, had ten market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

6. Kingsfield Capital Corp. (n/k/a Kingsfield Environmental Corp.) ("Kingsfield") (CIK No. 945440) is an Alberta corporation located in Lethbridge, Alberta, Canada with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Kingsfield is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-FR/A amended registration statement on July 12, 1995 that included financial statements for the fiscal year ended December 31, 1994.

B. DELINQUENT PERIODIC FILINGS

7. As discussed in more detail above, all of the respondents are delinquent in their periodic filings with the Commission (*see* Chart of Delinquent Filings, 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.

8. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports (Forms 10-K, 10-KSB, or 20-F), and Rule 13a-13 requires domestic issuers to file quarterly reports (Forms 10-Q or 10-QSB). Rule 13a-16 requires foreign private issuers to furnish quarterly and other reports to the Commission under cover of Form 6-K if they make or are required to make the information public under the laws of the jurisdiction of their domicile or in which they are incorporated or organized; if they file or are required to file information with a stock exchange on which their securities are traded and the information was made public by the exchange; or if they distribute or are required to distribute information to their security holders.

9. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 or 13a-16 thereunder.

III.

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

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

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

Florence E. Harmon
Acting Secretary

Attachment

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

<u>Appendix 1</u>

Chart of Delinquent Filings
K-2 Logistics.Com, Inc., et al.

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
K-2 Logistics.Com, Inc.					
	10-KSB	05/31/02	08/29/02	Not filed	70
	10-QSB	08/31/02	10/15/02	Not filed	68
	10-QSB	11/30/02	01/14/03	Not filed	65
	10-QSB	02/28/03	04/14/03	Not filed	62
	10-KSB	05/31/03	08/29/03	Not filed	58
	10-QSB	08/31/03	10/15/03	Not filed	56
	10-QSB	11/30/03	01/14/04	Not filed	53
	10-QSB	02/28/04	04/13/04	Not filed	50
	10-KSB	05/31/04	08/30/04	Not filed	46
	10-QSB	08/31/04	10/15/04	Not filed	44
	10-QSB	11/30/04	01/14/05	Not filed	41
	10-QSB	02/28/05	04/14/05	Not filed	38
	10-KSB	05/31/05	08/29/05	Not filed	34
	10-QSB	08/31/05	10/17/05	Not filed	32
	10-QSB	11/30/05	01/17/06	Not filed	29
	10-QSB	02/28/06	04/14/06	Not filed	26
	10-KSB	05/31/06	08/29/06	Not filed	22
	10-QSB	08/31/06	10/16/06	Not filed	20
	10-QSB	11/30/06	01/16/07	Not filed	17
	10-QSB	02/28/07	04/16/07	Not filed	14
	10-KSB	05/31/07	08/29/07	Not filed	10
	10-QSB	08/31/07	10/15/07	Not filed	8
	10-QSB	11/30/07	01/14/08	Not filed	5
	10-QSB	02/28/08	04/14/08	Not filed	2
Total Filings Delinquent	24				

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Kafus Industries, Ltd.					
	20-F	12/31/00	07/02/01	Not filed	83
	20-F	12/31/01	07/01/02	Not filed	71
	20-F	12/31/02	06/30/03	Not filed	60
	20-F	12/31/03	06/30/04	Not filed	48
	20-F	12/31/04	06/30/05	Not filed	36
	20-F	12/31/05	06/30/06	Not filed	24
	20-F	12/31/06	07/02/07	Not filed	11
Total Filings Delinquent	7				
Kakkimon Acquisitions Corp.					
	10-QSB	06/30/02	09/25/02	Not filed	69
	10-QSB	09/30/02	11/14/02	Not filed	67
	10-KSB	12/31/02	03/31/03	Not filed	63
	10-QSB	03/31/03	05/15/03	Not filed	61
	10-QSB	06/30/03	08/14/03	Not filed	58
	10-QSB	09/30/03	11/14/03	Not filed	55
	10-KSB	12/31/03	03/30/04	Not filed	51
	10-QSB	03/31/04	05/17/04	Not filed	49
	10-QSB	06/30/04	08/16/04	Not filed	46
	10-QSB	09/30/04	11/15/04	Not filed	43
	10-KSB	12/31/04	03/31/05	Not filed	39
	10-QSB	03/31/05	05/16/05	Not filed	37
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/14/05	Not filed	31
	10-KSB	12/31/05	03/31/06	Not filed	27
	10-QSB	03/31/06	05/15/06	Not filed	25
	10-QSB	06/30/06	08/14/06	Not filed	22
	10-QSB	09/30/06	11/14/06	Not filed	19
	10-KSB	12/31/06	04/02/07	Not filed	14
	10-QSB	03/31/07	05/15/07	Not filed	13
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/30/07	11/14/07	Not filed	7
	10-KSB	12/31/07	03/31/08	Not filed	3
	10-QSB	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	24				

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Kevco, Inc.					
	10-K	12/31/00	04/02/01	Not filed	86
	10-Q	03/31/01	05/15/01	Not filed	85
	10-Q	06/30/01	08/14/01	Not filed	82
	10-Q	09/30/01	11/14/01	Not filed	79
	10-K	12/31/01	04/01/02	Not filed	74
	10-Q	03/31/02	05/15/02	Not filed	73
	10-Q	06/30/02	08/14/02	Not filed	70
	10-Q	09/30/02	11/14/02	Not filed	67
	10-K	12/31/02	03/31/03	Not filed	63
	10-Q	03/31/03	05/15/03	Not filed	61
	10-Q	06/30/03	08/14/03	Not filed	58
	10-Q	09/30/03	11/14/03	Not filed	55
	10-K	12/31/03	03/30/04	Not filed	51
	10-Q	03/31/04	05/17/04	Not filed	49
	10-Q	06/30/04	08/16/04	Not filed	46
	10-Q	09/30/04	11/15/04	Not filed	43
	10-K	12/31/04	03/31/05	Not filed	39
	10-Q	03/31/05	05/16/05	Not filed	37
	10-Q	06/30/05	08/15/05	Not filed	34
	10-Q	09/30/05	11/14/05	Not filed	31
	10-K	12/31/05	03/31/06	Not filed	27
	10-Q	03/31/06	05/15/06	Not filed	25
	10-Q	06/30/06	08/14/06	Not filed	22
	10-Q	09/30/06	11/14/06	Not filed	19
	10-K	12/31/06	04/02/07	Not filed	14
	10-Q	03/31/07	05/15/07	Not filed	13
	10-Q	06/30/07	08/14/07	Not filed	10
	10-Q	09/30/07	11/14/07	Not filed	7
	10-K	12/31/07	03/31/08	Not filed	3
	10-Q	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	30				

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Kings Road Entertainment, Inc.					
	10-QSB	10/31/05	12/15/05	Not filed	30
	10-QSB	01/31/06	03/17/06	Not filed	27
	10-KSB	04/30/06	07/31/06	Not filed	23
	10-QSB	07/31/06	09/14/06	Not filed	21
	10-QSB	10/31/06	12/15/06	Not filed	18
	10-QSB	01/31/07	03/19/07	Not filed	15
	10-KSB	04/30/07	07/30/07	Not filed	11
	10-QSB	07/31/07	09/14/07	Not filed	9
	10-QSB	10/31/07	12/17/07	Not filed	6
	10-QSB	01/31/08	03/17/08	Not filed	3
Total Filings Delinquent	11				
Kingsfield Capital Corp. (n/k/a Kingsfield Entertainment Corp.)					
	20-F	12/31/95	07/01/96	Not filed	143
	20-F	12/31/96	06/30/97	Not filed	132
	20-F	12/31/97	06/30/98	Not filed	120
	20-F	12/31/98	06/30/99	Not filed	108
	20-F	12/31/99	06/30/00	Not filed	96
	20-F	12/31/00	07/02/01	Not filed	83
	20-F	12/31/01	07/01/02	Not filed	71
	20-F	12/31/02	06/30/03	Not filed	60
	20-F	12/31/03	06/30/04	Not filed	48
	20-F	12/31/04	06/30/05	Not filed	36
	20-F	12/31/05	06/30/06	Not filed	24
	20-F	12/31/06	07/02/07	Not filed	11
Total Filings Delinquent	12				

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

June 19, 2008

IN THE MATTER OF Kafus Industries, Ltd., Kevco, Inc., and Kings Road Entertainment, 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 Kafus Industries, Ltd. because it has not filed any periodic reports since the period ended December 31, 1999.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Kevco, Inc. because it has not filed any periodic reports since the period ended September 30, 2000.

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

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

Document 26 of 48

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. EDT on June 19, 2008, through 11:59 p.m. EDT on July 2, 2008.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
June 20, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13077

In the Matter of **Baroque Corp.,** **Mother Lode Gold Mines Consolidated,** **and** **Solvis Group, 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 Baroque Corp., Mother Lode Gold Mines Consolidated, and Solvis Group, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Baroque Corp. ("Baroque") (CIK No. 1088796) is a void Delaware corporation located in Buena Park, California with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Baroque is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2004, which reported a net loss of $5,330 since inception in 1999.

2. Mother Lode Gold Mines Consolidated ("MLGM") (CIK No. 802595) is a California corporation located in Livermore, California with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). For at least seven years, MLGM has filed Forms 10-KSB without the audited financial statements required by the Exchange Act and rules thereunder. During that same period, MLGM has filed Forms 10-QSB containing financial statements which have not been reviewed by an auditor, as is required by the Exchange Act and rules thereunder. As of June 19, 2008, the common stock of MLGM was traded on the over-the-counter markets.

Document 27 of 48

3. Solvis Group, Inc. ("SLVG") (CIK No. 806513) is a Nevada corporation located in Buena Park, California with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). SLVG is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the period ended September 30, 2003, which reported a net loss of $144,257 for that year. This Form 10-KSB included a "going concern" paragraph. As of June 19, 2008, the common stock of SLVG was traded on the over-the-counter markets.

B. DELINQUENT PERIODIC FILINGS

4. All of the Respondents are delinquent in their periodic filings, or in the case of Mother Lode Gold Mines Consolidated, filed non-compliant 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 and complete 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. In the case of Mother Lode Gold Mines Consolidated, the respondent filed non-compliant quarterly and annual reports in that they were not reviewed or audited by an independent auditor, and the respondent failed to correct these deficiencies in response to inquiries from the Commission.

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

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

III.

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

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

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

Florence E. Harmon
Acting Secretary

Attachment

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. 57992 / June 20, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13076

In the Matter of **CARDINAL COMMUNICATIONS, 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 Cardinal Communications, Inc. ("Cardinal" 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.

Document 28 of 48

III.

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

A. Cardinal is a Nevada corporation based in Westminster, Colorado. Cardinal is in the business of providing communications services and developing residential real estate. The common stock of Cardinal has been registered under Section 12(b) of the Exchange Act since October 1999. From October 14, 1999 until March 9, 2004, Cardinal's stock was traded on the American Stock Exchange. From March 22, 2004 until April 27, 2007, Cardinal's stock was quoted on the OTC Bulletin Board. Cardinal's stock is currently quoted on the Pink Sheets.

B. Cardinal 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 or Form 10-KSB since April 17, 2006, or periodic or quarterly reports on Form 10-Q or Form 10-QSB for any fiscal period subsequent to its fiscal quarter ending September 30, 2006.

IV.

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

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

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

---

[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.

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.

J. Lynn Taylor

Florence E. Harmon
Acting Secretary

By: J. Lynn Taylor
Assistant Secre

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

June 23, 2008

In the Matter of **Acclaim Entertainment, Inc.,** **Benguet Corp.,** **Clean Systems Technology Group, Ltd.,** **Family Golf Centers, Inc.,** **Graham-Field Health Products, Inc.,** **Lechters, Inc.,** **Symbiat, Inc.,** **Texfi Industries, Inc., and** **Value Holdings, Inc.** **(n/k/a Galea Life Sciences, 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 Acclaim Entertainment, Inc. because it has not filed any periodic reports since the period ended March 31, 2004.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Benguet Corp. because it has not filed any periodic reports since the period ended December 31, 2002.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Clean Systems Technology Group Ltd. because it has not filed any periodic reports since the period ended September 30, 2004.

Document 29 of 48

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Family Golf Centers, Inc. because it has not filed any periodic reports since the period ended September 30, 2000.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Graham-Field Health Products, Inc. because it has not filed any periodic reports since the period ended September 30, 1999.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Lechters, Inc. because it has not filed any periodic reports since the period ended May 5, 2001.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Symbiat, Inc. because it has not filed any periodic reports since the period ended December 31, 2002.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Texfi Industries, Inc. because it has not filed any periodic reports since the period ended July 30, 1999.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Value Holdings, Inc. (n/k/a Galea Life Sciences, Inc.) because it has not filed any periodic reports since the period ended July 31, 2001.

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

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on June 23, 2008, through 11:59 p.m. EDT on July 7, 2008.

By the Commission.

Florence E. Harmon
Acting Secretary

J. Lynn Taylor

By: J. Lynn Taylor
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
June 23, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13079

In the Matter of	
Benguet Corp., **Clean Systems Technology Group, Ltd.,** **Lumenon Innovative Lightwave Technology, Inc.,** **Symbiat, Inc.,** **Uniroyal Technology Corp., and** **Value Holdings, Inc. (n/k/a Galea Life Sciences, 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 Benguet Corp., Clean Systems Technology Group, Ltd., Lumenon Innovative Lightwave Technology, Inc., Symbiat, Inc., Uniroyal Technology Corp., and Value Holdings, Inc. (n/k/a Galea Life Sciences, Inc.).

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Benguet Corp. ("BENGF [1]") (CIK No. 11290) is a Philippines corporation located in Makati City, Philippines with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). BENGF is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended December 31, 2002, which reported a net loss of Philippine Pesos (PHP) 301,000,000 ($5,638,288 based on the exchange rate on December 31, 2002) for the prior year. As of June 17, 2008, the common stock of

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

Document 30 of 48

BENGF was quoted on the Pink Sheets, had nineteen market makers, was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3), and had an average daily trading volume of 49,197 shares for the six months ended March 7, 2008.

2. Clean Systems Technology Group, Ltd. ("CSTM") (CIK No. 764587) is a New York corporation located in Kiryat Gat, Israel with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). CSTM is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2004. As of June 17, 2008, the common stock of CSTM was quoted on the Pink Sheets, had twelve market makers, was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3), and had an average daily trading volume of 19,387 shares for the six months ended March 7, 2008.

3. Lumenon Innovative Lightwave Technology, Inc. ("LUMMQ") (CIK No. 1098432) is a Delaware corporation located in St-Laurent, Quebec, Canada, with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). LUMMQ 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 December 31, 2002, which reported a net loss of C$9,822,000 for the prior six months. On February 9, 2003, LUMMQ filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Delaware. The case was closed on April 25, 2003. As of June 17, 2008, the common stock of LUMMQ was traded on the over-the-counter markets.

4. Symbiat, Inc. ("SYBA") (CIK No. 819479) is a void Delaware corporation located in Norcross, Georgia with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). SYBA 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, 2002, which reported a net loss of $11,065,000 for the prior nine months. On March 29, 2004, SYBA filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Northern District of Georgia which was still pending as of June 17, 2008. As of June 17, 2008, the common stock of SYBA was quoted on the Pink Sheets, had six market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3). The common stock of SYBA had an average daily trading volume of 14,669 shares for the six months ended March 7, 2008.

5. Uniroyal Technology Corp. ("UTCIQ") (CIK No. 890096) is a forfeited Delaware corporation located in Tampa, Florida with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). UTCIQ is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended September 29, 2002, which was materially deficient because it failed to include financial statements, as required by the Exchange Act and Commission rules. The Form 10-Q filed for the period ended June 30, 2002 reported a net loss of $47,042,000 for the prior nine months. On August 25, 2002, UTCIQ filed a Chapter 7 petition in the U.S. Bankruptcy Court for the District of Delaware. The case was converted to a Chapter 11 proceeding and was still pending as of June 17, 2008. As of June 17, 2008, the common stock of UTCIQ was quoted on the

Pink Sheets and had one market maker. The common stock of UTCIQ had an average daily trading volume of 150 shares for the six months ended March 7, 2008.

6. Value Holdings, Inc. (n/k/a Galea Life Sciences, Inc.) ("GLSN") (CIK No. 804191) is a Florida corporation located in Miami, Florida with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). GLSN 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 July 31, 2001, which reported a net loss of $5,520,002 for the prior nine months. The audit report accompanying GLSN's Form 10-K for the period ended October 31, 2000 contained a "going concern" paragraph based on the company's default on the terms of a credit facility. During August 2007, GLSN changed its name to Galea Life Sciences, Inc. with the State of Florida and in the Pink Sheets, but did not report that change to the Commission as required by Commission rules. As of June 17, 2008, the common stock of GLSN was quoted on the Pink Sheets, had seven market makers, was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3), and had an average daily trading volume of 19,155 shares for the six months ended March 7, 2008.

B. DELINQUENT PERIODIC FILINGS

7. 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.

8. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports. Rule 13a-16 requires foreign private issuers to furnish quarterly and other reports to the Commission under cover of Form 6-K if they make or are required to make the information public under the laws of the jurisdiction of their domicile or in which they are incorporated or organized; if they file or are required to file information with a stock exchange on which their securities are traded and the information was made public by the exchange; or if they distribute or are required to distribute information to their security holders.

9. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 or 13a-16 thereunder.

III.

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

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

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

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

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

By the Commission.

Florence E. Harmon
Secretary

Attachment

By: J. Lynn Taylor
Assistant Secretary

Appendix 1

Chart of Delinquent Filings

In the Matter of Benguet Corp., et al.

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Benguet Corp.					
	20-F	12/31/03	06/30/04	Not filed	48
	20-F	12/31/04	06/30/05	Not filed	36
	20-F	12/31/05	06/30/06	Not filed	24
	20-F	12/31/06	07/02/07	Not filed	11
Total Filings Delinquent	**4**				
Clean Systems Technology Group Ltd.					
	10-KSB	12/31/04	03/31/05	Not filed	39
	10-QSB	03/31/05	05/16/05	Not filed	37
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/14/05	Not filed	31
	10-KSB	12/31/05	03/31/06	Not filed	27
	10-QSB	03/31/06	05/15/06	Not filed	25
	10-QSB	06/30/06	08/14/06	Not filed	22
	10-QSB	09/30/06	11/14/06	Not filed	19
	10-KSB	12/31/06	04/02/07	Not filed	14
	10-QSB	03/31/07	05/15/07	Not filed	13
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/30/07	11/14/07	Not filed	7
	10-KSB	12/31/07	03/31/08	Not filed	3
	*10-Q**	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	**14**				
Lumenon Innovative Lightwave Technology, Inc.					
	10-Q	03/31/03	5/15/03	Not filed	61
	10-K	06/30/03	9/29/03	Not filed	57
	10-Q	09/30/03	11/14/03	Not filed	55
	10-Q	12/31/03	2/17/04	Not filed	52
	10-Q	03/31/04	5/17/04	Not filed	49
	10-K	06/30/04	9/28/04	Not filed	45
	10-Q	09/30/04	11/15/04	Not filed	43

*Regulation S-B and its accompanying forms, including Forms 10-QSB and 10-KSB, are in the process of being removed from the federal securities laws. *See* Release No. 34-56994 (Dec. 19, 2007). The removal is taking effect over a transition period that will conclude on March 15, 2009, so by that date, all reporting companies that previously filed their periodic reports on Forms 10-QSB and 10-KSB will be required to use Forms 10-Q and 10-K instead. Forms 10-QSB and 10-KSB will no longer be available, though issuers that meet the definition of a "smaller reporting company" (generally, a company that has less than $75 million in public equity float as of the end of its most recently completed second fiscal quarter) will have the option of using new, scaled disclosure requirements that Regulation S-K now includes.

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Lumenon Innovative Lightwave Technology, Inc. *(continued)*	*10-Q*	12/31/04	2/14/05	Not filed	40
	10-Q	03/31/05	5/16/05	Not filed	37
	10-K	06/30/05	9/28/05	Not filed	33
	10-Q	09/30/05	11/14/05	Not filed	31
	10-Q	12/31/05	2/14/06	Not filed	28
	10-Q	03/31/06	5/15/06	Not filed	25
	10-K	06/30/06	9/28/06	Not filed	21
	10-Q	09/30/06	11/14/06	Not filed	19
	10-Q	12/31/06	2/14/07	Not filed	16
	10-Q	03/31/07	5/15/07	Not filed	13
	10-K	06/30/07	9/28/07	Not filed	9
	10-Q	09/30/07	11/14/07	Not filed	7
	10-Q	12/31/07	2/14/08	Not filed	4
	10-Q	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	**21**				
Symbiat, Inc.					
	10-KSB	03/31/03	06/30/03	Not filed	60
	10-QSB	06/30/03	08/14/03	Not filed	58
	10-QSB	09/30/03	11/14/03	Not filed	55
	10-QSB	12/31/03	02/17/04	Not filed	52
	10-KSB	03/31/04	06/29/04	Not filed	48
	10-QSB	06/30/04	08/16/04	Not filed	46
	10-QSB	09/30/04	11/15/04	Not filed	43
	10-QSB	12/31/04	02/14/05	Not filed	40
	10-KSB	03/31/05	06/29/05	Not filed	36
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/14/05	Not filed	31
	10-QSB	12/31/05	02/14/06	Not filed	28
	10-KSB	03/31/06	06/29/06	Not filed	24
	10-QSB	06/30/06	08/14/06	Not filed	22
	10-QSB	09/30/06	11/14/06	Not filed	19
	10-QSB	12/31/06	02/14/07	Not filed	16
	10-KSB	03/31/07	06/29/07	Not filed	12
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/30/07	11/14/07	Not filed	7
	10-QSB	12/31/07	02/14/08	Not filed	4
	*10-Q**				
Total Filings Delinquent	**21**				
Uniroyal Technology Corp.					
	10-K	09/29/02	12/30/02	Filed without audited financial statements	66
	10-Q	12/29/02	02/12/03	Not filed	64
	10-Q	03/30/03	05/14/03	Not filed	61

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Uniroyal Technology Corp.	10-Q	06/29/03	08/13/03	Not filed	58
(continued)	10-K	09/28/03	12/29/03	Not filed	54
	10-Q	12/28/03	02/11/04	Not filed	52
	10-Q	03/28/04	05/12/04	Not filed	49
	10-Q	06/27/04	08/11/04	Not filed	46
	10-K	09/26/04	12/27/04	Not filed	42
	10-Q	12/26/04	02/09/05	Not filed	40
	10-Q	03/27/05	05/11/05	Not filed	37
	10-Q	06/26/05	08/10/05	Not filed	34
	10-K	09/25/05	12/26/05	Not filed	30
	10-Q	01/01/06	02/15/06	Not filed	28
	10-Q	04/02/06	05/17/06	Not filed	25
	10-Q	07/02/06	08/16/06	Not filed	22
	10-K	10/01/06	01/02/07	Not filed	17
	10-Q	12/31/06	02/14/07	Not filed	16
	10-Q	04/01/07	05/16/07	Not filed	13
	10-Q	07/01/07	08/15/07	Not filed	10
	10-K	09/30/07	12/31/07	Not filed	6
	10-Q	12/30/07	02/13/08	Not filed	4
	10-Q	03/30/08	05/14/08	Not filed	1
Total Filings Delinquent	**23**				
Value Holdings, Inc. (n/k/a Galea Life Sciences, Inc.)					
	10-K	10/31/01	01/29/02	Not filed	77
	10-Q	01/31/02	03/18/02	Not filed	75
	10-Q	04/30/02	06/14/02	Not filed	72
	10-Q	07/31/02	09/16/02	Not filed	69
	10-K	10/31/02	01/29/03	Not filed	65
	10-Q	01/31/03	03/17/03	Not filed	63
	10-Q	04/30/03	06/16/03	Not filed	60
	10-Q	07/31/03	09/15/03	Not filed	57
	10-K	10/31/03	01/29/04	Not filed	53
	10-Q	01/31/04	03/16/04	Not filed	51
	10-Q	04/30/04	06/14/04	Not filed	48
	10-Q	07/31/04	09/14/04	Not filed	45
	10-K	10/31/04	01/31/05	Not filed	41
	10-Q	01/31/05	03/17/05	Not filed	39
	10-Q	04/30/05	06/14/05	Not filed	36
	10-Q	07/31/05	09/14/05	Not filed	33
	10-K	10/31/05	01/30/06	Not filed	29
	10-Q	01/31/06	03/17/06	Not filed	27

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Value Holdings, Inc. (n/k/a					
Galea Life Sciences, Inc.)	*10-Q*	04/30/06	06/14/06	Not filed	24
(continued)	*10-Q*	07/31/06	09/14/06	Not filed	21
	10-K	10/31/06	01/29/07	Not filed	17
	10-Q	01/31/07	03/19/07	Not filed	15
	10-Q	04/30/07	06/14/07	Not filed	12
	10-Q	07/31/07	09/14/07	Not filed	9
	10-K	10/31/07	01/29/08	Not filed	5
	10-Q	01/31/08	03/17/08	Not filed	3
	10-Q	04/30/08	06/14/08	Not filed	0
Total Filings Delinquent	**27**				

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
June 23, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13078

In the Matter of **Acclaim Entertainment, Inc.,** **Family Golf Centers, Inc.,** **Graham-Field Health Products, Inc.,** **Lechters, Inc., and** **Texfi Industries, 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 Acclaim Entertainment, Inc., Family Golf Centers, Inc., Graham-Field Health Products, Inc., Lechters, Inc., and Texfi Industries, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Acclaim Entertainment, Inc. ("AKLMQ [1]") (CIK No. 804888) is a Delaware corporation located in Glen Cove, New York with common stock, preferred stock purchase rights, common stock purchase warrants, convertible subordinated notes, and series A and B warrants registered with the Commission pursuant to Exchange Act Section 12(g). AKLMQ is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended March 31, 2004, which reported a net loss of $56,408,000 for the prior year. On September 1, 2004, AKLMQ filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Eastern District of New York, which was still pending as of June 17, 2008. On September 26, 2000, the Commission ordered AKLMQ to cease and desist from committing or causing any future

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

Document 31 of 48

violations of Exchange Act Sections 10(b) and 13(b)(2)(A) and Rules 10b-5 and 13b2-1 thereunder. *See Acclaim Entertainment, Inc.,* Exchange Act Rel. No. 43340 (Sept. 26, 2000). As of June 17, 2008, the common stock of AKLMQ was quoted on the Pink Sheets, had fourteen market makers, was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3), and had an average daily trading volume of 99,219 shares for the six months ended March 7, 2008.

2. Family Golf Centers, Inc. ("FGCIQ") (CIK No. 929941) is a forfeited Delaware corporation located in Melville, New York with common stock and preferred stock purchase rights registered with the Commission pursuant to Exchange Act Section 12(g). FGCIQ is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2000, which reported a net loss of $104,449,000 for the prior nine months. On May 4, 2000, FGCIQ filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Southern District of New York, which was closed on December 17, 2004. As of June 17, 2008, the common stock of FGCIQ was quoted on the Pink Sheets, had six market makers, was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3), and had an average daily trading volume of 7,401 shares for the six months ended March 7, 2008.

3. Graham-Field Health Products, Inc. ("GFIHQ") (CIK No. 709136) is a forfeited Delaware corporation located in Bay Shore, New York with common stock, 11% convertible subordinated exchangeable debentures, and 7 1/2% convertible senior subordinated notes registered with the Commission pursuant to Exchange Act Section 12(g). GFIHQ is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 1999, which reported a net loss of $41,083,000 for the prior nine months. On December 27, 1999, GFIHQ filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Delaware. The proceeding was converted to a Chapter 7 proceeding on May 28, 2003 and was still pending as of June 17, 2008. As of June 17, 2008, the common stock of GFIHQ was quoted on the Pink Sheets, had seven market makers, was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3), and had an average daily trading volume of 27,362 shares for the six months ended March 7, 2008.

4. Lechters, Inc. ("LECH") (CIK No. 798186) is a New Jersey corporation located in Harrison, New Jersey with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). LECH 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 5, 2001, which reported a net loss of $26,728,000 for the prior thirteen weeks. On May 21, 2001, LECH filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Southern District of New York. The proceeding was terminated on April 12, 2006. As of June 17, 2008, the common stock of LECH was quoted on the Pink Sheets, had six market makers, was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3), and had an average daily trading volume of 7,231 shares for the six months ended March 7, 2008.

5. Texfi Industries, Inc. ("TXFIQ") (CIK No. 97579) 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). TXFIQ 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 July 30, 1999, which reported a net loss of $7,516,000 for the prior nine months. On February 15, 2000, TXFIQ filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Southern District of New York. The case was dismissed on March 29, 2007. As of June 17, 2008, the common stock of TXFIQ was quoted on the Pink Sheets, had five market makers, was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3), and had an average daily trading volume of 56,407 shares for the six months ended March 7, 2008.

B. DELINQUENT PERIODIC FILINGS

6. 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.

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

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

III.

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

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

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

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

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

By the Commission.

Florence E. Harmon
Acting Secretary

J. Lynn Taylor

By: J. Lynn Taylor
Assistant Secretary

Attachment

Appendix 1

Chart of Delinquent Filings

In the Matter of Acclaim Entertainment, Inc., et al.

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Acclaim Entertainment, Inc.					
	10-Q	06/27/04	08/11/04	Not filed	46
	10-Q	09/26/04	11/10/04	Not filed	43
	10-Q	12/26/04	02/09/05	Not filed	40
	10-K	03/31/05	07/01/05	Not filed	35
	10-Q	06/26/05	08/10/05	Not filed	34
	10-Q	09/25/05	11/09/05	Not filed	31
	10-Q	10/29/06	12/13/06	Not filed	18
	10-K	03/31/06	07/01/06	Not filed	23
	10-Q	06/25/06	08/09/06	Not filed	22
	10-Q	09/24/06	11/08/06	Not filed	19
	10-Q	12/31/06	02/14/07	Not filed	16
	10-K	03/31/07	07/01/07	Not filed	11
	10-Q	06/24/07	08/08/07	Not filed	10
	10-Q	09/30/07	11/14/07	Not filed	7
	10-Q	12/30/07	02/13/08	Not filed	4
Total Filings Delinquent	**15**				
Family Golf Centers, Inc.					
	10-K	12/31/00	04/02/01	Not filed	86
	10-Q	03/31/01	05/15/01	Not filed	85
	10-Q	06/30/01	08/14/01	Not filed	82
	10-Q	09/30/01	11/14/01	Not filed	79
	10-K	12/31/01	04/01/02	Not filed	74
	10-Q	03/31/02	05/15/02	Not filed	73
	10-Q	06/30/02	08/14/02	Not filed	70
	10-Q	09/30/02	11/14/02	Not filed	67
	10-K	12/31/02	03/31/03	Not filed	63
	10-Q	03/31/03	05/15/03	Not filed	61
	10-Q	06/30/03	08/14/03	Not filed	58
	10-Q	09/30/03	11/14/03	Not filed	55
	10-K	12/31/03	03/30/04	Not filed	51
	10-Q	03/31/04	05/17/04	Not filed	49
	10-Q	06/30/04	08/16/04	Not filed	46
	10-Q	09/30/04	11/15/04	Not filed	43
	10-K	12/31/04	03/31/05	Not filed	39
	10-Q	03/31/05	05/16/05	Not filed	37
	10-Q	06/30/05	08/15/05	Not filed	34
	10-Q	09/30/05	11/14/05	Not filed	31
	10-K	12/31/05	03/31/06	Not filed	27
	10-Q	03/31/06	05/15/06	Not filed	25
	10-Q	06/30/06	08/14/06	Not filed	22
	10-Q	09/30/06	11/14/06	Not filed	19

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Family Golf Centers, Inc.	*10-K*	12/31/06	04/02/07	Not filed	14
(continued)	*10-Q*	03/31/07	05/15/07	Not filed	13
	10-Q	06/30/07	08/14/07	Not filed	10
	10-Q	09/30/07	11/14/07	Not filed	7
	10-K	12/31/07	03/31/08	Not filed	3
	10-Q	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	**30**				
Graham-Field Health Products, Inc.					
	10-K	12/31/99	03/30/00	Not filed	99
	10-Q	03/31/00	05/15/00	Not filed	97
	10-Q	06/30/00	08/14/00	Not filed	94
	10-Q	09/30/00	11/14/00	Not filed	91
	10-K	12/31/00	04/02/01	Not filed	86
	10-Q	03/31/01	05/15/01	Not filed	85
	10-Q	06/30/01	08/14/01	Not filed	82
	10-Q	09/30/01	11/14/01	Not filed	79
	10-K	12/31/01	04/01/02	Not filed	74
	10-Q	03/31/02	05/15/02	Not filed	73
	10-Q	06/30/02	08/14/02	Not filed	70
	10-Q	09/30/02	11/14/02	Not filed	67
	10-K	12/31/02	03/31/03	Not filed	63
	10-Q	03/31/03	05/15/03	Not filed	61
	10-Q	06/30/03	08/14/03	Not filed	58
	10-Q	09/30/03	11/14/03	Not filed	55
	10-K	12/31/03	03/30/04	Not filed	51
	10-Q	03/31/04	05/17/04	Not filed	49
	10-Q	06/30/04	08/16/04	Not filed	46
	10-Q	09/30/04	11/15/04	Not filed	43
	10-K	12/31/04	03/31/05	Not filed	39
	10-Q	03/31/05	05/16/05	Not filed	37
	10-Q	06/30/05	08/15/05	Not filed	34
	10-Q	09/30/05	11/14/05	Not filed	31
	10-K	12/31/05	03/31/06	Not filed	27
	10-Q	03/31/06	05/15/06	Not filed	25
	10-Q	06/30/06	08/14/06	Not filed	22
	10-Q	09/30/06	11/14/06	Not filed	19
	10-K	12/31/06	04/02/07	Not filed	14
	10-Q	03/31/07	05/15/07	Not filed	13
	10-Q	06/30/07	08/14/07	Not filed	10
	10-Q	09/30/07	11/14/07	Not filed	7
	10-K	12/31/07	03/31/08	Not filed	3
	10-Q	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	**34**				

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Lechters, Inc.					
	10-Q	07/28/01	9/11/01	Not filed	81
	10-Q	11/03/01	12/18/01	Not filed	78
	10-K	02/02/02	5/3/02	Not filed	73
	10-Q	04/27/02	6/11/02	Not filed	72
	10-Q	08/03/02	9/17/02	Not filed	69
	10-Q	11/02/02	12/17/02	Not filed	66
	10-K	02/01/03	5/2/03	Not filed	61
	10-Q	05/03/03	6/17/03	Not filed	60
	10-Q	08/02/03	9/16/03	Not filed	57
	10-Q	11/01/03	12/16/03	Not filed	54
	10-K	01/31/04	4/30/04	Not filed	50
	10-Q	05/01/04	6/15/04	Not filed	48
	10-Q	07/31/04	9/14/04	Not filed	45
	10-Q	10/30/04	12/14/04	Not filed	42
	10-K	01/29/05	4/29/05	Not filed	38
	10-Q	04/30/05	6/14/05	Not filed	36
	10-Q	07/30/05	9/13/05	Not filed	33
	10-Q	10/29/05	12/13/05	Not filed	30
	10-K	01/28/06	4/28/06	Not filed	26
	10-Q	04/29/06	6/13/06	Not filed	24
	10-Q	07/29/06	9/12/06	Not filed	21
	10-Q	10/28/06	12/12/06	Not filed	18
	10-K	02/03/07	5/4/07	Not filed	13
	10-Q	04/28/07	6/12/07	Not filed	12
	10-Q	07/28/07	9/11/07	Not filed	9
	10-Q	11/03/07	12/18/07	Not filed	6
	10-K	02/02/08	5/2/08	Not filed	1
Total Filings Delinquent	**27**				
Texfi Industries, Inc.					
	10-K	10/29/99	01/27/00	Not filed	101
	10-Q	01/28/00	03/13/00	Not filed	99
	10-Q	04/28/00	06/12/00	Not filed	96
	10-Q	07/28/00	09/11/00	Not filed	93
	10-K	11/03/00	02/01/01	Not filed	88
	10-Q	02/02/01	03/19/01	Not filed	87
	10-Q	04/27/01	06/11/01	Not filed	84
	10-Q	08/03/01	09/17/01	Not filed	81
	10-K	11/02/01	01/31/02	Not filed	77
	10-Q	02/01/02	03/18/02	Not filed	75
	10-Q	05/03/02	06/17/02	Not filed	72
	10-Q	08/02/02	09/16/02	Not filed	69
	10-K	11/01/02	01/30/03	Not filed	65
	10-Q	01/31/03	03/17/03	Not filed	63
	10-Q	05/02/03	06/16/03	Not filed	60
	10-Q	08/01/03	09/15/03	Not filed	57

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Texfi Industries, Inc. (continued)	*10-K*	10/31/03	01/29/04	Not filed	53
	10-Q	01/30/04	03/15/04	Not filed	51
	10-Q	04/30/04	06/14/04	Not filed	48
	10-Q	07/30/04	09/13/04	Not filed	45
	10-K	10/29/04	01/27/05	Not filed	41
	10-Q	01/28/05	03/14/05	Not filed	39
	10-Q	04/29/05	06/13/05	Not filed	36
	10-Q	07/29/05	09/12/05	Not filed	33
	10-K	10/28/05	01/26/06	Not filed	29
	10-Q	02/03/06	03/20/06	Not filed	27
	10-Q	04/28/06	06/12/06	Not filed	24
	10-Q	07/28/06	09/11/06	Not filed	21
	10-K	11/03/06	02/01/07	Not filed	16
	10-Q	02/02/07	03/19/07	Not filed	15
	10-Q	04/27/07	06/11/07	Not filed	12
	10-Q	08/03/07	09/17/07	Not filed	9
	10-K	11/02/07	01/31/08	Not filed	5
	10-Q	02/01/08	03/17/08	Not filed	3
	10-Q	05/02/08	06/16/08	Not filed	1
Total Filings Delinquent	**35**				

UNITED STATES OF AMERICA
BEFORE THE
SECURITES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58000 / June 23, 2008

ORDER GRANTING REGISTRATION OF REALPOINT LLC AS A NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION

Realpoint LLC ("Realpoint"), a credit rating agency, furnished to the Securities and Exchange Commission ("Commission") an application for registration as a nationally recognized statistical rating organization ("NRSRO") under Section 15E of the Securities Exchange Act of 1934 ("Exchange Act") for the class of credit ratings described in clause (iv) of Section 3(a)(62)(B) of the Exchange Act.

Based on the information provided in the application, Realpoint has a conflict of interest that would cause the firm to be in violation of Exchange Act Rule 17g-5(c)(1) (17 CFR 240.17g-5(c)(1)) if it became registered. Realpoint requested that the Commission grant Realpoint an exemption from the conflict of interest prohibition in Exchange Act Rule 17g-5(c)(1). Simultaneously with this Order, the Commission is issuing an Order ("Exemptive Order") granting Realpoint an exemption from Exchange Act Rule 17g-5(c)(1) until January 1, 2009.[1]

The Commission finds that the application furnished by Realpoint is in the form required by Exchange Act Section 15E, Exchange Act Rule 17g-1 (17 CFR 240.17g-1), and Form NRSRO (17 CFR 249b.300) and contains the information described in subparagraph (B) of Section 15E(a)(1) of the Exchange Act.

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1 Release No. 34-58001 (June 23, 2008).

Document 32 of 48

Based on the application and Exemptive Order, the Commission finds that the requirements of Section 15E of the Exchange Act are satisfied.

Accordingly,

IT IS ORDERED, under paragraph (a)(2)(A) of Section 15E of the Exchange Act, that the registration of Realpoint LLC with the Commission as an NRSRO under Section 15E of the Exchange Act for the class of credit ratings described in clause (iv) of Section 3(a)(62)(B) of the Exchange Act is granted.

By the Commission.

Florence E. Harmon

Florence E. Harmon
Acting Secretary

SECURITES AND EXCHANGE COMMISSION
(Release No. 34-58001)

June 23, 2008

Order Granting Temporary Exemption of Realpoint LLC from the Conflict of Interest Prohibition in Rule 17a-5(c)(1) under the Securities Exchange Act of 1934

I. Introduction

The Credit Rating Agency Reform Act of 2006 ("Rating Agency Act"),[1] enacted on September 29, 2006, defined the term "nationally recognized statistical rating organization" ("NRSRO"), added Section 15E to the Securities Exchange Act of 1934 ("Exchange Act"), and provided authority for the Securities and Exchange Commission ("Commission") to implement registration, recordkeeping, financial reporting, and oversight rules with respect to registered credit rating agencies. Exchange Act Rule 17g-1 (17 CFR 240.17g-1), and Form NRSRO (17 CFR 249b.300), prescribe the process for a credit rating agency to apply for registration. Rule 17g-1 and Form NRSRO were effective on June 18, 2007, and the other rules, Rules 17g-2 through 17g-6 (17 CFR 240.17g-2 through 17g-6), became effective on June 26, 2007.[2]

In particular, Rule 17g-5(c)(1) prohibits an NRSRO from issuing or maintaining a credit rating solicited by a person that, in the most recently ended fiscal year, provided the NRSRO with net revenue equaling or exceeding 10% of the total net revenue of the NRSRO for the fiscal year. In adopting this rule, the Commission stated that such a person would be in a position to exercise substantial influence on the NRSRO, which in turn would make it difficult for the NRSRO to remain impartial.[3]

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1 Pub. L. No. 109-291 (2006).
2 Release No. 34-55857 (June 5, 2007), 72 FR 33564, 33564-65 (June 18, 2007).
3 Id. at 33598.

Document 33 of 48

II. Application and Exemption Request of Realpoint LLC

Realpoint LLC ("Realpoint"), a credit rating agency, furnished to the Commission an application for registration as an NRSRO under Section 15E of the Exchange Act for the class of credit ratings described in clause (iv) of Section 3(a)(62)(B) of the Exchange Act.[4] Based on the information provided in the application, Realpoint has a conflict of interest that would cause the firm to be in violation of Rule 17g-5(c)(1) if Realpoint became registered. Specifically, for the fiscal year ending December 31, 2007, Realpoint maintained credit ratings solicited by a person that provided Realpoint with 10% or more of its total net revenue for that year.

Realpoint has requested[5] that the Commission exempt it from Rule 17g-5(c)(1) for the fiscal year ending December 31, 2007 on the grounds that the prohibition hinders its ability as a small entity to further develop its business issuing credit ratings on asset-backed securities. Realpoint also stated that it expects the percentage of net revenue attributable to the relevant client to decrease to approximately 7.5% of its fiscal year 2008 net revenue.

III. Discussion

The Commission, when adopting Rule 17g-5(c)(1), noted that it intended to monitor how the prohibition operates in practice, particularly with respect to asset-backed securities, and whether exemptions may be appropriate.[6] The Commission notes that the

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4 This class of credit ratings is for "issuers of asset-backed securities (as that term is defined in section 1101(c) of part 229 of title 17, Code of Federal Regulations...") ("asset-backed securities"). Section 3(a)(62)(B)(iv) of the Exchange Act.

5 Letter dated April 28, 2008 to the Commission from Robert Dobilas, CEO and President of Realpoint.

6 Release No. 34-55857 (June 5, 2007), 72 FR 33564, 33598 (June 18, 2007).

revenue in question was earned by Realpoint before it submitted its application for registration and in the year before Rule 17g-5 was adopted, which limited the time for Realpoint to adjust its activities to conform to the requirements of the rule. In addition, the Commission recognizes that, given Realpoint's size, it is more likely that the firm would be affected by Rule 17g-5(c)(1) than a larger credit rating agency with a more diversified client base. Further, the Commission notes that Realpoint has stated that it expects that the percentage of total net revenue provided by the client will be below 10% for fiscal year 2008. Finally, the Commission notes that the threshold in Rule 17g-5(c)(1) is, of necessity, a bright line, but activities that exceed that threshold may or may not necessarily raise the concerns that are the basis for the rule. Hence, the Commission believes that it is important for the Commission to consider for each application the specific facts and circumstances of the applicant and whether to grant an exemption from Rule 17g-5(c)(1). Moreover, in this instance, the Commission recognizes that granting this exemption furthers the primary purpose of the Rating Agency Act, which is to enhance competition in the highly concentrated ratings industry. Granting Realpoint's registration will increase the number of NRSROs registered in the asset-backed security class, which could increase competition.

For these reasons, the Commission finds that granting Realpoint an exemption from Rule 17g-5(c)(1) for calendar year 2008 is necessary and appropriate in the public interest and is consistent with the protection of investors.[7] The exemption will expire on January 1, 2009 (Realpoint's fiscal year ends on December 31, 2008). The Commission

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7 Section 36 of the Exchange Act authorizes the Commission, by rule, regulation, or order, to conditionally or unconditionally exempt any person from any rule under the Exchange Act, to the extent that the exemption is necessary or appropriate in the public interest and is consistent with the protection of investors. 15 U.S.C. 78mm.

believes that providing Realpoint with the opportunity to be registered as an NRSRO during this time frame is an appropriate approach to addressing the unique circumstances of a small credit rating agency, while balancing this against the goal of Rule 17g-5(c)(1)--to prohibit a conflict that has the potential to influence a credit rating agency's impartiality. Consequently, this exemption is conditioned on Realpoint disclosing in Exhibit 6 to Form NRSRO that the firm received more than 10% of its net revenue in fiscal year 2007 from a client that paid it for a credit rating. This disclosure is designed to alert users of credit ratings to the existence of this specific conflict.

Simultaneously with this Order, the Commission is issuing an Order granting the registration of Realpoint with the Commission as an NRSRO under Section 15E of the Exchange Act.[8]

IV. Conclusion

Accordingly, pursuant to Section 36 of the Exchange Act,

IT IS HEREBY ORDERED that Realpoint LLC is exempt from the conflict of interest prohibition in Exchange Act Rule 17g-5(c)(1) until January 1, 2009, provided that Realpoint LLC discloses in Exhibit 6 to Form NRSRO that the firm received more than 10% of its net revenue in fiscal year 2007 from a client that paid it for a credit rating.

By the Commission.

Florence E. Harmon

Florence E. Harmon
Acting Secretary

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8 Release No. 34-58000 (June 23, 2008).

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58012 / June 24, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13081

In the Matter of SCOTTRADE, INC., Respondent.	ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER

I.

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

II.

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

Document 34 of 48

III.

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

Summary

1. This matter arises from representations Scottrade made to its customers in connection with their Nasdaq pre-open orders from January 1, 2001 through December 31, 2004 (the "relevant time period").[1] First, Scottrade expressly misrepresented in the customer account opening documents and account statements it sent to its customers that one of its policies was to route its customers' orders based on factors that included "liquidity at market opening," among other things, which gave its customers the opportunity to receive executions "that may be superior to the national best bid offer ('NBBO') in any one market center."[2] During the relevant time period, Scottrade had no written policies and procedures to assess liquidity at the market opening provided by market centers and, as a result, did not consider the availability of executions that may be superior to the NBBO, such as single or midpoint pricing, for its Nasdaq pre-open orders.[3]

2. Second, as a broker-dealer, Scottrade has a legal duty to seek to obtain for its customers' orders the most favorable terms reasonably available under the circumstances, taking into account price, order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market, as well as the potential for price improvement (i.e., best execution). By accepting customers' orders, a broker-dealer impliedly represents to customers that it will regularly and rigorously review the quality of execution that it receives on its orders, and where material differences exist between the price improvement opportunities offered by market centers, these differences will be taken into

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1 Nasdaq pre-open orders refer to those orders traded in the Nasdaq Stock Market, Inc. that are received after the previous day's close and before the current day's market open to be executed at the market open.

2 Market center refers to a market maker, i.e., in this case, a firm that maintains firm bid and offer prices in any given security by standing ready to buy or sell stocks at publicly quoted prices. The National Best Bid and Offer ("NBBO") is the best ask price available to a customer when he buys securities and the best bid price available to a customer when he sells securities. Liquidity refers to, among other things, the volume of trading in a particular stock. A liquid market allows buying and selling with relative ease and, accordingly, allows market centers to offer opportunities for superior executions.

3 "Midpoint pricing" is one price that is offered by a market center to both buy and sell orders at the midpoint between the NBBO. A single opening price ("single price") is an execution price offered to both buy and sell orders somewhere between the NBBO, depending on order imbalances. A single or midpoint price offering could allow the customer to receive superior execution than an NBBO price offering because corresponding customer buy and sell orders are executed against each other at a price between the national bid and offer price. See Disclosure of Order Execution and Routing Practices, Exchange Act Release No. 43590, 2000 WL 1721163 (November 17, 2000) ("Order Routing Release") (adopting Rules 605 and 606, which required market centers that trade national market system securities to make available publicly monthly electronic reports that include uniform statistical measures of execution quality and required broker-dealers that route customers' orders in equity and options securities to make available publicly quarterly reports that, among other things, disclose to what venues individual orders were routed).

account by the broker-dealer when deciding where to route its orders. Just prior to the relevant time period, the Commission stated that some market centers offered investors an opportunity to avoid paying a liquidity premium at the opening. The Commission stated that an example of this is "midpoint pricing" for Nasdaq pre-open orders and that broker-dealers should take these alternative pricing options into consideration when seeking to obtain best execution for their customers' Nasdaq pre-open orders.

3. Contrary to these implied representations, Scottrade did not conduct a regular and rigorous review of the execution quality of its Nasdaq pre-open orders during the relevant time period because its procedures did not require it to consider the availability of market centers that could have provided executions superior to the NBBO through single or midpoint pricing when routing its customers' Nasdaq pre-open orders to market centers.

Respondent

4. Scottrade is a discount brokerage firm serving individual investors with its home office in St. Louis, Missouri. Scottrade is a private company that was incorporated in Arizona. It has been registered with the Commission as a broker-dealer since 1980. At its inception, Scottrade offered customers deeply discounted commissions on trades placed via the telephone through a registered representative. In the fall of 1996, Scottrade expanded its services and introduced online trading at Scottrade.com.

The Pre-Open Market for Nasdaq Securities

5. During the relevant time period, after the previous day's market close and before the current day's market open, Scottrade received customer orders to buy and sell Nasdaq securities. Customers' Nasdaq orders received after the close of the market from the prior day queued in Scottrade's system, awaiting routing and possible execution at 9:30 a.m., when the market opened. Prior to market open, Scottrade routed its pre-open orders to market centers that Scottrade had previously selected to execute orders in a specific security. Once Scottrade set its computers to route orders for a specific security to a certain market center, all orders were generally sent to that market center.

6. From at least January 2001 until December 13, 2004, unlike the listed marketplace, there was not a unified single opening for Nasdaq securities.[4] Therefore, market centers had the option of executing orders several different ways, each of which could result in a different price for broker-dealers' customers' orders. For example, some market centers looked for the first unlocked/uncrossed[5] NBBO and then automatically executed all buy and sell orders at a

[4] Nasdaq now offers a pricing option called the Nasdaq Official Opening Price ("NOOP"). The NOOP is a single price opening for Nasdaq pre-open orders, which means that a customer can receive a single price for its trade somewhere between the bid price and the offer price. The NOOP was first offered in a pilot program and Nasdaq launched its first stage on October 2, 2004. By December 13, 2004, all stocks sold on the Nasdaq were added to the NOOP and broker-dealers could receive the single price opening for their customers if they chose to opt in.

[5] A market is "locked" if the bid price equals the ask price. A market is "crossed" when the inside market (refers to the best or highest bid and best or lowest ask) consists of a highest bid price that is higher than the lowest

single crossing price, which, depending on the order imbalances, would be somewhere between the best bid and best offer. In comparison, others matched their pre-open orders at the midpoint of the first unlocked, uncrossed NBBO. Finally, still other market centers executed Nasdaq pre-open orders at the NBBO. During the relevant time period, Scottrade failed to consider alternate Nasdaq pre-open pricing such as single or midpoint pricing when determining where to route Nasdaq pre-open orders.

Scottrade Misrepresented to Customers in Account Opening Documents and Statements that it Considered Liquidity at the Market Open and that its Policies and Procedures Gave its Customers Opportunities to Receive Prices that were Better than the NBBO

7. Scottrade made representations in the account opening documents and account statements that it sent to its customers regarding the factors that Scottrade examined when routing its customers' Nasdaq pre-open orders.

8. Specifically, from at least January 2001 through December 2004, Scottrade's customer account opening documents contained the following language:

- It is our policy to route customer orders to execution centers that can provide superior execution services based on factors such as: price improvement; speed of execution; order size; liquidity at market opening; and high limits on automatic order execution for the thousands of securities our customers trade. This policy gives our customers the opportunity to receive executions that may be superior to the national best bid offer ("NBBO") in any one market center.

9. During the relevant time period, however, Scottrade did not have policies in place to route pre-open orders to market centers that could have provided superior execution services based on liquidity at the market open and, as a result, did not consider the availability of executions that may be superior to the NBBO, such as single or midpoint pricing, for its Nasdaq pre-open orders.

Scottrade Failed to Perform a Regular and Rigorous Review of its Nasdaq Pre-Open Orders

10. In November 2000, the Commission's Order Routing Release stated:

> The Commission is aware that several important market centers trading Nasdaq securities have begun to offer services that give investors an opportunity to avoid paying a liquidity premium on opening orders. Such services can include, for example, "midpoint pricing," pursuant to which both buy and sell orders are executed at the midpoint of the opening quoted bid and offer . . . The Commission also is concerned that many investors may not be

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ask price. Conversely, a market is "unlocked" when there is a spread between the bid and the ask price and a market is "uncrossed" when the ask price is higher than the bid price.

aware of the differing services offered by market centers for execution of opening orders in Nasdaq securities, and their impact on execution quality.

* * *

[T]he Commission believes that the markets and broker-dealers handling customer orders should be given a further opportunity to improve execution quality at the opening in Nasdaq securities. Market centers generally inform broker-dealers in advance how they will execute opening orders. Broker-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 customers orders.[6]

11. Scottrade's Written Supervisory Procedures ("WSPs") are procedures that govern how different departments within Scottrade should operate.[7] During the relevant time period, the WSPs failed to provide for a regular or rigorous review of Nasdaq pre-open orders. Consequently, no one at Scottrade performed this review.

12. For example, the 2001 and 2002 WSPs discussed sending orders to outside market centers and noted that "[t]raders are obliged to use reasonable diligence to route the order to obtain a price as favorable as possible under prevailing market conditions." Although the WSPs listed factors to consider when sending orders to outside market centers, the WSPs did not list options such as single or midpoint pricing as factors to consider for Nasdaq pre-open orders.

13. In January 2003, senior personnel revised the WSPs to provide that an employee in Scottrade's compliance department and Scottrade's head trader would prepare a monthly trading summary that would provide an overall view of trading statistics and a list of the factors used to compile the summary. Nasdaq pre-open orders were not a category of trading statistics that was separately reviewed. When the employee in compliance and the head trader began to document their best execution evaluations, senior personnel did not provide any guidance on how to do so or at what they should be looking. The monthly trading report was circulated and supposed to be reviewed monthly by senior personnel; however, the report was not reviewed by all responsible senior personnel on a regular basis.

14. Also in December 2003, an employee in the compliance department drafted and circulated a memo to senior personnel suggesting that Scottrade undertake certain procedures, including establishing a best execution committee, developing a clear supervisory hierarchy and procedures and creating a system to determine the best order routing practices on a stock-by-stock

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6 See Order Routing Release, Exchange Act Release No. 43590, 2000 WL 1721163, at *15 (November 17, 2000). Although the Commission stated at the time of the Order Routing Release that many investors may not be aware of the differing services offered by market centers for execution of Nasdaq pre-open orders, neither the Commission, nor Nasdaq had any specific rule requiring that market centers offer a single or midpoint price.

7 Scottrade did not establish separate procedures for non-supervisors and Scottrade had no separate compliance manual.

basis, so Scottrade could find the best execution venue for individual securities. The employee noted that best execution and trade desk monitoring were important because Scottrade was doing an increasingly greater number of trades, which left Scottrade increasingly open to regulatory scrutiny. The employee also noted that there had been several high profile best execution related lawsuits in 2003 and his suggestions were "a good way to find problems before they find us." The employee further noted that currently best execution and trade desk monitoring was a part-time job that he devoted about 10 hours a week to, when he could. He deemed that inadequate for a firm of Scottrade's size and ended the memo with suggestions that his responsibilities be shifted from other compliance duties to best execution monitoring and trade desk compliance support. He also recommended that Scottrade hire someone with trading supervision experience.

15. It was not until approximately September 2004 that senior personnel revised the WSPs to provide for a regular and rigorous review of the quality of its routing decisions and established a "Best Execution Review Committee." The WSPs still did not direct that Nasdaq pre-open orders be analyzed.

Market Centers Offered Pre-Open Single or Midpoint Pricing During the Relevant Time Period, but Scottrade did not Consider the Single or Midpoint Pricing Options for its Customers

16. At various times, from January 2001 to December 2004, market centers offered a single or midpoint price option for Nasdaq pre-open orders that was reasonably available to Scottrade. Scottrade was also notified by a market center during this time period that single or midpoint pricing was available.

17. Scottrade had no procedures that provided for a regular and rigorous review of the execution quality it received from market centers for its Nasdaq pre-open orders and it did not perform such reviews during the relevant time period because Scottrade failed to consider whether alternatives such as single or midpoint pricing were available for its customers.

LEGAL DISCUSSION

18. Section 15(c)(1)(A) of the Exchange Act makes it unlawful for any broker or dealer to "effect any transaction in . . . any security by means of any manipulative, deceptive, or other fraudulent device or contrivance." A broker-dealer violates Section 15(c)(1)(A) when it makes material misrepresentations in connection with the execution of customer orders.[8]

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[8] See Section 15(c)(1)(A) of the Exchange Act ("No 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 or attempt to induce the purchase or sale of, any security . . . by means of any manipulative, deceptive, or other fraudulent device or contrivance."). See also Disclosure of Order Routing and Execution Practices, Exchange Act Rel. No. 43084, 2000 WL 1092311, at *35 (July 28, 2000) ("False or misleading statements made by market centers to routing firms regarding execution quality, if material and made with the requisite state of mind, may be actionable under antifraud provisions.") (citations omitted). The Commission has charged Section 15(c)(1)(A) violations against broker-dealers where material misrepresentations in connection with the execution of customer orders existed. See, e.g., In re Pacific Growth Equities, LLC, et al., Exchange Act Release No. 55148, 2007 WL 162559 (Jan. 23, 2007) (settled

19. A broker-dealer has a legal duty to seek to obtain best execution of customer orders.[9] By accepting an order, a broker-dealer impliedly represents that the order will be executed in a manner consistent with the duty of best execution.[10] The duty of best execution includes a requirement that the broker-dealer "seek to obtain for its customer orders the most favorable terms reasonably available under the circumstances."[11] The duty of best execution does not require "an order-by-order analysis of competing market [centers]."[12] It, instead, requires a broker-dealer to regularly and rigorously evaluate the quality of the execution it obtains for customers' orders, consider the best reasonably available terms from competing market centers for its customers' orders, and where material differences exist between the price improvement opportunities offered by market centers, take these differences into account when deciding where to route its orders.[13]

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action finding broker-dealer violated Section 15(c)(1)(A) by failing to disclose that it would add mark-ups and mark-downs in addition to commissions.

9 See Newton v. Merrill, Lynch, Pierce, Fenner & Smith, 135 F.3d 266, 269-70, 274 (3d Cir. 1998) (finding Merrill Lynch may have failed to maximize the economic benefit to its customers by failing to take advantage of prices better than the NBBO); Geman v. SEC, 334 F.3d 1183, 1192-93 (10th Cir. 2003) (finding that broker-dealer violated its duty of best execution by failing to disclose that its method of executing orders deprived customers of the possibility of getting a price better than the NBBO). In addition, the Commission has instituted settled enforcement actions addressing a broker-dealer's duty of best execution. See, e.g., In re Morgan Stanley & Co., Inc., Exchange Act Release No. 55726, 2007 WL 1364323 (May 9, 2007) (settled action finding that broker-dealer violated its duty of best execution by embedding undisclosed mark-ups and mark-downs in retail orders for over-the-counter securities); Certain Market Making Activities on Nasdaq, Exchange Act Release No. 40900, 1998 WL 919673, at *5 (Jan. 11, 1999) (settled action finding that Nasdaq market makers failed to provide best execution for their customers' orders by favoring their own interests, or those of a cooperating market maker, over the interests of their customers).

10 Newton, 135 F.3d at 269 ("[A] broker-dealer, by accepting an order without price instructions, impliedly represents that the order will be executed in a manner consistent with the duty of best execution and that a broker-dealer who accepts such an order while intending to breach that duty makes a misrepresentation that is material to the purchase or sale.").

11 Newton, 135 F.3d at 270.

12 See Order Execution Obligation, Exchange Act Release No. 37619A, 1996 WL 506154, at *51-53 (September 6, 1996).

13 Newton, 135 F.3d at 269-72; see also Order Execution Obligation, Exchange Act Release No. 37619A, 1996 WL 506154, at *51-53 (September 6, 1996) ("[T]he Commission has emphasized that best execution obligations require that broker-dealers routing orders for automatic execution must periodically assess the quality of competing markets to assure that order flow is directed to markets providing the most beneficial terms for their customers' orders . . . 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. . . . [W]here reliable, superior prices are readily accessible in such systems, broker-dealers should consider these prices in making decisions regarding the routing of customer orders . . . . [T]he Commission believes that because technology is rapidly making these systems more accessible, broker-dealers must regularly evaluate whether prices or other benefits offered by these systems are reasonably available for purposes of seeking best execution of these customer orders."); NASD Notice to Members 01-22, "Regulation Reiterates Member Firm Best Execution Obligations and Provides Guidance to Members" (April 2001) (stating "a member

20. As described above, during the relevant time period, Scottrade expressly represented to its customers in account opening documents and account statements that its policy was to route its customers' orders based on factors that included "liquidity at market opening," which gave its customers the opportunity to receive executions "that may be superior to the national best bid offer ('NBBO') in any one market center." During the relevant time period, Scottrade had no written policies and procedures to assess liquidity at the market opening provided by the market centers to which it routed its customers' Nasdaq pre-open orders and, as a result, did not consider the availability of executions that may be superior to the NBBO, such as single or midpoint pricing, for its Nasdaq pre-open orders. Further, Scottrade impliedly represented to its customers when it accepted its orders that it would regularly and rigorously evaluate the quality of the execution of customers' Nasdaq pre-open orders and that it would consider the availability of superior pricing when routing its customers' Nasdaq pre-open orders to market centers. Scottrade, however, did not conduct a regular and rigorous review of its customers' Nasdaq pre-open orders because it did not consider the availability of market centers that could have provided executions superior to the NBBO through single or midpoint pricing. Accordingly, Scottrade willfully violated Section 15(c)(1)(A) of the Exchange Act.

Remedial Efforts

21. In determining to accept the Offer, the Commission considered remedial actions by Scottrade.

IV.

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

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

A. Scottrade is censured.

B. Scottrade shall cease and desist from committing or causing any violations and any future violations of Section 15(c)(1)(A) of the Exchange Act;

C. It is further ordered that Scottrade shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of $950,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Scottrade as a Respondent in these proceedings, the file number of

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firm, in conducting its regular and rigorous review, should take into account [midpoint pricing or some other form of price improvement] in determining how to obtain best execution for [its] customer orders").

these proceedings, a copy of which cover letter and money order or check shall be sent to Elaine C. Greenberg, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, 701 Market Street, Suite 2000, Philadelphia, PA 19106.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

F.,.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
June 24, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13080

In the Matter of	
National Fruit and Vegetable Technology Corp., National Properties Investment Trust, National Record Mart, Inc., National Sorbents, Inc., Nations Flooring, Inc., Netcare Health Group, Inc., and Netgain Development, 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 National Fruit and Vegetable Technology Corp., National Properties Investment Trust, National Record Mart, Inc., National Sorbents, Inc., Nations Flooring, Inc., Netcare Health Group, Inc., and Netgain Development, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. National Fruit and Vegetable Technology Corp. (CIK No. 815747) is a defaulted Nevada corporation located in Baltimore, Ohio with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). National Fruit is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the period ended December 31, 2000, which reported an accumulated deficit of over $1 million.

Document 35 of 48

2. National Properties Investment Trust (CIK No. 761236) is a Massachusetts trust located in Canton Center, Connecticut with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). National Properties is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended December 31, 2000, which reported an accumulated deficit of over $11 million.

3. National Record Mart, Inc. (CIK No. 904535) is a Delaware corporation located in Carnegie, Pennsylvania with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). National Record is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended June 30, 2001, which reported a net loss of $6.5 million for the prior thirteen weeks. As of June 19, 2008, the company's common stock (symbol "NRMI") was traded on the over-the-counter markets.

4. National Sorbents, Inc. (CIK No. 1100980) is a revoked Nevada corporation located in Cincinnati, Ohio with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). National Sorbents 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 net loss of $366,618 for the prior six months. As of June 20, 2008, the company's common stock (symbol "NSIE") was traded on the over-the-counter markets.

5. Nations Flooring, Inc. (CIK No. 853271) 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). Nations Flooring is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended June 30, 2001, which reported a net loss of $257,380 for the prior six months.

6. Netcare Health Group, Inc. (CIK No. 705581) is a forfeited Delaware corporation located in Middletown, Connecticut with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Netcare 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 net loss of $1.5 million for the prior three months.

7. Netgain Development, Inc. (CIK No. 1046529) is a dissolved Colorado corporation located in New York, New York with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Netgain is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2000, which reported a net loss of over $10 million for the prior nine months. As of June 20, 2008, the company's common stock (symbol "NRMI") was traded on the over-the-counter markets.

B. DELINQUENT PERIODIC FILINGS

8. 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.

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

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

III.

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

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

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

Florence E. Harmon
Acting Secretary

Attachment

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

Appendix 1

Chart of Delinquent Filings
National Fruit and Vegetable Technology Corp., et al.

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
National Fruit and Vegetable Technology Corp.					
	10-QSB	03/31/01	05/15/01	Not filed	85
	10-QSB	06/30/01	08/14/01	Not filed	82
	10-QSB	09/30/01	11/14/01	Not filed	79
	10-KSB	12/31/01	04/01/02	Not filed	74
	10-QSB	03/31/02	05/15/02	Not filed	73
	10-QSB	06/30/02	08/14/02	Not filed	70
	10-QSB	09/30/02	11/14/02	Not filed	67
	10-KSB	12/31/02	03/31/03	Not filed	63
	10-QSB	03/31/03	05/15/03	Not filed	61
	10-QSB	06/30/03	08/14/03	Not filed	58
	10-QSB	09/30/03	11/14/03	Not filed	55
	10-KSB	12/31/03	03/30/04	Not filed	51
	10-QSB	03/31/04	05/17/04	Not filed	49
	10-QSB	06/30/04	08/16/04	Not filed	46
	10-QSB	09/30/04	11/15/04	Not filed	43
	10-KSB	12/31/04	03/31/05	Not filed	39
	10-QSB	03/31/05	05/16/05	Not filed	37
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/14/05	Not filed	31
	10-KSB	12/31/05	03/31/06	Not filed	27
	10-QSB	03/31/06	05/15/06	Not filed	25
	10-QSB	06/30/06	08/14/06	Not filed	22
	10-QSB	09/30/06	11/14/06	Not filed	19
	10-KSB	12/31/06	04/02/07	Not filed	14
	10-QSB	03/31/07	05/15/07	Not filed	13
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/30/07	11/14/07	Not filed	7
	10-KSB	12/31/07	03/30/08	Not filed	3
	*10-Q**	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	29				

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
National Properties Investment Trust					
	10-Q	03/31/00	05/15/00	Not filed	97
	10-Q	06/30/00	08/14/00	Not filed	94
	10-Q	09/30/00	11/14/00	Not filed	91
	10-Q	03/31/01	05/15/01	Not filed	85
	10-Q	06/30/01	08/14/01	Not filed	82
	10-Q	09/30/01	11/14/01	Not filed	79
	10-K	12/31/01	04/01/02	Not filed	74
	10-Q	03/31/02	05/15/02	Not filed	73
	10-Q	06/30/02	08/14/02	Not filed	70
	10-Q	09/30/02	11/14/02	Not filed	67
	10-K	12/31/02	03/31/03	Not filed	63
	10-Q	03/31/03	05/15/03	Not filed	61
	10-Q	06/30/03	08/14/03	Not filed	58
	10-Q	09/30/03	11/14/03	Not filed	55
	10-Q	03/31/03	05/15/03	Not filed	61
	10-Q	06/30/03	08/14/03	Not filed	58
	10-Q	09/30/03	11/14/03	Not filed	55
	10-K	12/31/03	03/30/04	Not filed	51
	10-Q	03/31/04	05/17/04	Not filed	49
	10-Q	06/30/04	08/16/04	Not filed	46
	10-Q	09/30/04	11/15/04	Not filed	43
	10-K	12/31/04	03/31/05	Not filed	39
	10-Q	03/31/05	05/16/05	Not filed	37
	10-Q	06/30/05	08/15/05	Not filed	34
	10-Q	09/30/05	11/14/05	Not filed	31
	10-K	12/31/05	03/31/06	Not filed	27
	10-Q	03/31/06	05/15/06	Not filed	25
	10-Q	06/30/06	08/14/06	Not filed	22
	10-Q	09/30/06	11/14/06	Not filed	19
	10-K	12/31/06	04/02/07	Not filed	14
	10-Q	03/31/07	05/15/07	Not filed	13
	10-Q	06/30/07	08/14/07	Not filed	10
	10-Q	09/30/07	11/14/07	Not filed	7
	10-K	12/31/07	03/31/08	Not filed	3
	10-Q	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	35				

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
National Record Mart, Inc.					
	10-KSB	03/31/01	06/29/01	Not filed	84
	10-QSB	06/30/01	08/14/01	Not filed	82
	10-QSB	09/29/01	11/13/01	Not filed	79
	10-QSB	12/29/01	02/12/02	Not filed	76
	10-KSB	03/30/02	06/28/02	Not filed	72
	10-QSB	06/29/02	08/13/02	Not filed	70
	10-QSB	09/28/02	11/12/02	Not filed	67
	10-QSB	12/28/02	02/11/03	Not filed	64
	10-KSB	03/29/03	06/27/03	Not filed	60
	10-QSB	06/28/03	08/12/03	Not filed	58
	10-QSB	09/27/03	11/12/03	Not filed	55
	10-QSB	12/27/03	02/10/04	Not filed	52
	10-KSB	03/27/04	06/25/04	Not filed	48
	10-QSB	06/26/04	08/10/04	Not filed	46
	10-QSB	09/25/04	11/09/04	Not filed	43
	10-QSB	12/25/04	02/08/05	Not filed	40
	10-KSB	03/26/05	06/24/05	Not filed	36
	10-QSB	06/25/05	08/09/05	Not filed	34
	10-QSB	09/24/05	11/08/05	Not filed	31
	10-QSB	12/31/05	02/14/06	Not filed	28
	10-KSB	03/25/06	06/23/06	Not filed	24
	10-QSB	06/24/06	08/08/06	Not filed	22
	10-QSB	09/30/06	11/14/06	Not filed	19
	10-QSB	12/30/06	02/13/07	Not filed	16
	10-KSB	03/31/07	06/29/07	Not filed	12
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/29/07	11/13/07	Not filed	7
	10-QSB	12/29/07	02/12/08	Not filed	4
Total Filings Delinquent	28				
National Sorbents, Inc.					
	10-QSB	09/30/02	11/14/02	Not filed	67
	10-KSB	12/31/02	03/31/03	Not filed	63
	10-QSB	03/31/03	05/15/03	Not filed	61
	10-QSB	06/30/03	08/14/03	Not filed	58

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
National Sorbents, Inc.					
	10-QSB	09/30/03	11/14/03	Not filed	55
	10-KSB	12/31/03	03/30/04	Not filed	51
	10-QSB	03/31/04	05/17/04	Not filed	49
	10-QSB	06/30/04	08/16/04	Not filed	46
	10-QSB	09/30/04	11/15/04	Not filed	43
	10-KSB	12/31/04	03/31/05	Not filed	39
	10-QSB	03/31/05	05/16/05	Not filed	37
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/14/05	Not filed	31
	10-KSB	12/31/05	03/31/06	Not filed	27
	10-QSB	03/31/06	05/15/06	Not filed	25
	10-QSB	06/30/06	08/14/06	Not filed	22
	10-QSB	09/30/06	11/14/06	Not filed	19
	10-KSB	12/31/06	04/02/07	Not filed	14
	10-QSB	03/31/07	05/15/07	Not filed	13
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/30/07	11/14/07	Not filed	7
	10-KSB	12/31/07	03/30/08	Not filed	3
	*10-Q**	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	23				
Nations Flooring, Inc.					
	10-Q	09/30/01	11/14/01	Not filed	79
	10-K	12/31/01	04/01/02	Not filed	74
	10-Q	03/31/02	07/01/02	Not filed	71
	10-Q	06/30/02	08/14/02	Not filed	70
	10-Q	09/30/02	11/14/02	Not filed	67
	10-K	12/31/02	03/31/03	Not filed	63
	10-Q	03/31/03	05/15/03	Not filed	61
	10-Q	06/30/03	08/14/03	Not filed	58
	10-Q	09/30/03	11/14/03	Not filed	55
	10-K	12/31/03	03/30/04	Not filed	51
	10-Q	03/31/04	05/17/04	Not filed	49
	10-Q	06/30/04	08/16/04	Not filed	46
	10-Q	09/30/04	11/15/04	Not filed	43
	10-K	12/31/04	03/31/05	Not filed	39
	10-Q	03/31/05	05/16/05	Not filed	37

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Nations Flooring, Inc.					
	10-Q	06/30/05	08/15/05	Not filed	34
	10-Q	09/30/05	11/14/05	Not filed	31
	10-K	12/31/05	03/31/06	Not filed	27
	10-Q	03/31/06	05/15/06	Not filed	25
	10-Q	06/30/06	08/14/06	Not filed	22
	10-Q	09/30/06	11/14/06	Not filed	19
	10-K	12/31/06	04/02/07	Not filed	14
	10-Q	03/31/07	05/15/07	Not filed	13
	10-Q	06/30/07	08/14/07	Not filed	10
	10-Q	09/30/07	11/14/07	Not filed	7
	10-K	12/31/07	03/30/08	Not filed	3
	10-Q	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	27				
Netcare Health Group, Inc.					
	10-QSB	09/30/02	11/14/02	Not filed	67
	10-KSB	12/31/02	03/31/03	Not filed	63
	10-QSB	03/31/03	05/15/03	Not filed	61
	10-QSB	06/30/03	08/14/03	Not filed	58
	10-QSB	09/30/03	11/14/03	Not filed	55
	10-KSB	12/31/03	03/30/04	Not filed	51
	10-QSB	03/31/04	05/17/04	Not filed	49
	10-QSB	06/30/04	08/16/04	Not filed	46
	10-QSB	09/30/04	11/15/04	Not filed	43
	10-KSB	12/31/04	03/31/05	Not filed	39
	10-QSB	03/31/05	05/16/05	Not filed	37
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/14/05	Not filed	31
	10-KSB	12/31/05	03/31/06	Not filed	27
	10-QSB	03/31/06	05/15/06	Not filed	25
	10-QSB	06/30/06	08/14/06	Not filed	22
	10-QSB	09/30/06	11/14/06	Not filed	19
	10-KSB	12/31/06	04/02/07	Not filed	14
	10-QSB	03/31/07	05/15/07	Not filed	13
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/30/07	11/14/07	Not filed	7

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Netcare Health Group, Inc.					
	10-KSB	12/31/07	03/30/08	Not filed	3
	*10-Q**	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	23				
Netgain Development, Inc.					
	10-KSB	12/31/00	04/02/01	Not filed	86
	10-QSB	03/31/01	05/15/01	Not filed	85
	10-QSB	06/30/01	08/14/01	Not filed	82
	10-QSB	09/30/01	11/14/01	Not filed	79
	10-KSB	12/31/01	04/01/02	Not filed	74
	10-QSB	03/31/02	05/15/02	Not filed	73
	10-QSB	06/30/02	08/14/02	Not filed	70
	10-QSB	09/30/02	11/14/02	Not filed	67
	10-KSB	12/31/02	03/31/03	Not filed	63
	10-QSB	03/31/03	05/15/03	Not filed	61
	10-QSB	06/30/03	08/14/03	Not filed	58
	10-QSB	09/30/03	11/14/03	Not filed	55
	10-KSB	12/31/03	03/30/04	Not filed	51
	10-QSB	03/31/04	05/17/04	Not filed	49
	10-QSB	06/30/04	08/16/04	Not filed	46
	10-QSB	09/30/04	11/15/04	Not filed	43
	10-KSB	12/31/04	03/31/05	Not filed	39
	10-QSB	03/31/05	05/16/05	Not filed	37
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/14/05	Not filed	31
	10-KSB	12/31/05	03/31/06	Not filed	27
	10-QSB	03/31/06	05/15/06	Not filed	25
	10-QSB	06/30/06	08/14/06	Not filed	22
	10-QSB	09/30/06	11/14/06	Not filed	19
	10-KSB	12/31/06	04/02/07	Not filed	14
	10-QSB	03/31/07	05/15/07	Not filed	13
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/30/07	11/14/07	Not filed	7
	10-KSB	12/31/07	04/01/08	Not filed	2

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Netgain Development, Inc.					
	*10-Q**	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	30				

*Regulation S-B and its accompanying forms, including Forms 10-QSB and 10-KSB, are in the process of being removed from the federal securities laws. *See* Release No. 34-56994 (Dec. 19, 2007). The removal is taking effect over a transition period that will conclude on March 15, 2009, so by that date, all reporting companies that previously filed their periodic reports on Forms 10-QSB and 10-KSB will be required to use Forms 10-Q and 10-K instead. Forms 10-QSB and 10-KSB will no longer be available, though issuers that meet the definition of a "smaller reporting company" (generally, a company that has less than $75 million in public equity float as of the end of its most recently completed second fiscal quarter) will have the option of using new, scaled disclosure requirements that Regulation S-K now includes.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58023 / June 25, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2842 / June 25, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12065

In the Matter of William E. Caswell, CPA	ORDER GRANTING APPLICATION FOR REINSTATEMENT TO APPEAR AND PRACTICE BEFORE THE COMMISSION AS AN ACCOUNTANT

On September 30, 2005, William E. Caswell ("Caswell") 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 Caswell pursuant to Rule 102(e) of the Commission's Rules of Practice.[1] Caswell consented to the entry of the September 30, 2005 order without admitting or denying the findings therein. This order is issued in response to Caswell's application for reinstatement to practice before the Commission as an accountant.

Caswell was found to have engaged in improper professional conduct with respect to the audits of Adelphia Communications Corporation's ("Adelphia") financial statements for the year ended December 31, 2000 by Deloitte & Touche LLP ("Deloitte"). During this time Caswell served as a director and held the most senior, non-partner position on Deloitte's Adelphia engagement. The Commission found that Adelphia's 2000 financial statements were materially false and misleading and failed to comply with Generally Accepted Accounting Principles ("GAAP"). In its Form 10-K for the year ended December 31, 2000, Adelphia understated its co-borrowing debt by $1.6 billion and improperly netted related party receivables and payables between Adelphia and certain entities owned or controlled by Adelphia's controlling shareholders. Adelphia also failed to disclose the nature and extent of thousands of related party transactions between Adelphia and these shareholders. Caswell reasonably should have known that Adelphia's 2000 financial statements had not been prepared in conformity with GAAP. He

[1] *See* Accounting and Auditing Enforcement Release No. 2326 dated September 30, 2005. Caswell was permitted, pursuant to the order, to apply for reinstatement after two years upon making certain showings.

Document 36 of 48

nonetheless failed to object to the issuance by Deloitte of its audit report containing an unqualified opinion. Caswell also failed to comply with Generally Accepted Auditing Standards during the audit of Adelphia's 2000 Financial Statements and engaged in improper professional conduct within the meaning of Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

Caswell 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 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, Caswell 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 Caswell, it appears that he has complied with the terms of the September 30, 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 Caswell, 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 Caswell, 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,

[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 William E. Caswell, CPA is hereby reinstated to appear and practice before the Commission as an accountant.

By the Commission.

Florence E. Harmon
Acting Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 230 and 240

[Release Nos. 33-8933, 34-58022; File No. S7-14-08]

RIN 3235-AK16

INDEXED ANNUITIES AND CERTAIN OTHER INSURANCE CONTRACTS

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: We are proposing a new rule that would define the terms "annuity contract" and "optional annuity contract" under the Securities Act of 1933. The proposed rule is intended to clarify the status under the federal securities laws of indexed annuities, under which payments to the purchaser are dependent on the performance of a securities index. The proposed rule would apply on a prospective basis to contracts issued on or after the effective date of the rule. We are also proposing to exempt insurance companies from filing reports under the Securities Exchange Act of 1934 with respect to indexed annuities and other securities that are registered under the Securities Act, provided that the securities are regulated under state insurance law, the issuing insurance company and its financial condition are subject to supervision and examination by a state insurance regulator, and the securities are not publicly traded.

DATES: Comments should be received on or before September 10, 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);

Document 37 of 48

- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-14-08 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 Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-14-08. 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 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: Michael L. Kosoff, Attorney, or Keith E. Carpenter, Senior Special Counsel, Office of Disclosure and Insurance Products Regulation, Division of Investment Management, at (202) 551-6795, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5720.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") is proposing to add rule 151A under the Securities Act of 1933

("Securities Act")[1] and rule 12h-7 under the Securities Exchange Act of 1934 ("Exchange Act").[2]

Table of Contents

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[1] 15 U.S.C. 77a et seq.

[2] 15 U.S.C. 78a et seq.

I. EXECUTIVE SUMMARY

We are proposing a new rule that is intended to clarify the status under the federal securities laws of indexed annuities, under which payments to the purchaser are dependent on the performance of a securities index. Section 3(a)(8) of the Securities Act provides an exemption under the Securities Act for certain insurance contracts. The proposed rule would prospectively define certain indexed annuities as not being "annuity contracts" or "optional annuity contracts" under this insurance exemption if the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

The proposed definition would hinge upon a familiar concept: the allocation of risk. Insurance provides protection against risk, and the courts have held that the allocation of investment risk is a significant factor in distinguishing a security from a contract of insurance. The Commission has also recognized that the allocation of investment risk is significant in determining whether a particular contract that is regulated as insurance under state law is insurance for purposes of the federal securities laws.

Individuals who purchase indexed annuities are exposed to a significant investment risk – i.e., the volatility of the underlying securities index. Insurance companies have successfully utilized this investment feature, which appeals to purchasers not on the usual insurance basis of stability and security, but on the prospect of investment growth. Indexed annuities are attractive to purchasers because they promise to offer market-related gains. Thus, these purchasers obtain indexed annuity contracts for many of the same reasons that individuals purchase mutual funds and variable annuities, and open brokerage accounts.

When the amounts payable by an insurer under an indexed annuity are more likely than not to exceed the amounts guaranteed under the contract, the majority of the investment risk for the fluctuating, equity-linked portion of the return is borne by the individual purchaser, not the insurer. The individual underwrites the effect of the underlying index's performance on his or her contract investment and assumes the majority of the investment risk for the equity-linked returns under the contract.

The federal interest in providing investors with disclosure, antifraud, and sales practice protections arises when individuals are offered indexed annuities that expose them to securities investment risk. Individuals who purchase such indexed annuities assume many of the same risks and rewards that investors assume when investing their money in mutual funds, variable annuities, and other securities. However, a fundamental difference between these securities and indexed annuities is that – with few exceptions – indexed annuities historically have not been registered as securities. As a result, most purchasers of indexed annuities have not received the benefits of federally mandated disclosure and sales practice protections.

We have determined that providing greater clarity with regard to the status of indexed annuities under the federal securities laws would enhance investor protection, as well as provide greater certainty to the issuers and sellers of these products with respect to their obligations under the federal securities laws. Accordingly, we are proposing a new definition of "annuity contract" that, on a prospective basis, would define a class of indexed annuities that are outside the scope of Section 3(a)(8). With respect to these annuities, investors would be entitled to all the protections of the federal securities laws, including full and fair disclosure and sales practice protections.

We are aware that many insurance companies, in the absence of definitive interpretation or definition by the Commission, have of necessity acted in reliance on their own analysis of the legal status of indexed annuities based on the state of the law prior to this release. Under these circumstances, we do not believe that insurance companies should be subject to any additional legal risk relating to their past offers and sales of indexed annuities as a result of our proposal today or its eventual adoption. Therefore, we are also proposing that the new definition apply prospectively only – that is, only to indexed annuities that are issued on or after the effective date of our final rule.

Finally, we are proposing a new exemption from Exchange Act reporting that would apply to insurance companies with respect to indexed annuities and certain other securities that are registered under the Securities Act and regulated as insurance under state law. We believe that this exemption is necessary or appropriate in the public interest and consistent with the protection of investors. Where an insurer's financial condition and ability to meet its contractual obligations are subject to oversight under state law, and where there is no trading interest in an insurance contract, the concerns that periodic and current financial disclosures are intended to address are generally not implicated. Rather, investors who purchase these securities are primarily affected by issues relating to the insurer's financial ability to satisfy its contractual obligations – issues that are addressed by state law and regulation.

II. BACKGROUND

Beginning in the mid-1990s, the life insurance industry introduced a new type of annuity, referred to as an "equity-indexed annuity," or, more recently, "fixed indexed annuity" (herein "indexed annuity"). Amounts paid by the insurer to the purchaser of an indexed annuity are based, in part, on the performance of an equity index or another securities index, such as a bond index.

The status of indexed annuities under the federal securities laws has been uncertain since their introduction in the mid-1990s. Under existing precedents, the status of each indexed annuity is determined based on a facts and circumstances analysis of factors that have been articulated by the U.S. Supreme Court.[3] Insurers have typically marketed and sold indexed annuities without complying with the federal securities laws, and sales of the products have grown dramatically in recent years. This growth has, unfortunately, been accompanied by growth in complaints of abusive sales practices. These include claims that the often-complex features of these annuities have not been adequately disclosed to purchasers, as well as claims that rapid sales growth has been fueled by the payment of outsize commissions that are funded by high surrender charges imposed over long periods, which can make these annuities particularly unsuitable for seniors and others who may need ready access to their assets.

We have observed the development of indexed annuities for some time, and we have become persuaded that guidance is needed with respect to their status under the federal securities laws. Today, we are proposing rules that are intended to provide greater clarity regarding the scope of the exemption provided by Section 3(a)(8). We believe our proposed action is consistent with Congressional intent in that the proposed definition would afford the disclosure and sales practice protections of the federal securities laws to purchasers of indexed annuities who are more likely than not to receive

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3 SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959) ("VALIC"); SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967) ("United Benefit").

payments that vary in accordance with the performance of a security. In addition, the proposed rules are intended to provide regulatory certainty and relief from Exchange Act reporting obligations to the insurers that issue these indexed annuities and certain other securities that are regulated as insurance under state law. We base our proposed exemption on two factors: first, the nature and extent of the activities of insurance company issuers, and their income and assets, and, in particular, the regulation of these activities and assets under state insurance law; and, second, the absence of trading interest in the securities.

A. Description of Indexed Annuities

An indexed annuity is a contract issued by a life insurance company that generally provides for accumulation of the purchaser's payments, followed by payment of the accumulated value to the purchaser either as a lump sum, upon death or withdrawal, or as a series of payments (an "annuity"). During the accumulation period, the insurer credits the purchaser with a return that is based on changes in a securities index, such as the Dow Jones Industrial Average, Lehman Brothers Aggregate U.S. Index, Nasdaq 100 Index, or Standard & Poor's 500 Composite Stock Price Index. The insurer also guarantees a minimum value to the purchaser.[4]

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[4] Financial Industry Regulatory Authority, Inc. ("FINRA"), Equity-Indexed Annuities – A Complex Choice (updated Apr. 22, 2008), available at: http://www.finra.org/InvestorInformation/InvestorAlerts/AnnuitiesandInsurance/Equity-IndexedAnnuities-AComplexChoice/P010614; National Association of Insurance Commissioners, Buyer's Guide to Fixed Deferred Annuities with Appendix for Equity-Indexed Annuities, at 9 (2007); National Association for Fixed Annuities, White Paper on Fixed Indexed Insurance Products Including 'Fixed Indexed Annuities' and Other Fixed Indexed Insurance Products, at 1 (2006), available at: http://www.nafa.us/pdfs/White%20Paper%20Final_11-10-06_All%20Inquiries.pdf; Jack Marrion, Index Annuities: Power and Protection, at 13 (2004).

Life insurance companies began offering indexed annuities in the mid-1990s.[5] Sales of indexed annuities for 1998 totaled $4 billion and grew each year through 2005, when sales totaled $27.2 billion.[6] Indexed annuity sales for 2006 totaled $25.4 billion and $24.8 billion in 2007.[7] In 2007, indexed annuity assets totaled $123 billion, 58 companies were issuing indexed annuities, and there were a total of 322 indexed annuities offered.[8] The specific features of indexed annuities vary from product to product. Some of the key features are as follows.

Computation of Index-Based Return

The purchaser's index-based return under an indexed annuity depends on the particular combination of features specified in the contract. Typically, an indexed annuity specifies all aspects of the formula for computing return in advance of the period for which return is to be credited, and the crediting period is generally at least one year long.[9] The rate of the index-based return is computed at the end of the crediting period, based on the actual performance of a specified securities index during that period, but the computation is performed pursuant to a mathematical formula that is guaranteed in advance of the crediting period. Common indexing features are described below.

- Index. Indexed annuities credit return based on the performance of a securities index, such as the Dow Jones Industrial Average, Lehman Brothers Aggregate

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5 See National Association for Fixed Annuities, supra note 4, at 4.

6 NAVA, 2008 Annuity Fact Book, 57 (2008).

7 Id.

8 Id.

9 National Association for Fixed Annuities, supra note 4, at 13.

U.S. Index, Nasdaq 100 Index, or Standard & Poor's 500 Composite Stock Price Index. Some annuities permit the purchaser to select one or more indices from a specified group of indices.

- Determining Change in Index. There are several methods for determining the change in the relevant index over the crediting period.[10] For example, the "point-to-point" method compares the index level at two discrete points in time, such as the beginning and ending dates of the crediting period. Another method, sometimes referred to as "monthly point-to-point," combines both positive and negative changes in the index values from one month to the next during the crediting period and recognizes the aggregate change as the amount of index credit for the period, if it is positive. Another method compares an average of index values at periodic intervals during the crediting period to the index value at the beginning of the period. Typically, in determining the amount of index change, dividends paid on securities underlying the index are not included. Indexed annuities typically do not apply negative changes in an index to contract value. Thus, if the change in index value is negative over the course of a crediting period, no deduction is taken from contract value nor is any index-based return credited.[11]

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10 See FINRA, supra note 4; National Association of Insurance Commissioners, supra note 4, at 12-14; National Association for Fixed Annuities, supra note 4, at 9-10; Marrion, supra note 4, at 38-59.

11 National Association of Insurance Commissioners, supra note 4, at 11; National Association for Fixed Annuities, supra note 4, at 5 and 9; Marrion, supra note 4, at 2.

- Portion of Index Change to be Credited. The portion of the index change to be credited under an indexed annuity is typically determined through the application of caps, participation rates, spread deductions, or a combination of these features.[12] Some contracts "cap" the index-based returns that may be credited. For example, if the change in the index is 6%, and the contract has a 5% cap, 5% would be credited. A contract may establish a "participation rate," which is multiplied by index growth to determine the rate to be credited. If the change in the index is 6%, and a contract's participation rate is 75%, the rate credited would be 4.5% (75% of 6%). In addition, some indexed annuities may deduct a percentage, or spread, from the amount of gain in the index in determining return. If the change in the index is 6%, and a contract has a spread of 1%, the rate credited would be 5% (6% minus 1%).

Surrender Charges

Surrender charges are commonly deducted from withdrawals taken by a purchaser.[13] The maximum surrender charges, which may be as high as 15-20%,[14] are imposed on surrenders made during the early years of the contract and decline gradually to 0% at the end of a specified surrender charge period, which may be in excess of 15

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12 See FINRA, supra note 4; National Association of Insurance Commissioners, supra note 4, at 10-11; National Association for Fixed Annuities, supra note 4, at 10; Marrion, supra note 4, at 38-59.

13 See FINRA, supra note 4; National Association of Insurance Commissioners, supra note 4, at 3-4 and 11; National Association for Fixed Annuities, supra note 4, at 7; Marrion, supra note 4, at 31.

14 The highest surrender charges are often associated with annuities in which the insurer credits a "bonus" equal to a percentage of purchase payments to the purchaser at the time of purchase. The surrender charge may serve, in part, to recapture the bonus.

years. Imposition of a surrender charge may have the effect of reducing or eliminating any index-based return credited to the purchaser up to the time of a withdrawal. In addition, a surrender charge may result in a loss of principal, so that a purchaser who surrenders prior to the end of the surrender charge period may receive less than the original purchase payments.[15] Many indexed annuities permit purchasers to withdraw a portion of contract value each year, typically 10%, without payment of surrender charges.

Guaranteed Minimum Value

Indexed annuities generally provide a guaranteed minimum value, which serves as a floor on the amount paid upon withdrawal, as a death benefit, or in determining the amount of annuity payments. The guaranteed minimum value is typically a percentage of purchase payments, accumulated at a specified interest rate, and may not be lower than a floor established by applicable state insurance law. Indexed annuities typically provide that the guaranteed minimum value is equal to at least 87.5% of purchase payments, accumulated at annual interest rate of between 1% and 3%.[16] Assuming a guarantee of 87.5% of purchase payments, accumulated at 1% interest compounded annually, it would take approximately 13 years for a purchaser's guaranteed minimum value to be 100% of purchase payments.

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[15] FINRA, supra note 4; Marrion, supra note 4, at 31.

[16] National Association for Fixed Annuities, supra note 4, at 6.

Registration

Insurers typically have concluded that the indexed annuities they issue are not securities. As a result, virtually all indexed annuities have been issued without registration under the Securities Act.[17]

B. Marketing of Indexed Annuities

In the years after indexed annuities were first introduced, sales volumes were relatively small. In 1998, when sales totaled $4 billion, the impact of these products on both purchasers and issuing insurance companies was limited. As sales have grown in more recent years, with sales of $24.8 billion and total indexed annuity assets of $123 billion in 2007, these products have affected larger and larger numbers of purchasers. They have also become an increasingly important business line for some insurers.[18] In

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17 In a few instances, insurers have registered indexed annuities as securities as a result of particular features, such as the absence of any guaranteed interest rate or the absence of a guaranteed minimum value. See, e.g., Pre-Effective Amendment No. 4 to Registration Statement on Form S-1 of PHL Variable Insurance Company (File No. 333-132399) (filed Feb. 7, 2007); Pre-Effective Amendment No. 1 to Registration Statement on Form S-3 of Allstate Life Insurance Company (File No. 333-105331) (filed May 16, 2003); Initial Registration Statement on Form S-2 of Golden American Life Insurance Company (File No. 333-104547) (filed Apr. 15, 2003).

18 See, e.g., Allianz Life Insurance Company of North America (Best's Company Reports, Allianz Life Ins. Co. of N. Am., Dec. 3, 2007) (Indexed annuities represent approximately two-thirds of gross premiums written.); American Equity Investment Life Holding Company (Annual Report on Form 10-K, at F-16 (Mar. 14, 2008)) (Indexed annuities accounted for approximately 97% of total purchase payments in 2007.); Americo Financial Life and Annuity Insurance Company (Best's Company Reports, Americo Fin. Life and Annuity Ins. Co., Jul. 10, 2007) (Indexed annuities represent over eighty percent of annuity premiums and almost half of annuity reserves.); Aviva USA Group (Best's Company Reports, AmerUs Life Insurance Company, Nov. 6, 2007) (Indexed annuity sales represent more than 90% of total annuity production.); Conseco Insurance Group (CIG) (Best's Company Reports, Conseco Ins. Group, Nov. 7, 2008) (CIG's business was heavily weighted toward indexed annuities, which contributed approximately 77% of new first year premiums.); Investors Insurance Corporation (IIC) (Best's Company Reports, Investors Ins. Corp., Aug. 20, 2007) (IIC's primary product has been indexed annuities.); Life Insurance Company of the Southwest ("LSW") (Best's Company Reports, Life Ins. Co. of the Southwest, Jun. 28, 2007) (LSW specializes in the

addition, in recent years, guarantees provided by indexed annuities have been reduced. In the years immediately following their introduction, indexed annuities typically guaranteed 90% of purchase payments accumulated at 3% annual interest.[19] More recently, however, following changes in state insurance laws,[20] guarantees in indexed annuities have been as low as 87.5% of purchase payments accumulated at 1% annual interest.[21]

At the same time that sales of indexed annuities have increased and guarantees within the products have been reduced, concerns about potentially abusive sales practices

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sale of annuities, primarily indexed annuities.); Midland National Life Insurance Company (Best's Company Reports, Midland Nat'l Life Ins. Co., Jan. 24, 2008) (Sales of indexed annuities in recent years has been the principal driver of growth in annuity deposits.).

19 Securities Act Release No. 7438 (Aug. 20, 1997) [62 FR 45359, 45360 (Aug. 27, 1997)] (concept release requesting comments on structure of equity indexed insurance products, the manner in which they are marketed, and other matters the Commission should consider in addressing federal securities law issues raised by these products) ("1997 Concept Release"). See also Letter from American Academy of Actuaries (Jan. 5, 1998); Letter from Aid Association for Lutherans (Nov. 19, 1997) (comment letters in response to 1997 Concept Release). The comment letters on the 1997 Concept Release are available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC (File No. S7-22-97). Some of the comment letters are also available on the Commission's Web site at http://www.sec.gov/rules/concept/s72297.shtml.

20 See, e.g., CAL. INS. CODE § 10168.25 (West 2007) (current requirements, providing for guarantee based on 87.5% of purchase payments accumulated at minimum of 1% annual interest); CAL. INS. CODE § 10168.2 (West 2003) (former requirements, providing for guarantee for single premium annuities based on 90% of premium accumulated at minimum of 3% annual interest).

21 See A Producer's Guide to Indexed Annuities 2006, LIFE INSURANCE SELLING (Jun. 2006), available at: http://www.lifeinsuranceselling.com/Media/MediaManager/6IAsurveyforweb3.pdf.

and inadequate disclosure have grown. In August 2005, NASD[22] issued a Notice to Members in which it cited its concerns about the manner in which persons associated with broker-dealers were marketing unregistered indexed annuities and the absence of adequate supervision of those sales practices.[23] The Notice to Members also expressed NASD's concern with indexed annuity sales materials that do not fully describe the features and risks of the products. Citing uncertainty as to whether indexed annuities are subject to the federal securities laws, NASD encouraged member firms to supervise transactions in these products as though they are securities.

At the Senior Summit held at the Commission in July 2006, at which securities regulators and others met to explore how to coordinate efforts to protect older Americans from abusive sales practices and securities fraud, concerns were cited about sales of indexed annuities to seniors.[24] Patricia Struck, then President of the North American Securities Administrators Association ("NASAA"), identified indexed annuities as among the most pervasive products involved in senior investment fraud.[25] In a joint

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22 In July 2007, NASD and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange were consolidated to create FINRA. The NASD materials cited in this release were issued prior to the creation of FINRA.

23 NASD, Equity-Indexed Annuities, Notice to Members 05-50 (Aug. 2005), available at: http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p014821.pdf.

See also FINRA, supra note 4 (investor alert on indexed annuities, stating that indexed annuities are "anything but easy to understand").

24 The average age of issuance for indexed annuities has been reported to be 64. Advantage Compendium, 4th Quarter Index Annuity Sales Slip (Mar. 2008), available at: http://www.indexannuity.org/ic2008.htm#4q07.

25 Statement of Patricia Struck, President, NASAA, at the Senior Summit of the United States Securities and Exchange Commission, July 17, 2006, available at: http://www.nasaa.org/IssuesAnswers/Legislative Activity/Testimony/4999.cfm.

examination conducted by the Commission, NASAA, and the Financial Industry Regulatory Authority, Inc. ("FINRA") of "free lunch" seminars that are aimed at selling financial products, often to seniors, with a free meal as enticement, examiners identified potentially misleading sales materials and potential suitability issues relating to the products discussed at the seminars, which commonly included indexed annuities.[26]

C. Section 3(a)(8) Exemption

Section 3(a)(8) of the Securities Act provides an exemption for any "annuity contract" or "optional annuity contract" issued by a corporation that is subject to the supervision of the insurance commissioner, bank commissioner, or similar state regulatory authority.[27] The exemption, however, is not available to all contracts that are considered annuities under state insurance law. For example, variable annuities, which pass through to the purchaser the investment performance of a pool of assets, are not exempt annuity contracts.

The U.S. Supreme Court has addressed the insurance exemption on two occasions.[28] Under these cases, factors that are important to a determination of an

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26 Office of Compliance Inspections and Examinations, Securities and Exchange Commission, et al., Protecting Senior Investors: Report of Examinations of Securities Firms Providing 'Free Lunch' Sales Seminars, at 4 (Sept. 2007), available at: http://www.sec.gov/spotlight/seniors/freelunchreport.pdf.

27 The Commission has previously stated its view that Congress intended any insurance contract falling within Section 3(a)(8) to be excluded from all provisions of the Securities Act notwithstanding the language of the Act indicating that Section 3(a)(8) is an exemption from the registration but not the antifraud provisions. Securities Act Release No. 6558 (Nov. 21, 1984) [49 FR 46750, 46753 (Nov. 28, 1984)]. See also Tcherepnin v. Knight, 389 U.S. 332, 342 n.30 (1967) (Congress specifically stated that "insurance policies are not to be regarded as securities subject to the provisions of the [Securities] act," (quoting H.R. Rep. 85, 73d Cong., 1st Sess. 15 (1933)).

28 VALIC, supra note 3, 359 U.S. 65; United Benefit, supra note 3, 387 U.S. 202.

annuity's status under Section 3(a)(8) include (1) the allocation of investment risk between insurer and purchaser, and (2) the manner in which the annuity is marketed.

With regard to investment risk, beginning with SEC v. Variable Annuity Life Ins. Co. ("VALIC"),[29] the Court has considered whether the risk is borne by the purchaser (tending to indicate that the product is not an exempt "annuity contract") or by the insurer (tending to indicate that the product falls within the Section 3(a)(8) exemption). In VALIC, the Court determined that variable annuities, under which payments varied with the performance of particular investments and which provided no guarantee of fixed income, were not entitled to the Section 3(a)(8) exemption. In SEC v. United Benefit Life Ins. Co. ("United Benefit"),[30] the Court extended the VALIC reasoning, finding that a contract that provides for some assumption of investment risk by the insurer may nonetheless not be entitled to the Section 3(a)(8) exemption. The United Benefit insurer guaranteed that the cash value of its variable annuity contract would never be less than 50% of purchase payments made and that, after ten years, the value would be no less than 100% of payments. The Court determined that this contract, under which the insurer did assume some investment risk through minimum guarantees, was not an "annuity contract" under the federal securities laws. In making this determination, the Court concluded that "the assumption of an investment risk cannot by itself create an insurance provision under the federal definition" and distinguished a "contract which to some degree is insured" from a "contract of insurance."[31]

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29 VALIC, supra note 3, 359 U.S. at 71-73.

30 United Benefit, supra note 3, 387 U.S. at 211.

31 Id. at 211.

In analyzing investment risk, Justice Brennan's concurring opinion in VALIC applied a functional analysis to determine whether a new form of investment arrangement that emerges and is labeled "annuity" by its promoters is the sort of arrangement that Congress was willing to leave exclusively to the state insurance commissioners. In that inquiry, the purposes of the federal securities laws and state insurance laws are important. Justice Brennan noted, in particular, that the emphasis in the Securities Act is on disclosure and that the philosophy of the Act is that "full disclosure of the details of the enterprise in which the investor is to put his money should be made so that he can intelligently appraise the risks involved."[32] Where an investor's investment in an annuity is sufficiently protected by the insurer, state insurance law regulation of insurer solvency and the adequacy of reserves are relevant. Where the investor's investment is not sufficiently protected, the disclosure protections of the Securities Act assume importance.

Marketing is another significant factor in determining whether a state-regulated insurance contract is entitled to the Securities Act "annuity contract" exemption . In United Benefit, the U.S. Supreme Court, in holding an annuity to be outside the scope of Section 3(a)(8), found significant the fact that the contract was "considered to appeal to the purchaser not on the usual insurance basis of stability and security but on the prospect of 'growth' through sound investment management."[33] Under these circumstances, the

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32 VALIC, supra note 3, 359 U.S. at 77.

33 United Benefit, supra note 3, 387 U.S. at 211.

Court concluded "it is not inappropriate that promoters' offerings be judged as being what they were represented to be."[34]

In 1986, given the proliferation of annuity contracts commonly known as "guaranteed investment contracts," the Commission adopted rule 151 under the Securities Act to establish a "safe harbor" for certain annuity contracts that are not deemed subject to the federal securities laws and are entitled to rely on Section 3(a)(8) of the Securities Act.[35] Under rule 151, an annuity contract issued by a state-regulated insurance company is deemed to be within Section 3(a)(8) of the Securities Act if (1) the insurer assumes the investment risk under the contract in the manner prescribed in the rule; and (2) the contract is not marketed primarily as an investment.[36] Rule 151 essentially codifies the tests the courts have used to determine whether an annuity contract is entitled to the Section 3(a)(8) exemption, but adds greater specificity with respect to the investment risk test. Under rule 151, an insurer is deemed to assume the investment risk under an annuity contract if, among other things,

(1) the insurer, for the life of the contract,

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34 Id. at 211 (quoting SEC v. Joiner Leasing Corp., 320 U.S. 344, 352-53 (1943)). For other cases applying a marketing test, see Berent v. Kemper Corp., 780 F. Supp. 431 (E.D. Mich. 1991), aff'd, 973 F. 2d 1291 (6th Cir. 1992); Associates in Adolescent Psychiatry v. Home Life Ins. Co., 729 F.Supp. 1162 (N.D. Ill. 1989), aff'd, 941 F.2d 561 (7th Cir. 1991); and Grainger v. State Security Life Ins. Co., 547 F.2d 303 (5th Cir. 1977).

35 17 CFR 230.151; Securities Act Release No. 6645 (May 29, 1986) [51 FR 20254 (June 4, 1986)]. A guaranteed investment contract is a deferred annuity contract under which the insurer pays interest on the purchaser's payments at a guaranteed rate for the term of the contract. In some cases, the insurer also pays discretionary interest in excess of the guaranteed rate.

36 17 CFR 230.151(a).

(a) guarantees the principal amount of purchase payments and credited interest, less any deduction for sales, administrative, or other expenses or charges; and

(b) credits a specified interest rate that is at least equal to the minimum rate required by applicable state law; and

(2) the insurer guarantees that the rate of any interest to be credited in excess of the guaranteed minimum rate described in paragraph 1(b) will not be modified more frequently than once per year.[37]

Indexed annuities are not entitled to rely on the safe harbor of rule 151 because they fail to satisfy the requirement that the insurer guarantee that the rate of any interest to be credited in excess of the guaranteed minimum rate will not be modified more frequently than once per year.[38]

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[37] 17 CFR 230.151(b) and (c). In addition, the value of the contract may not vary according to the investment experience of a separate account.

[38] Some indexed annuities also may fail other aspects of the safe harbor test.

In adopting rule 151, the Commission declined to extend the safe harbor to excess interest rates that are computed pursuant to an indexing formula that is guaranteed for one year. Rather, the Commission determined that it would be appropriate to permit insurers to make limited use of index features, provided that the insurer specifies an index to which it would refer, no more often than annually, to determine the excess interest rate that it would guarantee for the next 12-month or longer period. For example, an insurer would meet this test if it established an "excess" interest rate of 5% by reference to the past performance of an external index and then guaranteed to pay 5% interest for the coming year. Securities Act Release No. 6645, supra note 35, 51 FR at 20260. The Commission specifically expressed concern that index feature contracts that adjust the rate of return actually credited on a more frequent basis operate less like a traditional annuity and more like a security and that they shift to the purchaser all of the investment risk regarding fluctuations in that rate.

The only judicial decision that we are aware of regarding the status of indexed annuities under the federal securities laws is a district court case that concluded that the contracts at issue in the case fell within the Commission's Rule 151 safe harbor notwithstanding the fact that they apparently did not meet the limited test described above, i.e., specifying an

III. DISCUSSION OF THE PROPOSED AMENDMENTS

The Commission has determined that providing greater clarity with regard to the status of indexed annuities under the federal securities laws would enhance investor protection, as well as provide greater certainty to the issuers and sellers of these products with respect to their obligations under the federal securities laws. We are proposing a new definition of "annuity contract" that, on a prospective basis, would define a class of indexed annuities that are outside the scope of Section 3(a)(8). With respect to these annuities, investors would be entitled to all the protections of the federal securities laws, including full and fair disclosure and sales practice protections. We are also proposing a new exemption under the Exchange Act that would apply to insurance companies that issue indexed annuities and certain other securities that are registered under the Securities Act and regulated as insurance under state law. We believe that this exemption is necessary or appropriate in the public interest and consistent with the protection of investors because of the presence of state oversight of insurance company financial condition and the absence of trading interest in these securities.

A. Definition of Annuity Contract

The Commission is proposing new rule 151A, which would define a class of indexed annuities that are not "annuity contracts" or "optional annuity contracts"[39] for

index that would be used to determine a rate that would remain in effect for at least one year. Instead, the contracts appear to have guaranteed the index-based formula, but not the actual rate of interest. See Malone v. Addison Ins. Marketing, Inc., 225 F.Supp.2d 743, 751-754 (W.D. Ky. 2002).

39 An "optional annuity contract" is a deferred annuity. See United Benefit, supra note 3, 387 U.S. at 204. In a deferred annuity, annuitization begins at a date in the future, after assets in the contract have accumulated over a period of time (normally many years). In contrast, in an immediate annuity, the insurer begins making annuity payments shortly

purposes of Section 3(a)(8) of the Securities Act. Although we recognize that these instruments are issued by insurance companies and are treated as annuities under state law, these facts are not conclusive for purposes of the analysis under the federal securities laws.

1. Analysis

"Insurance" and "Annuity": Federal Terms under the Federal Securities Laws

Our analysis begins with the well-settled conclusion that the terms "insurance" and "annuity contract" as used in the Securities Act are "federal terms," the meanings of which are a "federal question" under the federal securities laws.[40] The Securities Act does not provide a definition of either term, and we have not previously provided a definition that applies to indexed annuities.[41] Moreover, indexed annuities did not exist and were not contemplated by Congress when it enacted the insurance exemption.

We therefore analyze indexed annuities under the facts and circumstances factors articulated by the U.S. Supreme Court in VALIC and United Benefit. In particular, we focus on whether these instruments are "the sort of investment form that Congress was

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after the purchase payment is made; i.e., within one year. See Kenneth Black, Jr., and Harold D. Skipper, Jr., Life and Health Insurance, at 164 (2000).

40 See VALIC, supra note 3, 359 U.S. at 69.

41 The last time the Commission formally addressed indexed annuities was in 1997. At that time, the Commission issued a concept release requesting public comment regarding indexed insurance contracts. The concept release stated that "depending on the mix of features . . . [an indexed insurance contract] may or may not be entitled to exemption from registration under the Securities Act" and that the Commission was "considering the status of [indexed annuities and other indexed insurance contracts] under the federal securities laws." See Concept Release, supra note 19, at 4-5.

The Commission has previously adopted a safe harbor for certain annuity contracts that are entitled to rely on Section 3(a)(8) of the Securities Act. However, as discussed in Part II.C., indexed annuities are not entitled to rely on the safe harbor.

. . . willing to leave exclusively to the State Insurance Commissioners" and whether they necessitate the "regulatory and protective purposes" of the Securities Act.[42]

Type of Investment

We believe that the indexed annuities that would be included in our proposed definition are not the sort of investment that Congress contemplated leaving exclusively to state insurance regulation. According to the U.S. Supreme Court, Congress intended to include in the insurance exemption only those policies and contracts that include a "true underwriting of risks" and "investment risk-taking" by the insurer.[43] Moreover, the level of risk assumption necessary for a contract to be "insurance" under the Securities Act must be meaningful – the assumption of an investment risk does not "by itself create an insurance provision under the federal definition."[44]

The annuities that "traditionally and customarily" were offered at the time Congress enacted the insurance exemption were fixed annuities that typically involved no investment risk to the purchaser.[45] These contracts offered the purchaser "specified and definite amounts beginning with a certain year of his or her life," and the "standards for

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42 See VALIC, supra note 3, 359 U.S. at 75 (Brennan, J., concurring) (". . . if a brand-new form of investment arrangement emerges which is labeled 'insurance' or 'annuity' by its promoters, the functional distinction that Congress set up in 1933 and 1940 must be examined to test whether the contract falls within the sort of investment form that Congress was then willing to leave exclusively to the State Insurance Commissioners. In that inquiry, an analysis of the regulatory and protective purposes of the Federal Acts and of state insurance regulation as it then existed becomes relevant.").

43 Id. at 71-73.

44 See United Benefit, supra note 3, 387 U.S. at 211 ("[T]he assumption of investment risk cannot by itself create an insurance provision. . . . The basic difference between a contract which to some degree is insured and a contract of insurance must be recognized.").

45 See VALIC, supra note 3, 359 U.S. at 69.

investments of funds" by the insurer under these contracts were "conservative."[46] Moreover, these types of annuity contracts were part of a "concept which had taken on its coloration and meaning largely from state law, from state practice, from state usage."[47] Thus, Congress exempted these instruments from the requirements of the federal securities laws because they were a "form of 'investment'. . . which did not present very squarely the problems that [the federal securities laws] were devised to deal with," and were "subject to a form of state regulation of a sort which made the federal regulation even less relevant."[48]

In contrast, when the amounts payable by an insurer under an indexed annuity contract are more likely than not to exceed the amounts guaranteed under the contract, the purchaser assumes substantially different risks and benefits. Notably, at the time that such a contract is purchased, the risk for the unknown, unspecified, and fluctuating securities-linked portion of the return is primarily assumed by the purchaser.

By purchasing this type of indexed annuity, the purchaser assumes the risk of an uncertain and fluctuating financial instrument, in exchange for exposure to future, securities-linked returns. The value of such an indexed annuity reflects the benefits and risks inherent in the securities market, and the contract's value depends upon the

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46 Id. ("While all the States regulate 'annuities' under their 'insurance' laws, traditionally and customarily they have been fixed annuities, offering the annuitant specified and definite amounts beginning with a certain year of his or her life. The standards for investment of funds underlying these annuities have been conservative.").

47 Id. ("Congress was legislating concerning a concept which had taken on its coloration and meaning largely from state law, from state practice, from state usage.").

48 Id. at 75 (Brennan, J., concurring).

trajectory of that same market. Thus, the purchaser obtains an instrument that, by its very terms, depends on market volatility and risk.

Such indexed annuity contracts provide some protection against the risk of loss, but these provisions do not, "by [themselves,] create an insurance provision under the federal definition."[49] Rather, these provisions reduce – but do not eliminate – a purchaser's exposure to investment risk under the contract. These contracts may to some degree be insured, but that degree may be too small to make the indexed annuity a contract of insurance.[50]

Thus, the protections provided by indexed annuities may not adequately transfer investment risk from the purchaser to the insurer when amounts payable by an insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract. Purchasers of these annuities assume the investment risk for investments that are more likely than not to fluctuate and move with the securities markets. The value of the purchaser's investment is more likely than not to depend on movements in the underlying securities index. The protections offered in these indexed annuities may give the instruments an aspect of insurance, but we do not believe that these protections are substantial enough.[51]

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49 See United Benefit, supra note 3, 387 U.S. at 211 (finding that while a "guarantee of cash value" provided by an insurer to purchasers of a deferred annuity plan reduced "substantially the investment risk of the contract holder, the assumption of investment risk cannot by itself create an insurance provision under the federal definition.").

50 Id. at 211 ("The basic difference between a contract which to some degree is insured and a contract of insurance must be recognized.").

51 See VALIC, supra note 3, 359 U.S. at 71 (finding that although the insurer's assumption of a traditional insurance risk gives variable annuities an "aspect of insurance," this is "apparent, not real; superficial, not substantial.").

Need for the Regulatory Protections of the Federal Securities Acts

We also analyze indexed annuities to determine whether they implicate the regulatory and protective purposes of the federal securities laws. Based on that analysis, we believe that the indexed annuities that would be included in our proposed definition present many of the concerns that Congress intended the federal securities laws to address.

Indexed annuities are similar in many ways to mutual funds, variable annuities, and other securities. Although these contracts contain certain features that are typical of insurance contracts,[52] they also may contain "to a very substantial degree elements of investment contracts."[53] Indexed annuities are attractive to purchasers precisely because they offer participation in the securities markets. Thus, individuals who purchase such indexed annuities are "vitally interested in the investment experience."[54] However, indexed annuities historically have not been registered with us as securities. Insurers have treated these annuities as subject only to state insurance laws.

There is a strong federal interest in providing investors with disclosure, antifraud, and sales practice protections when they are purchasing annuities that are likely to expose them to market volatility and risk. We believe that individuals who purchase indexed

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52 The presence of protection against loss does not, in itself, transform a security into an insurance or annuity contract. Like indexed annuities, variable annuities typically provide some protection against the risk of loss, but are registered as securities. Historically, variable annuity contracts have typically provided a minimum death benefit at least equal to the greater of contract value or purchase payments less any withdrawals. More recently, many contracts have offered benefits that protect against downside market risk during the purchaser's lifetime.

53 Id. at 91 (Brennan, J., concurring).

54 Id. at 89 (Brennan, J., concurring).

annuities that are more likely than not to provide payments that vary with the performance of securities are exposed to significant investment risks. They are confronted with many of the same risks and benefits that other securities investors are confronted with when making investment decisions. Moreover, they are more likely than not to experience market volatility.

Accordingly, we believe that the regulatory objectives that Congress was attempting to achieve when it enacted the Securities Act are present when the amounts payable by an insurer under an indexed annuity contract are more likely than not to exceed the guaranteed amounts. Therefore, we are proposing a rule that would define such contracts as falling outside the insurance exemption.

2. Proposed Definition

Scope of the Proposed Definition

Proposed rule 151A would apply to a contract that is issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia.[55] This language is the same language used in Section 3(a)(8) of the Securities Act. Thus, the insurance companies that will be covered by the proposed rule are the same as those covered by Section 3(a)(8). In addition, in order to be covered by the proposed rule, a contract must be subject to regulation as an annuity under state insurance law.[56] As a result, the proposed rule does not apply to contracts that

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55 Proposed rule 151A(a).

56 Id. We note that the majority of states include in their insurance laws provisions that define annuities. See, e.g., ALA. CODE § 27-5-3 (2008); CAL. INS. CODE § 1003 (West 2007); N.J. ADMIN. CODE tit. 11, § 4-2.2 (2008); N.Y. INS. LAW § 1113 (McKinney

are regulated under state insurance law as life insurance, health insurance, or any form of insurance other than an annuity, and it does not apply to any contract issued by an insurance company if the contract itself is not subject to regulation under state insurance law.

The proposed rule would expressly state that it does not apply to any contract whose value varies according to the investment experience of a separate account.[57] The effect of this provision is to eliminate variable annuities from the scope of the rule.[58] It has long been established that variable annuities are not entitled to the exemption under Section 3(a)(8) of the Securities Act, and, accordingly, we do not propose to cover them under the new definition or affect their regulation in any way.[59]

We request comment on the scope of the proposed definition and in particular on the following issues:

- Should the rule apply only to contracts that are issued by the same insurance companies that are covered by Section 3(a)(8) of the Securities Act, or should

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2007). Those states that do not expressly define annuities typically have regulations in place that address annuities. See, e.g., KAN. ADMIN. REGS. § 40-2-12 (2008); MISS. CODE ANN. § 83-1-151 (2008).

57 Proposed rule 151A(c).

58 The assets of a variable annuity are held in a separate account of the insurance company that is insulated for the benefit of the variable annuity owners from the liabilities of the insurance company, and amounts paid to the owner under a variable annuity vary according to the investment experience of the separate account. See Black and Skipper, supra note 39, at 174-77 (2000).

59 See, e.g., VALIC, supra note 3, 359 U.S. 65; United Benefit, supra note 3, 387 U.S. 202. In addition, an insurance company separate account issuing variable annuities is an investment company under the Investment Company Act of 1940. See Prudential Ins. Co. of Am. v. SEC, 326 F.2d 383 (3d Cir. 1964).

the proposed definition apply with respect to contracts of different issuers than those covered by Section 3(a)(8)?

- What contracts should be covered by the proposed definition? Should the scope of contracts covered be articulated by reference to state law? Should the proposed definition extend to all annuity contracts, or should any annuity contracts be excluded? Should variable annuity contracts be covered by the proposed definition? Should the proposed definition apply to forms of insurance other than annuities, such as life insurance or health insurance? Should the proposed definition apply to a contract issued by an insurance company if the contract is not itself regulated as insurance under state law?
- Should we permit insurance companies to register indexed annuities, as well as any other annuities that are securities, on Form N-4,[60] the form that is currently used by insurance companies to register variable annuities under the Securities Act? If so, should we modify Form N-4, which is also used by insurance company separate accounts to register under the Investment Company Act, in any way?

Definition of "Annuity Contract" and "Optional Annuity Contract"

We are proposing that an annuity issued by an insurance company would not be an "annuity contract" or an "optional annuity contract" under Section 3(a)(8) of the Securities Act if the annuity has the following two characteristics. First, amounts payable by the insurance company under the contract are calculated, in whole or in part, by reference to the performance of a security, including a group or index of securities.

60 17 CFR 239.17b and 274.11c.

Second, amounts payable by the insurance company under the contract are more likely than not to exceed the amounts guaranteed under the contract.

The first characteristic, that amounts payable by the insurance company under the contract are calculated by reference to the performance of a security or securities, defines a class of contracts that we believe, in all cases, require further scrutiny because they implicate the factors articulated by the U.S. Supreme Court as important in determining whether the Section 3(a)(8) exemption is applicable. When payments under a contract are calculated by reference to the performance of a security or securities, rather than being paid in a fixed amount, at least some investment risk relating to the performance of the securities is assumed by the purchaser. In addition, the contract may be marketed on the basis of the potential for growth offered by investments in the securities.

The proposed rule would define the class of contracts that is subject to scrutiny broadly. The rule would apply whenever any amounts payable under the contract under any circumstances, including full or partial surrender, annuitization, or death, are calculated, in whole or in part, by reference to the performance of a security or securities. If, for example, the amount payable under a contract upon a full surrender is not calculated by reference to the performance of a security or securities, but the amount payable upon annuitization is so calculated, then the contract would need to be analyzed under the rule. As another example, if amounts payable under a contract are partly fixed in amount and partly dependent on the performance of a security or securities, the contract would need to be analyzed under the rule.

We note that the proposed rule would apply to contracts under which amounts payable are calculated by reference to a security, including a group or index of securities.

Thus, the proposed rule would, by its terms, apply to indexed annuities but also to other annuities where amounts payable are calculated by reference to a single security or any group of securities. The federal securities laws, and investors' interests in full and fair disclosure and protection from abusive sales practices, are equally implicated, whether amounts payable under an annuity are calculated by reference to a securities index, another group of securities, or a single security.

The term "security" in proposed rule 151A would have the same broad meaning as in Section 2(a)(1) of the Securities Act. Proposed rule 151A does not define the term "security," and our existing rules provide that, unless otherwise specifically provided, the terms used in the rules and regulations under the Securities Act have the same meanings defined in the Act.[61]

The second characteristic, that amounts payable by the insurance company under the contract are more likely than not to exceed the amounts guaranteed under the contract, sets forth the test that would define a class of contracts that are not "annuity contracts" or "optional annuity contracts" under the Securities Act and that, therefore, are not entitled to the Section 3(a)(8) exemption. As explained above, by purchasing this type of indexed annuity, the purchaser assumes the risk of an uncertain and fluctuating financial instrument, in exchange for exposure to future, securities-linked returns.[62] As a result, the purchaser assumes many of the same risks that investors assume when investing in mutual funds, variable annuities, and other securities. Our proposal is intended to provide the purchaser of such an annuity with the same protections that are

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61 17 CFR 230.100(b).

62 See supra Part III.A.1.

provided under the federal securities laws to other investors who participate in the securities markets, including full and fair disclosure regarding the terms of the investment and the significant risks that he or she is assuming, as well as protection from abusive sales practices and the recommendation of unsuitable transactions.

Under proposed rule 151A, amounts payable by the insurance company under a contract would be more likely than not to exceed the amounts guaranteed under the contract if this were the expected outcome more than half the time. In order to determine whether this is the case, it would be necessary to analyze expected outcomes under various scenarios involving different facts and circumstances. In performing this analysis, the amounts payable by the insurance company under any particular set of facts and circumstances would be the amounts that the purchaser[63] would be entitled to receive from the insurer under those facts and circumstances. The facts and circumstances would include, among other things, the particular features of the annuity contract (e.g., in the case of an indexed annuity, the relevant index, participation rate, and other features), the particular options selected by the purchaser (e.g., surrender or annuitization), and the performance of the relevant securities benchmark (e.g., in the case of an indexed annuity, the performance of the relevant index, such as the Dow Jones Industrial Average, Lehman Brothers Aggregate U.S. Index, Nasdaq 100 Index, or Standard & Poor's 500 Composite Stock Price Index). The amounts guaranteed under a contract under any particular set of facts and circumstances would be the minimum amount that the insurer

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63 For simplicity, we are referring to payments to the purchaser. The proposed rule, however, references payments by the insurer without reference to a specified payee. In performing the analysis, payments to any payee, including the purchaser, annuitant, and beneficiaries would be included.

would be obligated to pay the purchaser under those facts and circumstances without reference to the performance of the security that is used in calculating amounts payable under the contract. Thus, if an indexed annuity, in all circumstances, were to guarantee that, on surrender, a purchaser would receive 87.5% of purchase payments, plus 1% interest compounded annually, and that any additional payout would be based exclusively on the performance of a securities index, the amount guaranteed after 3 years would be 90.15% of purchase payments (87.5% x 1.01 x 1.01 x 1.01).

<u>We request comment on the proposed definition and in particular on the following issues</u>:

- Should we define a class of annuities that are not "annuity contracts" or "optional annuity contracts" under the Securities Act? If so, should we adopt the proposed definition or should the proposed definition be modified?
- Should we provide greater clarity with respect to the status under the Securities Act of annuities under which amounts payable by the insurance company are calculated, in whole or in part, by reference to the performance of a security, including a group or index of securities? Should we, as proposed, adopt a definitional rule that would apply to all such annuities? Or should we adopt a definitional rule that applies to a more limited subset of annuities, such as annuities under which amounts payable are calculated by reference to the performance of a securities index?
- Is the proposed test that defines a class of contracts that are not "annuity contracts" or "optional annuity contracts," <u>i.e.</u>, that amounts payable by the insurance company under the contract are more likely than not to exceed the

amounts guaranteed under the contract, an appropriate test? Should the test be modified in any way, e.g., should the threshold be higher or lower than "more likely than not?" Should we provide further clarification with respect to the meaning of any of the elements of that test, including "amounts payable by the insurance company under the contract" and "amounts guaranteed under the contract?"

- Should we specify a particular point in time as of which "amounts payable by the insurance company under the contract" and "amounts guaranteed under the contract" should be determined under the rule? If so, what would be an appropriate time, e.g., contract maturity, the point where the surrender charge period ends, a specified number of years (5 years, 10 years, 15 years, 20 years, or some other period), or a specified age of the annuitant or a joint annuitant under the contract (60 years, 65 years, 75 years, or some other age)?

Determining Whether an Annuity Is not an "Annuity Contract" or "Optional Annuity Contract" under Proposed Rule 151A

Proposed rule 151A addresses the manner in which a determination would be made regarding whether amounts payable by the insurance company under a contract are more likely than not to exceed the amounts guaranteed under the contract. The proposed rule is principles-based, providing that a determination made by the insurer at or prior to issuance of a contract would be conclusive, provided that: (i) both the insurer's methodology and the insurer's economic, actuarial, and other assumptions are reasonable; (ii) the insurer's computations are materially accurate; and (iii) the determination is made not earlier that six months prior to the date on which the form of contract is first offered and not more than three years prior to the date on which the particular contract is issued.[64] The proposed rule would, however, specify the treatment of charges that are imposed at the time of payments under the contract by the insurer.[65]

We are proposing this principles-based approach because we believe that an insurance company should be able to evaluate anticipated outcomes under an annuity that it issues. Insurers routinely undertake such analyses for purposes of pricing and hedging their contracts.[66] In addition, we believe that it is important to provide reasonable certainty to insurers with respect to the application of the proposed rule and to preclude an insurer's determination from being second guessed, in litigation or otherwise, in light of actual events that may differ from assumptions that were reasonable when made.

As with all exemptions from the registration and prospectus delivery requirements of the Securities Act, the party claiming the benefit of the exemption – in this case, the insurer – bears the burden of proving that the exemption applies.[67] Thus, an insurer that believes an indexed annuity is entitled to the exemption under Section 3(a)(8) based, in part, on a determination made under the proposed rule would – if challenged in litigation – be required to prove that its methodology and its economic, actuarial, and other assumptions were reasonable, and that the computations were materially accurate.

The proposed rule provides that an insurer's determination under the rule would be conclusive only if it is made at or prior to issuance of the contract. Proposed rule

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64 Proposed rule 151A(b)(2).

65 Proposed rule 151A(b)(1).

66 See generally, Black and Skipper, supra note 39, at 26-47, 890-99.

67 See, e.g., SEC v. Ralston Purina, 346 U.S. 119, 126 (1953) (an issuer claiming an exemption under Section 4 of the Securities Act carries the burden of showing that the exemption applies).

151A is intended to provide certainty to both insurers and investors, and we believe that this certainty would be undermined unless insurance companies undertake the analysis required by the rule no later than the time that an annuity is issued. The proposed rule also provides that, for an insurer's determination to be conclusive, the computations made by the insurance company in support of the determination must be materially accurate. An insurer should not be permitted to rely on a determination of an annuity's status under the proposed rule that is based on computations that are materially inaccurate. For this purpose, we intend that computations would be considered to be materially accurate if any computational errors do not affect the outcome of the insurer's determination as to whether amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

In order for an insurer's determination to be conclusive, both the methodology and the economic, actuarial, and other assumptions used would be required to be reasonable. We recognize that a range of methodologies and assumptions may be reasonable and that a reasonable methodology or assumption utilized by one insurer may differ from a reasonable assumption or methodology selected by another insurer. In determining whether an insurer's methodology is reasonable, it would be appropriate to look to methods commonly used for valuing and hedging similar products in insurance and derivatives markets.

An insurer will need to make assumptions in several areas, including assumptions about (i) insurer behavior, (ii) purchaser behavior, and (iii) market behavior, and will need to assign probabilities to various potential behaviors. With regard to insurer behavior, the insurer will need to make assumptions about discretionary actions that it may take under the terms of an annuity. In the case of an indexed annuity, for example, an insurer often has discretion to modify various features, such as guaranteed interest rates, caps, participation rates, and spreads. Similarly, the insurer will need to make assumptions concerning purchaser behavior, including matters such as how long purchasers will hold a contract, how they will allocate contract value among different investment options available under the contract, and the form in which they will take payments under the contract. Assumptions about market behavior would include assumptions about expected return, market volatility, and interest rates. In general, insurers will need to make assumptions about any feature of insurer, purchaser, or market behavior, or any other factor, that is material in determining the likelihood that amounts payable under the contract exceed the amounts guaranteed.

In determining whether assumptions are reasonable, insurers should generally be guided by both history and their own expectations about the future. An insurer may look to its own, and to industry, experience with similar or otherwise comparable contracts in constructing assumptions about both insurer behavior and investor behavior. In making assumptions about future market behavior, an insurer may be guided, for example, by historical market characteristics, such as historical returns and volatility, provided that the insurer bases its assumptions on an appropriate period of time and does not have reason to believe that the time period chosen is likely to be unrepresentative. As a general matter, assumptions about insurer, investor, or market behavior that are not consistent with historical experience would not be reasonable unless an insurer has a reasonable basis for any differences between historical experience and the assumptions used.

In addition, an insurer may look to its own expectations about the future in constructing reasonable assumptions. As noted above, insurers routinely analyze anticipated outcomes for purposes of pricing and hedging their contracts, and for similar purposes. We would expect that, in making a determination under proposed rule 151A, an insurer would use assumptions that are consistent with the assumptions that it uses for other purposes. Generally, assumptions that are inconsistent with the assumptions that an insurer uses for other purposes would not be reasonable under proposed rule 151A.

We note that an insurer may offer a particular form of contract over a significant period of time. Assumptions that are reasonable when a contract is originally offered may or may not continue to be reasonable at a subsequent time when the insurer continues to offer the contract. For this reason, the rule would provide that an insurer's determination would be conclusive if it is sufficiently current. Specifically, the determination must be made not more than six months prior to the date on which the form of contract is first offered and not more than three years prior to the date on which a particular contract is issued. For example, if a form of contract were first offered on January 1, 2011, the insurer would be required to make the determination not earlier than July 1, 2010. If the same form of contract were issued to a particular individual on January 1, 2014, the insurer's determination would be required to be made not earlier than January 1, 2011, in order to be conclusive for this transaction. This approach is intended to address the changing nature of reasonable assumptions, while permitting an insurer to rely on its determination for a significant period of time (three years) once made.

Proposed rule 151A would require that, in determining whether amounts payable by the insurance company under the contract are more likely than not to exceed the amounts guaranteed under the contract, amounts payable under the contract be determined without reference to any charges that are imposed at the time of payment. For example, the calculation of amounts payable upon surrender would be computed without deduction of any surrender charges, which typically decline over time. We are proposing this calculation methodology in order to eliminate the differential impact that such charges would have on the determination depending on the assumptions made about contract holding periods. However, the proposed rule would require that charges imposed at the time of payment be reflected in computing the amounts guaranteed under the contract. In many cases, amounts guaranteed under annuities are not affected by charges imposed at the time payments are made by the insurer under the contract.[68] However, in the case of an annuity where the amounts guaranteed are affected by charges imposed at the time payments are made,[69] the determination under proposed rule 151A would be made using the actual amounts guaranteed under the contract (which reflect the impact of these charges).

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68 Guaranteed minimum value, as commonly defined in indexed annuity contracts, equals a percentage of purchase payments, accumulated at a specified interest rate, as explained above, and this amount is not subject to surrender charges.

69 For example, a purchaser buys a contract for $100,000. The contract defines surrender value as the greater of (i) purchase payments plus index-linked interest minus surrender charges or (ii) the guaranteed minimum value. The maximum surrender charge is equal to 10%. The guaranteed minimum value is defined in the contract as 87.5% of premium accumulated at 1% annual interest. If the purchaser surrenders within the first year of purchase, and there is no index-linked interest credited, the surrender value would equal $90,000 (determined under clause (i) as $100,000 purchase payment minus 10% surrender charge), and this amount would be the guaranteed amount under the contract, not the lower amount defined in the contract as guaranteed minimum value ($87,500).

We request comment on the manner in which a determination would be made under proposed rule 151A regarding whether amounts payable by the insurance company under a contract are more likely than not to exceed the amounts guaranteed under the contract and, in particular, on the following issues:

- Should we, as proposed, adopt a principles-based approach to this determination? Would the principles-based approach facilitate our goal of providing certainty?
- Should the insurer's determination be conclusive? If so, are the conditions in the proposed rule (i.e., determination at or prior to contract issuance, reasonable methodology and assumptions, materially accurate computation) appropriate, or should we modify these conditions in any way?
- Should we expressly specify the circumstances under which a computation is materially accurate? If so, should the rule, as proposed, provide that an insurer's computation is materially accurate if any computational errors do not affect the outcome of the insurer's determination as to whether amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract? Or should we provide a different guideline for determining whether the computation is "materially accurate?" For example, should the rule provide that an insurer's computation is materially accurate if any computational errors do not materially affect the insurer's determination of the likelihood that amounts payable by the insurer under the contract exceed the amounts guaranteed under the contract?

- Should the rule prescribe the assumptions to be used by an insurer in making its determination? What factors should affect a determination of whether an insurer's assumptions are reasonable? Should the rule specify how the determination should be made with respect to securities, including indices, that have little or no history?
- Should we, as proposed, provide that, in order for an insurer's determination to be conclusive, it must be made not more than six months prior to the date on which the form of contract is first offered? Should this period be shorter or longer, e.g., 30 days, 3 months, 9 months, 1 year?
- Should we, as proposed, provide that, in order for an insurer's determination to be conclusive, it must not be made more than three years prior to the date on which a particular contract is issued? Should this period be shorter or longer, e.g., 1 year, 2 years, or 5 years?
- Should an insurer's determination, once made for a particular form of contract, be conclusive with respect to every particular contract of that form that is sold provided that the determination meets the standards required for conclusiveness at the time of the insurer's original determination, i.e., reasonable methodology and assumptions and materially accurate computation? Or should an insurer's determination only be conclusive with respect to any particular sale of a contract if the methodology and assumptions are reasonable at the time of the particular sale?
- How should surrender charges and other charges imposed at the time of payout under an annuity be treated in making the determination required under the

proposed rule? Should amounts payable under the contract be determined with or without reference to such charges? Should amounts guaranteed under the contract be computed with or without reference to such charges? Should we define with greater specificity the concept of charges imposed at the time of payment under a contract?

- Should we provide any guidance with respect to the principles-based approach of the rule?
- Should we provide guidance on the circumstances under which it is reasonable to rely on historical experience? Would it be reasonable to use other asset prices (such as derivative prices) to form expectations about the future, as long as the use of these prices is supported by historical experience?
- Should we provide guidance about the circumstances under which it is reasonable to rely on insurer expectations about the future? Would it be reasonable to rely on these expectations for factors over which insurers have control (e.g., changes in contract features) or about which they have particular expertise (e.g., rates of annuitization, mortality rates)? Would it be reasonable to rely on these expectations for factors over which insurers do not have control, such as market behavior?
- Should we provide guidance that would specify how insurers should consider interactions between various factors that may affect the determination (such as interactions between market returns and surrender behavior)?
- Should the rule specify how the determination should be made in the case of contracts that offer more than one investment option, e.g., multiple indices or

multiple crediting formulas or the availability of a guaranteed interest rate option in addition to indexed investment options? In such a case, should we require a separate determination under each available option? If so, should we provide that the entire annuity is not an "annuity contract" or "optional annuity contract" if it is determined that the annuity would not be an "annuity contract" or "optional annuity contract" under any one or more of the available options?

- Should the rule require separate determinations with respect to the various benefits available under an annuity, such as lump sum payments, annuity payments, and death benefits? If so, should the rule prescribe that if the amounts payable under any one of these options are more likely than not to exceed the amounts guaranteed under that option, then the entire contract is not an "annuity contract" or "optional contract?"

3. Effective Date

We propose to have the new definition apply prospectively – that is, only to indexed annuities issued on or after the effective date of a final rule. We are using our definitional rulemaking authority under Section 19(a) of the Securities Act, and the explicitly prospective nature of our proposed rule is consistent with similar prospective rulemaking that we have undertaken in the past when doing so was appropriate and fair under the circumstances.[70]

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[70] See, e.g., Securities Act Release No. 4896 (Feb. 1, 1968) [33 FR 3142, 3143 (Feb. 17, 1968)] ("The Commission is aware that for many years issuers of the securities identified in this rule have not considered their obligations to be separate securities and that they have acted in reliance on the view, which they believed to be the view of the Commission, that registration under the Securities Act was not required. Under the circumstances, the Commission does not believe that such issuers are subject to any penalty or other damages resulting from entering into such arrangements in the past.

We are aware that many insurance companies, in the absence of definitive interpretation or definition by the Commission, have of necessity acted in reliance on their own analysis of the legal status of indexed annuities based on the state of the law prior to this release. Under these circumstances, we do not believe that insurance companies should be subject to any additional legal risk relating to their past offers and sales of indexed annuity contracts as a result of our proposal or its eventual adoption.

We also recognize that, if our proposal is adopted, the industry will need sufficient time to conduct the analysis required by the new definitional rule and comply with any applicable requirements under the federal securities laws. Therefore, we propose that if we adopt a final rule, the effective date of that rule would be a date that is 12 months after publication in the Federal Register.

We request comment on the proposed effective date of the rule and in particular on the following issue:

- Should the effective date of the new definitional rule, if adopted, be 12 months after publication in the Federal Register, or should it be effective sooner (e.g., 60 days after publication, six months after publication) or later (e.g, 18 months after publication, 2 years after publication)?

Paragraph (b) provides that the rule shall apply to transactions of the character described in paragraph (a) only with respect to bonds or other evidence of indebtedness issued after adoption of the rule."). See also Securities Act Release No. 5316 (Oct. 6, 1972) [37 FR 23631, 23632 (Nov. 7, 1972)] ("The Commission recognizes that the 'no-sale' concept has been in existence in one form or another for a long period of time. . . . The Commission believes, after a thorough reexamination of the studies and proposals cited above, that the interpretation embodied in Rule 133 is no longer consistent with the statutory objectives of the [Securities] Act. . . . Rule 133 is rescinded prospectively on and after January 1, 1973 . . . .").

4. Annuities not Covered by the Proposed Definition

Proposed rule 151A would apply to annuities under which amounts payable by the insurance company are calculated by reference to the performance of a security. The proposed rule would define certain of those annuities (annuities under which amounts payable by the issuer are more likely than not to exceed the amounts guaranteed under the contract) as not "annuity contracts" or "optional annuity contracts" under Section 3(a)(8) of the Securities Act. The proposed rule, however, would not provide a safe harbor under Section 3(a)(8) for any other annuities, including any other annuities under which amounts payable by the insurance company are calculated by reference to the performance of a security. The status under the Securities Act of any annuity, other than an annuity that is determined under proposed rule 151A to be not an "annuity contract" or "optional annuity contract," would continue to be determined by reference to the investment risk and marketing tests articulated in existing case law under Section 3(a)(8) and, to the extent applicable, the Commission's safe harbor rule 151.[71]

We request comment on the proposal not to include a safe harbor in the proposal and in particular on the following issues:

- Should we provide a safe harbor under Section 3(a)(8) of the Securities Act for any annuities under which amounts payable by the insurance company are calculated by reference to the performance of a security? If so, what should the safe harbor be?

[71] As noted in Part II.C., above, indexed annuities are not entitled to rely on the rule 151 safe harbor.

- Should we modify the Commission's existing safe harbor for certain annuities, rule 151, to address indexed annuities or other annuities under which amounts payable by the insurance company are calculated by reference to the performance of a security? If so, how?

B. Exchange Act Exemption for Securities that Are Regulated as Insurance

The Commission is also proposing new rule 12h-7, which would provide an insurance company with an exemption from Exchange Act reporting with respect to indexed annuities and certain other securities issued by the company that are registered under the Securities Act and regulated as insurance under state law.[72] We are proposing this exemption because we believe that the exemption is necessary or appropriate in the public interest and consistent with the protection of investors. We base that view on two factors: first, the nature and extent of the activities of insurance company issuers, and their income and assets, and, in particular, the regulation of those activities and assets under state insurance law; and, second, the absence of trading interest in the securities.[73] We are also proposing to impose conditions to the exemption that relate to these factors

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72 The Commission has received a petition requesting that we propose a rule that would exempt issuers of certain types of insurance contracts from Exchange Act reporting requirements. Letter from Stephen E. Roth, Sutherland Asbill & Brennan LLP, on behalf of Jackson National Life Insurance Co., to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission (Dec. 19, 2007) (File No. 4-553) available at: http://www.sec.gov/rules/petitions/2007/petn4-553.pdf.

73 See Section 12(h) of the Exchange Act [15 U.S.C. 78l(h)] (Commission may, by rules, exempt any class of issuers from the reporting provisions of the Exchange Act "if the Commission finds, by reason of the number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interest or the protection of investors.") (emphasis added).

and that we believe are necessary or appropriate in the public interest and consistent with the protection of investors.

State insurance regulation is focused on insurance company solvency and the adequacy of insurers' reserves, with the ultimate purpose of ensuring that insurance companies are financially secure enough to meet their contractual obligations.[74] State insurance regulators require insurance companies to maintain certain levels of capital, surplus, and risk-based capital; restrict the investments in insurers' general accounts; limit the amount of risk that may be assumed by insurers; and impose requirements with regard to valuation of insurers' investments.[75] Insurance companies are required to file annual reports on their financial condition with state insurance regulators. In addition, insurance companies are subject to periodic examination of their financial condition by state insurance regulators. State insurance regulators also preside over the conservation or liquidation of companies with inadequate solvency.[76]

State insurance regulation, like Exchange Act reporting, relates to an entity's financial condition. We are of the view that, as a general matter, it may be unnecessary for both to apply in the same situation, which may result in duplicative regulation that is burdensome. Through Exchange Act reporting, issuers periodically disclose their financial condition, which enables investors and the markets to independently evaluate an issuer's income, assets, and balance sheet. State insurance regulation takes a different approach to the issue of financial condition, instead relying on state insurance regulators

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74 Black and Skipper, supra note 39, at 949.

75 Id. at 949 and 956-59.

76 Id. at 949.

to supervise insurers' financial condition, with the goal that insurance companies be financially able to meet their contractual obligations. We believe that it would be consistent with our federal system of regulation, which has allocated the responsibility for oversight of insurers' solvency to state insurance regulators, to exempt insurers from Exchange Act reporting with respect to state-regulated insurance contracts.

Our conclusion in this regard is strengthened by the general absence of trading interest in insurance contracts. Insurance is typically purchased directly from an insurance company. While insurance contracts may be assigned in limited circumstances,[77] they typically are not listed or traded on securities exchanges or in other markets. As a result, outside the context of publicly owned insurance companies, there is little, if any, market interest in the information that is required to be disclosed in Exchange Act reports.

We request comment on whether we should provide insurance companies with exemptions from Exchange Act reporting with respect to securities that are regulated as insurance under state law and in particular on the following issues:

- Does the existence of state insurance regulation, and, in particular, state regulation of insurance company financial condition and solvency, support providing an exemption from Exchange Act reporting? Does Exchange Act reporting serve any purpose, in the context of insurance contracts that are also securities, that is not served by state insurance regulation?

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77 Insurance contracts may be assigned either as a complete assignment or as collateral. Insurance contracts that are assignable typically provide that the insurer need not recognize the assignment until it receives written notice. See Black and Skipper, supra note 39, at 234.

- Does the lack of trading interest in insurance contracts support providing an exemption from Exchange Act reporting for securities that are regulated as insurance under state law? Should Exchange Act reporting be required notwithstanding the absence of trading interest and, if so, why? Are there any circumstances where trading interest in insurance contracts that are securities is significant enough that Exchange Act reporting should be required?

1. The Exemption

Proposed rule 12h-7 would provide an insurance company that is covered by the rule with an exemption from the duty under Section 15(d) of the Exchange Act to file reports required by Section 13(a) of the Exchange Act with respect to certain securities registered under the Securities Act.[78]

Covered Insurance Companies

The proposed Exchange Act exemption would apply to an issuer that is a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any state, including

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[78] Introductory paragraph to proposed rule 12h-7. Cf. Rule 12h-3(a) under the Exchange Act [17 CFR 240.12h-3(a)] (suspension of duty under Section 15(d) of the Exchange Act to file reports with respect to classes of securities held by 500 persons or less where total assets of the issuer have not exceeded $10,000,000); Rule 12h-4 under the Exchange Act [17 CFR 240.12h-4] (exemption from duty under Section 15(d) of the Exchange Act to file reports with respect to securities registered on specified Securities Act forms relating to certain Canadian issuers).

Section 15(d) of the Exchange Act requires each issuer that has filed a registration statement that has become effective under the Securities Act to file reports and other information and documents required under Section 13 of the Exchange Act [15 U.S.C. 78m] with respect to issuers registered under Section 12 of the Exchange Act [15 U.S.C. 78l]. Section 13(a) of the Exchange Act [15 U.S.C. 78m(a)] requires issuers of securities registered under Section 12 of the Act to file annual reports and other documents and information required by Commission rule.

the District of Columbia, Puerto Rico, the Virgin Islands, and any other possession of the United States.[79] In the case of a variable annuity contract or variable life insurance policy, the exemption would apply to the insurance company that issues the contract or policy. However, the exemption would not apply to the insurance company separate account in which the purchaser's payments are invested and which is separately registered as an investment company under the Investment Company Act of 1940 and is not regulated as an insurance company under state law.[80]

Covered Securities

The proposed exemption would apply with respect to securities that do not constitute an equity interest in the insurance company issuer and that are either subject to regulation under the insurance laws of the domiciliary state of the insurance company or are guarantees of securities that are subject to regulation under the insurance laws of that jurisdiction.[81] The exemption does not apply with respect to any other securities issued by an insurance company. As a result, if an insurance company issues securities with

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79 Proposed rule 12h-7(a). The Exchange Act defines "State" as any state of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States. Section 3(a)(16) of the Exchange Act [15 U.S.C. 78c(a)(16)]. The term "State" in proposed rule 12h-7 has the same meaning as in the Exchange Act. Proposed rule 12h-7 does not define the term "State," and our existing rules provide that, unless otherwise specifically provided, the terms used in the rules and regulations under the Exchange Act have the same meanings defined in the Exchange Act. See rule 240.0-1(b) [17 CFR 240.0-1(b)].

80 This approach is consistent with the historical practice of insurance companies that issue variable annuities and do not file Exchange Act reports. The associated separate accounts, however, are required to file Exchange Act reports. These Exchange Act reporting requirements are deemed to be satisfied by filing annual reports on Form N-SAR. 17 CFR 274.101. See Section 30(d) of the Investment Company Act [15 U.S.C. 80a-30(d)] and rule 30a-1 under the Investment Company Act [17 CFR 270.30a-1].

81 Proposed rule 12h-7(b).

respect to which the exemption applies, and other securities that do not entitle the insurer to the exemption, the insurer will remain subject to Exchange Act reporting obligations. For example, if an insurer that is a stock company[82] also issues insurance contracts that are registered securities under the Securities Act, the insurer generally would be required to file Exchange Act reports as a result of being a stock company. Similarly, if an insurer raises capital through a debt offering, the proposed exemption would not apply with respect to the debt securities.

We are proposing that the exemption be available with respect to securities that are either subject to regulation under the insurance laws of the domiciliary state of the insurance company or are guarantees of securities that are subject to regulation under the insurance laws of that jurisdiction.[83] We are proposing a broad exemption that would apply to any contract that is regulated under the insurance laws of the insurer's home state because we intend that the exemption apply to all contracts, and only those contracts, where state insurance law, and the associated regulation of insurer financial condition, applies. A key basis for the proposed exemption is that investors are already entitled to the financial condition protections of state law and that, under our federal system of regulation, Exchange Act reporting may be unnecessary. Therefore, we

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82 A stock life insurance company is a corporation authorized to sell life insurance, which is owned by stockholders and is formed for the purpose of earning a profit for its stockholders. This is in contrast to another prevailing insurance company structure, the mutual life insurance company. In this structure, the corporation authorized to sell life insurance is owned by and operated for the benefit of its policyowners. Black and Skipper, supra note 39, at 577-78.

83 A domiciliary state is the jurisdiction in which an insurer is incorporated or organized. See National Association of Insurance Commissioners Model Laws, Regulations and Guidelines 555-1, § 104 (2007).

believe it is important that the reach of the exemption and the reach of state insurance law be the same.

The proposed Exchange Act exemption would apply both to certain existing types of insurance contracts and to types of contracts that are developed in the future and that are registered as securities under the Securities Act. The proposed exemption would apply to indexed annuities that are registered under the Securities Act. However, the proposed Exchange Act exemption is independent of proposed rule 151A and would apply to types of contracts in addition to those that are covered by proposed rule 151A. There are at least two types of existing insurance contracts with respect to which we intend that the proposed Exchange Act exemption would apply, contracts with so-called "market value adjustment" ("MVA") features and insurance contracts that provide certain guaranteed benefits in connection with assets held in an investor's account, such as a mutual fund, brokerage, or investment advisory account.

Contracts including MVA features have, for some time, been registered under the Securities Act.[84] Insurance companies issuing contracts with these features have also complied with Exchange Act reporting requirements.[85] MVA features have historically been associated with annuity and life insurance contracts that guarantee a specified rate of return to purchasers.[86] In order to protect the insurer against the risk that a purchaser

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84 Securities Act Release. No. 6645, supra note 35, 51 FR at 20256-58.

85 See, e.g., ING Life Insurance and Annuity Company (Annual Report on Form 10-K (Mar. 31, 2008)); Protective Life Insurance Company (Annual Report on Form 10-K (Mar. 31, 2008)); Union Security Insurance Company (Annual Report on Form 10-K (Mar. 3, 2008)).

86 Some indexed annuities also include MVA features. See, e.g., Pre-Effective Amendment No. 4 to Registration Statement on Form S-1 of PHL Variable Insurance Company (File

may make withdrawals from the contract at a time when the market value of the insurer's assets that support the contract has declined due to rising interest rates, insurers sometime impose an MVA upon surrender. Under an MVA feature, the insurer adjusts the proceeds a purchaser receives upon surrender prior to the end of the guarantee period to reflect changes in the market value of its portfolio securities supporting the contract. As a result, if a purchaser makes a withdrawal at a time when interest rates are higher than at the time of contract issuance (and the market value of the insurer's assets has decreased), the proceeds payable upon surrender are adjusted downwards. By contrast, if interest rates are lower than at the time of contract issuance (and the market value of the insurer's assets has increased), the proceeds payable upon surrender are adjusted upwards.

More recently, some insurance companies have registered under the Securities Act insurance contracts that provide certain guarantees in connection with assets held in an investor's account, such as a mutual fund, brokerage, or investment advisory account.[87] As a result, the insurers become subject to Exchange Act reporting requirements if they are not already subject to those requirements. These contracts, often called "guaranteed living benefits," are intended to provide insurance to the purchaser against the risk of outliving the assets held in the mutual fund, brokerage, or investment

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No. 333-132399) (filed Feb. 7, 2007); Initial Registration Statement on Form S-1 of ING USA Annuity and Life Insurance Company (File No. 333-133153) (filed Apr. 7, 2006); Pre-Effective Amendment No. 2 to Registration Statement on Form S-3 of Allstate Life Insurance Company (File No. 333-117685) (filed Dec. 20, 2004).

87 See, e.g., PHL Variable Life Insurance Company, File No. 333-137802 (Form S-1 filed Feb. 25, 2008); Genworth Life and Annuity Insurance Company, File No. 333-143494 (Form S-1 filed Apr. 4, 2008).

advisory account. An example of a guaranteed living benefit is a contract that guarantees regular income payments for the life of the purchaser to the extent that the value of the purchaser's investment in the relevant account is not sufficient to provide such payments. Such a contract could, for example, guarantee that if the purchaser withdraws no more than five percent per year of the amount invested, and if withdrawals and market performance reduce the account value to a zero balance, the insurer will thereafter make annual payments to the purchaser in an amount equal to five percent of the amount invested.

As noted above, the proposed Exchange Act exemption would also apply with respect to a guarantee of a security if the guaranteed security is subject to regulation under state insurance law.[88] We are proposing this provision because we believe that it would be appropriate to exempt from Exchange Act reporting an insurer that provides a guarantee of an insurance contract (that is also a security) when the insurer would not be subject to Exchange Act reporting if it had issued the guaranteed contract. This situation may arise, for example, when an insurance company issues a contract that is a security and its affiliate, also an insurance company, provides a guarantee of benefits provided under the first company's contract.[89]

Finally, the proposed exemption would be unavailable with respect to any security that constitutes an equity interest in the issuing insurance company. As a general matter,

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88 The Securities Act defines "security" in Section 2(a)(1) of the Act [15 U.S.C. 77b(a)(1)]. That definition provides that a guarantee of any of the instruments included in the definition is also a security.

89 For example, an insurance company may offer a registered variable annuity, and a parent or other affiliate of the issuing insurance company may act as guarantor for the issuing company's insurance obligations under the contract.

an equity interest in an insurer would not be covered by the proposed exemption because it would not be subject to regulation under state insurance law and often would be publicly traded. Nonetheless, we believe that the rule should expressly preclude any security that constitutes an equity interest in the issuing insurance company from being covered by the proposed exemption. Where investors own an equity interest in an issuing insurance company, and are therefore dependent on the financial condition of the issuer for the value of that interest, we believe that they have a significant interest in directly evaluating the issuers' financial condition for themselves on an ongoing basis and that Exchange Act reporting is appropriate.

<u>We request comment on the proposed exemption and in particular on the following issues</u>:

- Should we provide insurance companies with an exemption from the duty under Section 15(d) of the Exchange Act to file reports required by Section 13(a) of the Exchange Act with respect to certain securities that are also regulated as insurance? Should we modify the exemption in any way?
- What securities should be covered by the proposed exemption? Should the exemption, as proposed, only be available with respect to securities that are either subject to regulation under state insurance law or are guarantees of securities that are subject to regulation under state insurance law? Should the exemption apply to indexed annuities, contracts with MVA features, and insurance contracts that provide certain guaranteed benefits in connection with assets held in an investor's account, such as a mutual fund, brokerage, or investment advisory account? Should we limit the exemption to all or any of those three types of securities, or

should we also make the exemption available to types of securities that may be issued by insurance companies in the future?

- If we adopt the proposed Exchange Act exemption, should the adopted rule expressly provide that the exemption is unavailable with respect to any security that constitutes an equity interest in the issuing insurance company? Should the rule expressly provide that the exemption is unavailable with respect to debt securities? If so, how should we define the term "debt securities" so that it does not cover insurance obligations?

2. Conditions to Exemption

As described above, we believe that the proposed exemption is necessary or appropriate in the public interest and consistent with the protection of investors because of the existence of state regulation of insurers' financial condition and because of the general absence of trading interest in insurance contracts. We are proposing that the Exchange Act exemption be subject to conditions that are designed to ensure that both of these factors are, in fact, present in cases where an insurance company is permitted to rely on the exemption.

<u>Regulation of Insurer's Financial Condition</u>

In order to rely on the proposed exemption, an insurer must file an annual statement of its financial condition with, and the insurer must be supervised and its financial condition examined periodically by, the insurance commissioner, bank commissioner, or any agency or any officer performing like functions, of the insurer's domiciliary state.[90] This condition is intended to ensure that an insurer claiming the exemption is, in fact, subject to state insurance regulation of its financial condition. Absent satisfaction of this condition, Exchange Act reporting would not be duplicative of state insurance regulation, and the proposed exemption would not be available.

Absence of Trading Interest

The proposed Exchange Act exemption would be subject to two conditions intended to insure that there is no trading interest in securities with respect to which the exemption applies. First, the securities may not be listed, traded, or quoted on an exchange, alternative trading system,[91] inter-dealer quotation system,[92] electronic communications network, or any other similar system, network, or publication for trading or quoting.[93] This condition is designed to ensure that there is no established trading market for the securities. Second, the issuing insurance company must take steps reasonably designed to ensure that a trading market for the securities does not develop, including requiring written notice to, and acceptance by, the insurance company prior to any assignment or other transfer of the securities and reserving the right to refuse assignments or other transfers of the securities at any time on a non-discriminatory

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90 Proposed rule 12h-7(c). Cf. Section 26(f)(2)(B)(ii) and (iii) of the Investment Company Act [15 U.S.C. 80a-26(f)(2)(B)(ii) and (iii)] (using similar language in requirements that apply to insurance companies that sell variable insurance products).

91 For this purpose, "alternative trading system" would have the same meaning as in Regulation ATS. See 17 CFR 242.300(a) (definition of "alternative trading system").

92 For this purpose, "inter-dealer quotation system" would have the same meaning as in Exchange Act rule 15c2-11. See 17 CFR 240.15c2-11(e)(2) (definition of "inter-dealer quotation system").

93 Proposed rule 12h-7(d).

basis.[94] This condition is designed to ensure that the insurer takes reasonable steps to ensure the absence of trading interest in the securities. We recognize that insurance contracts typically permit assignment in some circumstances. The proposed condition is intended to permit these assignments to continue while requiring the insurer to monitor assignments and, if it observes development of trading interest in the securities, to step in and refuse assignments related to this trading interest. We understand that it is commonplace for insurers today to include restrictions on assignments in their contracts similar to those that would be required by the proposed rule.[95]

We request comment generally on the proposed conditions to the Exchange Act exemption and specifically on the following issues:

- Are the proposed conditions appropriate? Will they help to ensure that the proposed exemption is necessary or appropriate in the public interest and consistent with the protection of investors?
- Should we, as proposed, condition the exemption on the insurer filing an annual statement of its financial condition with its home state insurance regulator? Should we require more or less frequent filings relating to financial condition, e.g., quarterly, semi-annually, every two years, etc.?
- Should we require, as a condition to the exemption, any public disclosure of the insurer's financial condition, either through filing with us or by posting on the insurer's Web site? Should we require that an insurer post on its Web site, or make available to investors on request, any reports of financial condition that it

94 Proposed rule 12h-7(e).

95 See Roth, supra note 72, at 4 n. 4.

files with state insurance regulators or any third-party ratings of its claims-paying ability? Should we require, as a condition to the exemption, an insurer to report to the Commission, disclose to its contract owners, and/or publicly disclose any material disciplinary action undertaken, or material deficiency identified by, a state insurance regulator that relates to the insurer's financial condition or any other matter?

- Should we require, as a condition to the exemption, that the insurer be subject to supervision and periodic examination of its financial condition by its home state regulator, as proposed? Is the proposed condition consistent with state insurance regulation? Are there other conditions that should be imposed relating to supervision by the state insurance regulator?
- Should the Exchange Act exemption include conditions designed to limit trading interest in the securities? If so, are the proposed conditions appropriate? Does the proposed rule place appropriate restrictions on transfers of securities with respect to which the exemption is claimed without unduly restricting transfers in a manner that would be harmful to investors' interests?

IV. GENERAL REQUEST FOR COMMENTS

The Commission requests comment on the rules proposed in this release, whether any further changes to our rules are necessary or appropriate to implement the objectives of our proposed rules, and on other matters that might affect the proposals contained in this release.

V. PAPERWORK REDUCTION ACT

A. Background

Proposed rule 151A contains no new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[96] However, we believe that proposed rule 151A would, if adopted, result in an increase in the disclosure burden associated with existing Form S-1 as a result of additional filings that would be made on Form S-1.[97] Form S-1 contains "collection of information" requirements within the meaning of the PRA. Although we are not proposing to amend Form S-1, we are submitting the Form S-1 "collection of information" ("Form S-1 (OMB Control No. 3235-0065)), which we estimate would increase as a result of proposed rule 151A, to the Office of Management and Budget ("OMB") for review and approval in accordance with the PRA.[98]

We adopted existing Form S-1 pursuant to the Securities Act. This form sets forth the disclosure requirements for registration statements that are prepared by eligible issuers to provide investors with the information they need to make informed investment decisions in registered offerings. We anticipate that indexed annuities that register under the Securities Act would generally register on Form S-1.[99]

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96 44 U.S.C. 3501 et seq.

97 17 CFR 239.11.

98 44 U.S.C. 3507(d); 5 CFR 1320.11.

99 Some Securities Act offerings are registered on Form S-3 [17 CFR 239.13]. We do not believe that proposed rule 151A would have any significant impact on the disclosure burden associated with Form S-3 because we believe that very few insurance companies that issue indexed annuities would be eligible to register those contracts on Form S-3. In order to be eligible to file on Form S-3, an issuer, must, among other things, have filed Exchange Act reports for a period of at least 12 calendar months. General Instruction

The hours and costs associated with preparing disclosure, filing forms, and retaining records constitute reporting and cost burdens imposed by the collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

The information collection requirements related to registration statements on Form S-1 are mandatory. There is no mandatory retention period for the information disclosed, and the information disclosed would be made publicly available on the EDGAR filing system.

B. Summary of Information Collection

Because proposed rule 151A would affect the number of filings on Form S-1 but not the disclosure required by this form, we do not believe that the amendments will impose any new recordkeeping or information collection requirements. However, we expect that some insurance companies will register indexed annuities in the future that they would not previously have registered. We believe this will result in an increase in the number of annual responses expected with respect to Form S-1 and in the disclosure

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I.A.3. of Form S-3. Very few insurance companies that issue indexed annuities today are currently eligible to file Form S-3. Further, if we adopt the proposed Exchange Act reporting exemption, insurance companies that issue indexed annuities and rely on the exemption would not meet the eligibility requirements for Form S-3.

We also do not believe that the proposed rules would have any significant impact on the disclosure burden associated with reporting under the Exchange Act on Forms 10-K, 10-Q, and 8-K. As a result of proposed rule 12h-7, insurance companies would not be required to file Exchange Act reports on these forms in connection with indexed annuities that are registered under the Securities Act. While proposed rule 12h-7 would permit some insurance companies that are currently required to file Exchange Act reports as a result of issuing insurance contracts that are registered under the Securities Act to cease filing those reports, the number of such companies is insignificant compared to the total number of Exchange Act reporting companies.

burden associated with Form S-1. At the same time, we expect that, on a per response basis, proposed rule 151A would decrease the existing disclosure burden for Form S-1. This is because the disclosure burden for each indexed annuity on Form S-1 is likely to be lower than the existing burden per respondent on Form S-1. The decreased burden per response on Form S-1 would partially offset the increased burden resulting from the increase in the annual number of responses on Form S-1. We believe that, in the aggregate, the disclosure burden for Form S-1 would increase if proposed rule 151A were adopted.

C. Paperwork Reduction Act Burden Estimates

For purposes of the PRA, we estimate that our proposal will result in an annual increase in the paperwork burden for companies to comply with the Form S-1 collection of information requirements of approximately 60,000 hours of in-house company personnel time and approximately $72,000,000 for the services of outside professionals. These estimates represent the combined effect of an expected increase in the number of annual responses on Form S-1 and a decrease in the expected burden per response. These estimates include the time and the cost of preparing and reviewing disclosure, filing documents, and retaining records. Our methodologies for deriving the above estimates are discussed below.

We are proposing a new definition of "annuity contract" that, on a prospective basis, would define a class of indexed annuities that are not "annuity contracts" or "optional annuity contracts" for purposes of Section 3(a)(8) of the Securities Act, which provides an exemption under the Securities Act for certain insurance contracts. These indexed annuities would, on a prospective basis, be required to register under the Securities Act on Form S-1.[100]

Increase in Number of Annual Responses

For purposes of the PRA, we estimate that there would be an annual increase of 400 responses on Form S-1 as a result of the proposal. In 2007, there were 322 indexed annuity contracts offered.[101] For purposes of the PRA analysis, we assume that 400 indexed annuities will be offered each year. This allows for some escalation in the number of contracts offered in the future over the number offered in 2007. Our Office of Economic Analysis has considered the effect of the proposed rule on indexed annuity contracts with typical terms and has determined that these contracts would not meet the definition of "annuity contract" or "optional annuity contract" if they were to be issued after the effective date of the proposed rule, if adopted as proposed. Therefore, we assume that all indexed annuities that are offered will be registered, and that each of the 400 registered indexed annuities would be the subject of one response per year on Form S-1,[102] resulting in the estimated annual increase of 400 responses of Form S-1.

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100 Some Securities Act offerings are registered on Form S-3, but we believe that very few, if any, insurance companies that issue indexed annuities would be eligible to register those contracts on Form S-3. See supra note 99.

101 NAVA, supra note 6, at 57.

102 Annuity contracts are typically offered to purchasers on a continuous basis, and as a result, an insurer offering an annuity contract that is registered under the Securities Act generally would be required to update the registration statement once a year. See Section 10(a)(3) of the Securities Act [15 U.S.C. 77j(a)(3)] (when prospectus used more than 9 months after effective date of registration statement, information therein generally required to be not more than 16 months old).

Decrease in Expected Hours Per Response

For purposes of the PRA, we estimate that there would be a decrease of 265 hours per response on Form S-1 as a result of our proposal. Current OMB estimates and recent Commission rulemaking estimate the hours per response on Form S-1 as 1,176.[103] The current hour estimate represents the burden for all issuers, both large and small. We believe that registration statements on Form S-1 for indexed annuities would result in a significantly lower number of hours per response, which, based on our experience with other similar contracts, we estimate as 600 hours per indexed annuity response on Form S-1. We attribute this lower estimate to two factors. First, the estimated 400 indexed annuity registration statements will likely be filed by far fewer than 400 different insurance companies,[104] and a significant part of the information in each of the multiple registration statements filed by a single insurance company will be the same, resulting in economies of scale with respect to the multiple filings. Second, many of the 400 responses on Form S-1 each year will be annual updates to registration statements for existing contracts, rather than new registration statements, resulting in a significantly lower hour burden than a new registration statement.[105] Combining our estimate of 600 hours per indexed annuity response on Form S-1 (for an estimated 400 responses) with the existing estimate of 1,176 hours per response on Form S-1 (for an estimated 471

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[103] See Securities Act Release No. 8878 (Dec. 19, 2007) [72 FR 73534, 73547 (Dec. 27, 2007)].

[104] The 322 indexed annuities offered in 2007 were issued by 58 insurance companies. See NAVA, supra note 6, at 57.

[105] See supra note 102.

responses),[106] our new estimate is 911 hours per response (((400 x 600) + (471 x 1,176))/871).

Net Increase in Burden

To calculate the total effect of the proposed rules on the overall compliance burden for all issuers, large and small, we added the burden associated with the 400 additional Forms S-1 that we estimate will be filed annually in the future and subtracted the burden associated with our reduced estimate of 911 hours for each of the current estimated 471 responses. We used current OMB estimates in our calculation of the hours and cost burden associated with preparing, reviewing, and filing Form S-1.

Consistent with current OMB estimates and recent Commission rulemaking,[107] we estimate that 25% of the burden of preparation of Form S-1 is carried by the company internally and that 75% of the burden is carried by outside professionals retained by the issuer at an average cost of $400 per hour.[108] The portion of the burden carried by outside professionals is reflected as a cost, while the burden carried by the company internally is reflected in hours.

The tables below illustrate our estimates concerning the incremental annual compliance burden in the collection of information in hours and cost for Form S-1.

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106 See Supporting Statement to the Office of Management and Budget under the PRA for Securities Act Release No. 8878, available at: http://www.reginfo.gov/public/do/DownloadDocument?documentID=61283&version=1.

107 See Securities Act Release No. 8878, supra note 103, 72 FR at 73547.

108 Id. at n. 110 and accompanying text.

Incremental PRA Burden Due to Increased Filings

Estimated Increase in Annual Responses	Hours/Response	Incremental Burden (hours)
400	911	364,400

Incremental Decrease in PRA Burden Due to Decrease in Hours Per Response

Estimated Decrease in Hours/Response	Current Estimated Number of Annual Filings	Incremental Decrease in Burden (hours)
(265)	471	(124,800)

Summary of Change in Incremental Compliance Burden

Incremental Burden (hours)	25% Issuer (hours)	75% Professional (hours)	$400/hr. Professional Cost
240,000	60,000	180,000	$72,000,000

D. Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), we request comments to: (1) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the agency, including whether the information would have practical utility; (2) evaluate the accuracy of our estimate of the burden of the proposed collections of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (4) evaluate whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology. We note that the PRA burden will depend on the number of indexed annuity contracts that, under any rule we adopt, are not "annuity contracts," and therefore will be required to register under the Securities Act. We have assumed, for purposes of the PRA, that all indexed annuities would not be "annuity contracts" under the rule and that, if the proposed rule were adopted, they would be required to be registered under the Securities Act. We request comment regarding this assumption and, more generally, on the percentage, or number, of indexed annuities that would be required to register under the Securities Act if the proposed rule were adopted.

Persons submitting comments on the collection of information requirements should direct the comments to OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy of the comments to Office of the Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303, with reference to File No S7-14-08. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7-14-08, and be submitted to the Securities and Exchange Commission, Records Management Office, 100 F Street, NE, Washington, DC 20549-1110. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

VI. COST/BENEFIT ANALYSIS

The Commission is sensitive to the costs and benefits imposed by its rules. Proposed rule 151A is intended to clarify the status under the federal securities laws of indexed annuities, under which payments to the purchaser are dependent on the performance of a securities index. Section 3(a)(8) of the Securities Act provides an exemption for certain insurance contracts. The proposed rule would prospectively define certain indexed annuities as not being "annuity contracts" or "optional annuity contracts" under this insurance exemption if the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract. With respect to these annuities, investors would be entitled to all the protections of the federal securities laws, including full and fair disclosure and sales practice protections. We are also proposing new rule 12h-7 under the Exchange Act, which would exempt certain insurance companies from Exchange Act reporting with respect to indexed annuities and certain other securities that are registered under the Securities Act and regulated as insurance under state law.

A. Benefits

Possible benefits of the proposed amendments include the following: (i) enhanced disclosure of information needed to make informed investment decisions about indexed annuities; (ii) sales practice protections would apply with respect to those indexed annuities that are outside the insurance exemption; (iii) greater regulatory certainty with regard to the status of indexed annuities under the federal securities laws; (iv) enhanced competition; and (v) relief from Exchange Act reporting obligations to insurers that issue certain securities that are regulated as insurance under state law.

Disclosure

Proposed rule 151A would extend the benefits of full and fair disclosure under the federal securities laws to investors in indexed annuities that, under the proposed rule, fall outside the insurance exemption. Without such disclosure, investors face significant obstacles in making informed investment decisions with regard to purchasing indexed annuities that expose investors to securities investment risk. Extending the federal securities disclosure regime to such indexed annuities that impose securities investment risk should help to provide investors with the information they need.

Disclosures that would be required for registered indexed annuities include information about costs (such as surrender charges); the method of computing indexed return (e.g., applicable index, method for determining change in index, caps, participation rates, spreads); minimum guarantees, as well as guarantees, or lack thereof, with respect to the method for computing indexed return; and benefits (lump sum, as well as annuity and death benefits). We think there are significant benefits to the disclosures provided under the federal securities laws. This information will be public and accessible to all investors, intermediaries, third party information providers, and others through the SEC's EDGAR system. Public availability of this information would be helpful to investors in making informed decisions about purchasing indexed annuities. The information would enhance investors' ability to compare various indexed annuities and also to compare indexed annuities with mutual funds, variable annuities, and other securities and financial products. The potential liability for materially false and misleading statements and omissions under the federal securities laws would provide additional encouragement for accurate, relevant, and complete disclosures by insurers that issue indexed annuities and by the broker-dealers who sell them.[109]

In addition, we believe that potential purchasers of indexed annuities that an insurer determines do not fall outside the insurance exemption under the proposed rule

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[109] See, e.g., Section 12(a)(2) of the Securities Act [15 U.S.C. 77l(a)(2)] (imposing liability for materially false or misleading statements in a prospectus or oral communication, subject to a reasonable care defense). See also Section 10(b) of the Exchange Act [15 U.S.C. 78j(b)]; rule 10b-5 under the Exchange Act [17 CFR 240.10b-5]; Section 17 of the Securities Act [15 U.S.C. 77q] (general antifraud provisions).

may benefit from enhanced information available as a result of the proposed rule. An indexed annuity that is not registered under the Securities Act after the adoption of proposed rule 151A would reflect the insurer's determination that investors in the annuity would not receive more than the amounts guaranteed under the contract at least half the time. This information would help a purchaser to evaluate the value of the index-based return.

Sales Practice Protections

Investors would also benefit because, under the federal securities laws, persons effecting transactions in indexed annuities that fall outside the insurance exemption under proposed rule 151A would be required to be registered broker-dealers or become associated persons of a broker-dealer through a networking arrangement. Thus, the broker-dealer sales practice protections would apply to transactions in registered indexed annuities. As a result, investors who purchase these indexed annuities after the effective date of proposed rule 151A would receive the benefits associated with a registered representative's obligation to make only recommendations that are suitable. The registered representatives who sell registered indexed annuities would be subject to supervision by the broker-dealer with which they are associated. Both the selling broker-dealer and its registered representatives would be subject to the oversight of FINRA.[110] The registered broker-dealers would also be required to comply with specific

[110] Cf. NASD Rule 2821 (recently adopted rule designed to enhance broker-dealers' compliance and supervisory systems and provide more comprehensive and targeted protection to investors regarding deferred variable annuities). See Order Approving FINRA's NASD Rule 2821 Regarding Members' Responsibilities for Deferred Variable Annuities (Approval Order), Securities Exchange Act Release No. 56375 (Sept. 7, 2007), 72 FR 52403 (Sept. 13, 2007) (SR-NASD-2004-183); Corrective Order, Securities

books and records, supervisory, and other compliance requirements under the federal securities laws, as well as be subject to the Commission's general inspections and, where warranted, enforcement powers.

Regulatory Certainty

Proposed rule 151A would provide the benefit of increased regulatory certainty to insurance companies that issue indexed annuities and the distributors who sell them, as well as to purchasers of indexed annuities. The status of indexed annuities under the federal securities laws has been uncertain since their introduction in the mid-1990s. Under existing precedents, the status of each indexed annuity is determined based on a facts and circumstances analysis of factors that have been articulated by the U.S. Supreme Court. Proposed rule 151A would bring greater certainty into this area by defining a class of indexed annuities that are outside the scope of the insurance exemption and by providing that an insurer's determination, in accordance with the proposed rule, would be conclusive.

Enhanced Competition

Proposed rule 151A may result in enhanced competition among indexed annuities, as well as between indexed annuities and other competing financial products, such as mutual funds and variable annuities. Proposed rule 151A would result in enhanced disclosure, and, as a result, more informed investment decisions by potential investors, which may enhance competition among indexed annuities and competing products. The greater clarity that results from proposed rule 151A may enhance

Exchange Act Release No. 56375A (Sept. 14, 2007), 72 FR 53612 (September 19, 2007) (SR-NASD-2004-183) (correcting the rule's effective date).

competition as well because insurers who may have been reluctant to issue indexed annuities while their status was uncertain may now decide to enter the market. Similarly, registered broker-dealers who currently may be unwilling to sell unregistered indexed annuities because of their uncertain regulatory status may become willing to sell indexed annuities that are registered, thereby increasing competition among distributors of indexed annuities. Further, we believe that the proposed Exchange Act exemption may enhance competition among insurance products and between insurance products and other financial products because the exemption may encourage insurers to innovate and introduce a range of new insurance contracts that are securities, since the exemption would reduce the regulatory costs associated with doing so. Increased competition may benefit investors through improvements in the terms of insurance products and other financial products, such as reductions of direct or indirect fees.

Relief from Reporting Obligations

In addition, the proposed exemption from Exchange Act reporting requirements with respect to certain securities that are regulated as insurance under state law would provide a cost savings to insurers. We have identified approximately 24 insurance companies that currently are subject to Exchange Act reporting obligations solely as a result of issuing insurance contracts that are securities and that we believe would, if we adopt proposed rule 12h-7, be exempted from Exchange Act reporting obligations.[111] We

[111] In addition, if we adopt both proposed rules 151A and 12h-7, insurers that currently are not Exchange Act reporting companies and that would be required to register indexed annuities under the Securities Act could avail themselves of the Exchange Act exemption and obtain the benefits of the exemption. We have not included potential cost savings to these companies in our computation because they are not currently Exchange Act reporting companies.

estimate that, each year, these insurers file an estimated 24 annual reports on Form 10-K, 72 quarterly reports on Form 10-Q, and 26 reports on Form 8-K.[112] Based on current cost estimates, we believe that the total estimated annual cost savings to these companies would be approximately $15,414,600.[113]

2. Costs

While our proposal would result in significant cost savings for insurers as a result of the proposed exemption from Exchange Act reporting requirements, we believe that there would be costs associated with the proposal. These would include costs associated with: (i) determining under proposed rule 151A whether amounts payable by the insurer under an indexed annuity are more likely than not to exceed the amounts guaranteed under the contract; (ii) preparing and filing required Securities Act registration statements with the Commission; (iii) printing prospectuses and providing them to investors;

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112 These estimates are based on the requirement to file one Form 10-K each year and three Forms 10-Q each year, and on our review of the actual number of Form 8-K filings by these insurers in calendar year 2007.

113 This consists of $8,748,950 attributable to internal personnel costs, representing 49,994 burden hours at $175 per hour, and $6,665,600 attributable to the costs of outside professionals, representing 16,664 burden hours at $400 per hour. Our estimates of $175 per hour for internal time and $400 per hours for outside professionals are consistent with the estimates that we have used in recent rulemaking releases.

Our total burden hour estimate for Forms 10-K, 10-Q, and 8-K is 66,658 hours, which, consistent with current OMB estimates and recent Commission rulemaking, we have allocated 75% (49,994 hours) to the insurers internally and 25% (16,664 hours) to outside professional time. See Supporting Statement to the Office of Management and Budget under the PRA for Securities Act Release No. 8819, available at: http://www.reginfo.gov/public/do/DownloadDocument?documentID=42924&version=1. The total burden hour estimate was derived as follows. The burden attributable to Form 10-K is 52,704 hours, representing 24 Forms 10-K at 2,196 hours per Form 10-K. The burden attributable to Form 10-Q is 13,824 hours, representing 72 Forms 10-Q at 192 hours per Form 10-Q. The burden attributable to Form 8-K is 130 hours, representing 26 Forms 8-K at 5 hours per Form 8-K. The burden hours per response for Form 10-K (2,196 hours), Form 10-Q (192 hours), and Form 8-K (5 hours) are consistent with current OMB estimates.

(iv) entering into a networking arrangement with a registered broker-dealer for those entities that are not currently parties to a networking arrangement or registered as broker-dealers and that intend to distribute indexed annuities that are registered as securities;[114] (v) loss of revenue to insurance companies that determine to cease issuing indexed annuities; and (vi) diminished competition that may result if some insurance companies cease issuing indexed annuities.

Determination Under Proposed Rule 151A

Insurers may incur costs in performing the analysis necessary to determine whether amounts payable under an indexed annuity would be more likely than not to exceed the amounts guaranteed under the contract. This analysis calls for the insurer to analyze expected outcomes under various scenarios involving different facts and circumstances. Insurers routinely undertake such analyses for purposes of pricing and hedging their contracts.[115] As a result, we believe that the costs of undertaking the analysis for purposes of the proposed rule may not be significant. However, the determinations necessary under the proposed rule may result in some additional costs for insurers that issue indexed annuities, either because the timing of the determination does not coincide with other similar analyses undertaken by the insurer or because the level or type of actuarial and legal analysis that the insurer would determine is appropriate under

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114 While some distributors may register as broker-dealers or cease distributing indexed annuities that would be required to be registered as a result of proposed rule 151A, based on our experience with insurance companies that issue insurance products that are also securities, we believe that the vast majority would continue to distribute those indexed annuities via networking arrangements with registered broker-dealers, as discussed below.

115 See generally Black and Skipper, supra note 39, at 26-47, 890-899.

the proposed rule is different or greater than that undertaken for other purposes, or for other reasons. These costs, if any, could include the costs of software, as well as the costs of internal personnel and external consultants (e.g., actuarial, accounting, legal).

Securities Act Registration Statements

Insurers will incur costs associated with preparing and filing registration statements for indexed annuities that are outside the insurance exemption as a result of proposed rule 151A. These include the costs of preparing and reviewing disclosure, filing documents, and retaining records. As noted above, our Office of Economic Analysis has considered the effect of the proposed rule on indexed annuity contracts with typical terms and has determined that these contracts would not meet the definition of "annuity contract" or "optional annuity contract" if they were issued after the effective date of the proposed rule, if adopted as proposed. For purposes of the PRA, we have estimated an annual increase in the paperwork burden for companies to comply with the proposed rules to be 60,000 hours of in-house company personnel time and $72,000,000 for services of outside professionals. We estimate that the additional burden hours of in-house company personnel time would equal total internal costs of $10,500,000[116] annually, resulting in aggregate annual costs of $82,500,000[117] for in-house personnel and outside professionals. These costs reflect the assumption that filings will be made on Form S-1 for 400 contracts each year, which we made for purposes of the PRA.

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[116] This cost increase is estimated by multiplying the total annual hour burden (60,000 hours) by the estimated hourly wage rate of $175 per hour. Consistent with recent rulemaking releases, we estimate the value of work performed by the company internally at a cost of $ 175 per hour.

[117] $10,500,000 (in-house personnel) + $72,000,000 (outside professionals).

Costs of Printing Prospectuses and Providing them to Investors

Insurers will also incur costs to print and provide prospectuses to investors for indexed annuities that are outside the insurance exemption as a result of proposed rule 151A. For purposes of the PRA, we have estimated that registration statements would be filed for 400 indexed annuities per year. We estimate that it would cost $0.35 to print each prospectus and $1.21 to mail each prospectus,[118] for a total of $1.56 per prospectus.[119] These estimates would be reduced to the extent that prospectuses are delivered in person or electronically, or to the extent that Securities Act prospectuses are substituted for written materials used today, rather than being delivered in addition to those materials.

Networking Arrangements with Registered Broker-Dealers

Proposed rule 151A may impose costs on indexed annuity distributors that are not currently parties to a networking arrangement or registered as broker-dealers. While these entities may choose to register as broker-dealers, in order to continue to distribute indexed annuities that are registered as securities, these distributors would likely enter

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118 These estimates reflect estimates provided to us by Broadridge Financial Solutions, Inc., in connection with our recent proposal to create a summary prospectus for mutual funds. The estimates depend on factors such as page length and number of copies printed and not on the content of the disclosures. Because we believe that these factors may be reasonably comparable for indexed annuity and mutual fund prospectuses, we believe that it is reasonable to use these estimates in the context of indexed annuities. See Memorandum to File number S7-28-07 regarding October 27, 2007 meeting between Commission staff members and representatives of Broadridge Financial Solutions, Inc. (Nov. 28, 2007). The memorandum is available for inspection and copying in File No. S7-28-07 in the Commission's Public Reference Room and on the Commission's Web site at http://www.sec.gov/comments/s7-28-07/s72807-5.pdf.

119. We note that we solicit specific comment on the average number of prospectuses that would be provided each year to offerees and/or purchasers of a registered indexed annuity. This information may assist us in estimating an aggregate cost for printing and providing prospectuses.

into a networking arrangement with a registered broker-dealer. Under these arrangements, an affiliated or third-party broker-dealer provides brokerage services for an insurance agency's customers, in connection with transactions in insurance products that are also securities. Entering into a networking arrangement would impose costs associated with contracting with the registered broker-dealer regarding the terms, conditions, and obligations of each party to the arrangement. We anticipate that a distributor would incur legal costs in connection with entering into a networking arrangement with a registered broker-dealer, as well as ongoing costs associated with monitoring compliance with the terms of the networking arrangement.[120]

Possible Loss of Revenue

Insurance companies that determine that indexed annuities are outside the insurance exemption under proposed rule 151A could either choose to register those annuities under the Securities Act or to cease selling those annuities. If an insurer ceases selling such annuities, the insurer may experience a loss of revenue. The amount of lost revenue would depend on actual revenues prior to effectiveness of the proposed rules and to the particular determinations made by insurers regarding whether to continue to issue registered indexed annuities. The loss of revenue may be offset, in whole or in part, by gains in revenue from the sale of other financial products, as purchasers' need for financial products will not diminish. These gains could be experienced by the same insurers who exit the indexed annuity business or they could be experienced by other insurance companies or other issuers of securities or other financial products.

120 We note that we solicit specific comment on the number of entities that are distributors of indexed annuities, and on how many are parties to a networking arrangement.

Possible Diminished Competition

There could be costs associated with diminished competition as a result of our proposed rules. In order to issue indexed annuities that are outside the insurance exemption under proposed rule 151A, insurers would be required to register those annuities as securities. If some insurers determine to cease issuing indexed annuities rather than undertake the analysis required by proposed rule 151A and register those annuities that are outside the insurance exemption under the proposed rule, there will be fewer issuers of indexed annuities, which may result in reduced competition. Any reduction in competition may affect investors through potentially less favorable terms of insurance products and other financial products, such as increases in direct or indirect fees. Any reduction in competition must be considered in conjunction with the potential enhancements to competition that are described in the Benefits section, above.

B. Request for Comments

We request comments on all aspects of this cost/benefit analysis, including identification of any additional costs or benefits that may result from the proposed amendments. We also solicit comment on any alternatives to the proposal in light of the cost-benefit analysis. Commenters are requested to provide empirical data and other factual support for their views to the extent possible. In particular, we request comment on the following issues:

- Are our quantitative estimates of benefits and costs correct? If not, how should they be adjusted?
- What are the costs associated with determining whether amounts payable under an indexed annuity would be more likely than not to exceed the amounts

guaranteed under the contract? Are valuation and hedging models currently in use readily adaptable for the purposes of this calculation? How much, if any, additional cost would this represent for insurers over and above the costs they routinely incur for the analysis necessary for pricing and hedging contracts, or for other purposes?

- We have estimated that 400 indexed annuity contracts would be registered on Form S-1 each year. Is this an accurate estimate, or is it too high or too low? What percentage of indexed annuities currently offered would not be considered "annuity contracts" or "optional annuity contracts" under proposed rule 151A?
- What would the costs of printing and providing prospectuses be for indexed annuities that are outside the insurance exemption under proposed rule 151A? What would the per prospectus printing and mailing costs be? On average, how many prospectuses would be provided each year for a registered indexed annuity to offerees and/or purchasers? To what degree would prospectuses be delivered by mail, in person, or electronically? To what degree would Securities Act prospectuses be provided in lieu of written materials used today?
- What are the costs of entering into a networking arrangement with a registered broker-dealer? How many entities currently distribute indexed annuities? Of those, how many have entered into a networking arrangement to sell other insurance products that are also securities (i.e., variable annuities)? How many have registered as broker-dealers to sell other insurance products that are also securities?

- How much revenue would be lost by insurers that determine to cease issuing indexed annuities? Would this lost revenue be offset by revenue gains of these insurance companies or by revenue gains of others? If so, by how much?

VII. CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION; CONSIDERATION OF BURDEN ON COMPETITION

Section 2(b) of the Securities Act[121] and Section 3(f) of the Securities Exchange Act[122] require 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. Section 23(a)(2) of the Exchange Act[123] requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

We believe that proposed rule 151A would promote efficiency by extending the benefits of the disclosure and sales practice protections of the federal securities laws to indexed annuities that are more likely than not to provide payments that vary with the performance of securities. The required disclosures would enable investors to make more informed investment decisions, and investors would receive the benefits of the sales practice protections, including a registered representative's obligation to make only

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121 15 U.S.C. 77b(b).

122 15 U.S.C. 78c(f).

123 15 U.S.C. 78w(a)(2).

recommendations that are suitable. We believe that these investor protections would provide better dissemination of investment-related information, enhance investment decisions by investors, and, ultimately, lead to greater efficiency in the securities markets.

We also anticipate that, because proposed rule 151A would improve investors' ability to make informed investment decisions, it would lead to increased competition between issuers and sellers of indexed annuities, mutual funds, variable annuities, and other financial products, and increased competitiveness in the U.S. capital markets. The greater clarity that results from proposed rule 151A also may enhance competition because insurers who may have been reluctant to issue indexed annuities, while their status was uncertain, may decide to enter the market. Similarly, registered broker-dealers who currently may be unwilling to sell unregistered indexed annuities because of their uncertain regulatory status may become willing to sell indexed annuities that are registered, thereby increasing competition among distributors of indexed annuities.

Proposed rule 151A might have some negative effects on competition. In order to issue indexed annuities that are outside the insurance exemption under proposed rule 151A, insurers would be required to register those annuities as securities. If some insurers determine to cease issuing indexed annuities rather than undertake the analysis required by proposed rule 151A and register those annuities that are outside the insurance exemption under the proposed rule, there will be fewer issuers of indexed annuities, which may result in reduced competition. Any reduction in competition must be considered in conjunction with the potential enhancements to competition that are described in the preceding paragraph.

We also anticipate that the increased market efficiency resulting from enhanced investor protections under proposed rule 151A could promote capital formation by improving the flow of information between insurers that issue indexed annuities, the distributors of those annuities, and investors.

Proposed rule 12h-7 would provide insurance companies with an exemption from Exchange Act reporting with respect to indexed annuities and certain other securities that are regulated as insurance under state law. We have proposed this exemption because the concerns that Exchange Act financial disclosures are intended to address are generally not implicated where an insurer's financial condition and ability to meet its contractual obligations are subject to oversight under state law and where there is no trading interest in an insurance contract. Accordingly, we believe that the proposed exemption would improve efficiency by eliminating potentially duplicative and burdensome regulation relating to insurers' financial condition. Furthermore, we believe that proposed rule 12h-7 would not impose any burden on competition. Rather, we believe that the proposed rule would enhance competition among insurance products and between insurance products and other financial products because the exemption may encourage insurers to innovate and introduce a range of new insurance contracts that are securities, since the exemption would reduce the regulatory costs associated with doing so. We also anticipate that the innovations in product development could promote capital formation by providing new investment opportunities for investors.

We request comment on whether the proposed amendments, if adopted, would promote efficiency, competition, and capital formation. We also request comment on any anti-competitive effects of the proposed rules. Commenters are requested to provide empirical data and other factual support for their views.

VIII. INITIAL REGULATORY FLEXIBILITY ANALYSIS

This Initial Regulatory Flexibility Analysis has been prepared in accordance with the Regulatory Flexibility Act.[124] It relates to the Commission's proposed rule 151A that would define the terms "annuity contract" and "optional annuity contract" under the Securities Act of 1933 and proposed rule 12h-7 that would exempt insurance companies from filing reports under the Securities Exchange Act of 1934 with respect to indexed annuities and other securities that are registered under the Securities Act, subject to certain conditions.

A. Reasons for, and Objective of, Proposed Amendments

We are proposing the definition of the terms "annuity contract" and "optional annuity contract" to provide greater clarity with regard to the status of indexed annuities under the federal securities laws. We believe this would enhance investor protection and would provide greater certainty to the issuers and sellers of these products with respect to their obligations under the federal securities laws. We are proposing the exemption from Exchange Act reporting because we believe that the concerns that periodic financial disclosures are intended to address are generally not implicated where an insurer's financial condition and ability to meet its contractual obligations are subject to oversight under state law and where there is no trading interest in an insurance contract.

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[124] 5 U.S.C. 603 <u>et seq.</u>

B. Legal Basis

The Commission is proposing rules 151A and 12h-7 pursuant to the authority set forth in Sections 3(a)(8) and 19(a) of the Securities Act [15 U.S.C. 77c(a)(8) and 77s(a)] and Sections 12(h), 13, 15, 23(a), and 36 of the Exchange Act [15 U.S.C. 78l(h), 78m, 78o, 78w(a), and 78mm].

C. Small Entities Subject to the Proposed Rules

The Commission's rules define "small business" and "small organization" for purposes of the Regulatory Flexibility Act for each of the types of entities regulated by the Commission.[125] Rule 0-10(a)[126] defines an issuer, other than an investment company, to be a "small business" or "small organization" for purposes of the Regulatory Flexibility Act if it had total assets of $5 million or less on the last day of its most recent fiscal year.[127] No insurers currently issuing indexed annuities are small entities.[128] In

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125 See rule 157 under the Securities Act [17 CFR 230.157]; rule 0-10 under the Exchange Act [17 CFR 240.0-10].

126 17 CFR 240.0-10(a).

127 Securities Act rule 157(a) [17 CFR 157(a)] generally defines an issuer, other than an investment company, to be a "small business" or "small organization" for purposes of the Regulatory Flexibility Act if it had total assets of $5 million or less on the last day of its most recent fiscal year and it is conducting or proposing to conduct a securities offering of $5 million or less. For purposes of our analysis, however, we use the Exchange Act definition of "small business" or "small entity" because that definition includes more issuers than does the Securities Act definition and, as a result, assures that the definition we use would not itself lead to an understatement of the impact of the amendments on small entities.

128 The staff has determined that each insurance company that currently offers indexed annuities has total assets significantly in excess of $5 million. The staff compiled a list of indexed annuity issuers from four sources: AnnuitySpecs, Carrier List, http://www.annuityspecs.com/Page.aspx?s=carrierlist; Annuity Advantage, Equity Indexed Annuity Data, http://www.annuityadvantage.com/annuitydataequity.htm; Advantage Compendium, Current Rates, http://www.indexannuity.org/rates_by_carrier.htm; and a search of BEST'S COMPANY REPORTS (available on LEXIS) for indexed annuity issuers. The total assets of each

addition, no other insurers that would be covered by the proposed Exchange Act exemption are small entities.[129]

While there are no small entities among the insurers who are subject to the proposed rules, we note that there may be small entities among distributors of indexed annuities. Proposed rule 151A, if adopted as proposed, may affect indexed annuity distributors who are not currently parties to a networking arrangement or registered as broker-dealers. While these entities may choose to register as broker-dealers, in order to continue to distribute indexed annuities that are registered as securities, these distributors would likely enter into a networking arrangement with a registered broker-dealer.[130] Under these arrangements, an affiliated or third-party broker-dealer provides brokerage services for an insurance agency's customers, in connection with transactions in insurance products that are also securities. Entering into a networking arrangement would impose costs associated with contracting with the registered broker-dealer regarding the terms, conditions, and obligations of each party to the arrangement. We anticipate that a distributor would incur legal costs in connection with entering into a

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insurance company issuer of indexed annuities were determined by reviewing the most recent BEST'S COMPANY REPORTS for each indexed annuity issuer.

129 The staff has determined that each insurance company that currently offers contracts that are registered under the Securities Act and that include so-called market value adjustment features or guaranteed benefits in connection with assets held in an investor's account has total assets significantly in excess of $5 million. The total assets of each such insurance company were determined by reviewing the Form 10-K of that company and, in some cases, BEST'S COMPANY REPORTS (available on LEXIS).

130 We note that we solicit specific comment on the number of entities that are distributors of indexed annuities, and on how many are parties to a networking arrangement. See Part VI., above.

networking arrangement with a registered broker-dealer, as well as ongoing costs associated with monitoring compliance with the terms of the networking arrangement.

Rule 0-10(c)[131] states that the term "small business" or "small organization," when referring to a broker-dealer that is not required to file audited financial statements prepared pursuant to rule 17a-5(d) under the Exchange Act,[132] means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the last business day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization. Rule 0-1(a)[133] states that the term "small business" or "small organization," when used with reference to a "person," other than an investment company, means a "person" that, on the last day of its most recent fiscal year, had total assets of $5 million or less.

D. Reporting, Recordkeeping, and Other Compliance Requirements

Proposed rule 151A would result in Securities Act filing obligations for those insurance companies that, in the future, issue indexed annuities that fall outside the insurance exemption under proposed rule 151A, and proposed rule 12h-7 would result in the elimination of Exchange Act reporting obligations for those insurance companies that meet the conditions to the proposed exemption. As noted above, no insurance companies that currently issue indexed annuities or that would be covered by the proposed exemption are small entities.

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131 17 CFR 240.0-10(c).

132 17 CFR 240.17a-5(d).

133 17 CFR 240.10(a).

However, proposed rule 151A may affect indexed annuity distributors that are small entities and that are not currently parties to a networking arrangement or registered as broker-dealers. While these entities may choose to register as broker-dealers, in order to continue to distribute indexed annuities that are registered as securities, these distributors would likely enter into a networking arrangement with a registered broker-dealer. Entities that enter into such networking arrangements would not be subject to ongoing reporting, recordkeeping, or other compliance requirements. If any of these entities were to choose to register as broker-dealers as a result of proposed rule 151A,[134] they would be subject to ongoing reporting, recordkeeping, and other compliance requirements applicable to registered broker-dealers. Compliance with these requirements, if applicable, would impose costs associated with accounting, legal, and other professional personnel, and the design and operation of automated and other compliance systems.

E. Duplicative, Overlapping, or Conflicting Federal Rules

We believe that the proposed rules would not duplicate, overlap, or conflict with other federal rules.

F. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the proposed amendments, we considered the following alternatives:

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134 See, e.g., Submission for OMB Review; Comment Request, OMB Control No. 3235-0012 [72 FR 39646 (Jul. 19, 2007)] (discussing the total annual burden imposed by Form BD).

- establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- further clarifying, consolidating, or simplifying the proposed requirements for small entities;
- using performance standards rather than design standards; and
- providing an exemption from the proposed requirements, or any part of them, for small entities.

Because no insurers that currently issue indexed annuities or that would be covered by the proposed Exchange Act exemption are small entities, consideration of these alternatives for those insurance companies is not applicable. Small distributors of indexed annuities that choose to enter into networking arrangements with registered broker-dealers, which we believe would be likely if proposed rule 151A were adopted, would not be subject to ongoing reporting, recordkeeping, or other compliance requirements. However, because some small distributors may choose to register as broker-dealers, we did consider the alternatives above for small distributors.

The Commission believes that different registration, compliance, or reporting requirements or timetables for small entities that distribute registered indexed annuities would not be appropriate or consistent with investor protection. The proposed rules would provide investors with the sales practice protections of the federal securities laws when they purchase indexed annuities that are outside the insurance exemption. These indexed annuities would be required to be distributed by a registered broker-dealer. As a result, investors who purchase these indexed annuities after the effective date of proposed rule 151A would receive the benefits associated with a registered representative's obligation to make only recommendations that are suitable. The registered representatives who sell registered indexed annuities would be subject to supervision by the broker-dealer with which they are associated, and the selling broker-dealers would be subject to the oversight of FINRA. The registered broker-dealers would also be required to comply with specific books and records, supervisory, and other compliance requirements under the federal securities laws, as well as to be subject to the Commission's general inspections and, where warranted, enforcement powers.

Different registration, compliance, or reporting requirements or timetables for small entities that distribute indexed annuities may create the risk that investors would receive lesser sales practice and other protections when they purchase a registered indexed annuity through a distributor that is a small entity. We believe that it is important for all investors that purchase indexed annuities that are outside the insurance exemption to receive equivalent protections under the federal securities laws, without regard to the size of the distributor through which they purchase. For those same reasons, the Commission also does not believe that it would be appropriate or consistent with investor protection to exempt small entities from the broker-dealer registration requirements when those entities distribute indexed annuities that fall outside of the insurance exemption under our proposed rules.

Through our existing requirements for broker-dealers, we have endeavored to minimize the regulatory burden on all broker-dealers, including small entities, while meeting our regulatory objectives. Small entities that distribute indexed annuities that are outside the insurance exemption under our proposed rule should benefit from the Commission's reasoned approach to broker-dealer regulation to the same degree as other entities that distribute securities. In our existing broker-dealer regulatory framework, we have endeavored to clarify, consolidate, and simplify the requirements applicable to all registered broker-dealers, and the proposed rules do not change those requirements in any way. Finally, we do not consider using performance rather than design standards to be consistent with investor protection in the context of broker-dealer registration, compliance, and reporting requirements.

G. Solicitation of Comments

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, we request comments regarding:

- whether there are any small entity insurance companies that would be affected by the proposed rules and, if so, how many and the nature of the potential impact of the proposed rules on these insurance companies;
- the number of small entity distributors of indexed annuities that may be affected by proposed rule 151A and the potential effect of the rule on these small entities; and
- any other small entities that may be affected by the proposed rules.

Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. These comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rules are adopted, and will be placed in the same public file as comments on the proposed rules themselves.

IX. CONSIDERATION OF IMPACT ON THE ECONOMY

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA"),[135] a rule is "major" if it results or is likely to result in:

- an annual effect on the economy of $100 million or more;
- a major increase in costs or prices for consumers or individual industries; or
- significant adverse effects on competition, investment, or innovation.

We request comment on whether our proposal would be a ''major rule'' for purposes of SBREFA. We solicit comment and empirical data on:

- the potential effect on the U.S. economy on an annual basis;
- any potential increase in costs or prices for consumers or individual industries; and
- any potential effect on competition, investment, or innovation.

X. STATUTORY AUTHORITY

The Commission is proposing the amendments outlined above under Sections 3(a)(8) and 19(a) of the Securities Act [15 U.S.C. 77c(a)(8) and 77s(a)] and Sections 12(h), 13, 15, 23(a), and 36 of the Exchange Act [15 U.S.C. 78l(h), 78m, 78o, 78w(a), and 78mm].

List of Subjects

17 CFR Parts 230 and 240

Reporting and recordkeeping requirements, Securities.

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135 Pub. L. No. 104-21, Title II, 110 Stat. 857 (1996).

TEXT OF PROPOSED RULES

For the reasons set forth in the preamble, the Commission proposes to amend title 17, Chapter II, of the Code of Federal Regulations as follows:

PART 230 – GENERAL RULES AND REGULATONS, SECURITIES ACT OF 1933

1. The authority citation for Part 230 continues to read in part as follows:

Authority: 15 U.S.C. 77b, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z–3, 77sss, 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78t, 78w, 78ll (d), 78mm, 80a–8, 80a–24, 80a–28, 80a–29, 80a–30, and 80a–37, unless otherwise noted.

* * * * *

2. Add § 230.151A to read as follows:

§ 230.151A Certain contracts not "annuity contracts" or "optional annuity contracts" under section 3(a)(8).

(a) General. Except as provided in paragraph (c) of this section, a contract that is issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia, and that is subject to regulation under the insurance laws of that jurisdiction as an annuity is not an "annuity contract" or "optional annuity contract" under Section 3(a)(8) of the Securities Act (15 U.S.C. 77c(a)(8)) if:

(1) Amounts payable by the issuer under the contract are calculated, in whole or in part, by reference to the performance of a security, including a group or index of securities; and

(2) Amounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

(b) Determination of amounts payable and guaranteed. In making the determination under paragraph (a)(2) of this section:

(1) Amounts payable by the issuer under the contract shall be determined without reference to any charges that are imposed at the time of payment, but those charges shall be taken into account in computing the amounts guaranteed under the contract; and

(2) A determination by the issuer at or prior to issuance of the contract shall be conclusive, provided that:

(A) Both the methodology and the economic, actuarial, and other assumptions used in the determination are reasonable;

(B) The computations made by the issuer in support of the determination are materially accurate; and

(C) The determination is made not more than six months prior to the date on which the form of contract is first offered and not more than three years prior to the date on which the particular contract is issued.

(c) Separate accounts. This section does not apply to any contract whose value varies according to the investment experience of a separate account.

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

3. 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.

* * * * *

4. Add § 240.12h-7 to read as follows:

§ 240.12h-7 Exemption for issuers of securities that are subject to insurance regulation.

An issuer shall be exempt from the duty under section 15(d) of the Act (15 U.S.C. 78o(d)) to file reports required by section 13(a) of the Act (15 U.S.C. 78m(a)) with respect to securities registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.), provided that:

(a) The issuer is a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State;

(b) The securities do not constitute an equity interest in the issuer and are either subject to regulation under the insurance laws of the domiciliary State of the issuer or are guarantees of securities that are subject to regulation under the insurance laws of that jurisdiction;

(c) The issuer files an annual statement of its financial condition with, and is supervised and its financial condition examined periodically by, the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of the issuer's domiciliary State;

(d) The securities are not listed, traded, or quoted on an exchange, alternative trading system (as defined in §242.300(a) of this chapter), inter-dealer quotation system (as defined in § 240.15c2-11(e)(2)), electronic communications network, or any other similar system, network, or publication for trading or quoting; and

(e) The issuer takes steps reasonably designed to ensure that a trading market for the securities does not develop, including requiring written notice to, and acceptance by, the issuer prior to any assignment or other transfer of the securities and reserving the right to refuse assignments or other transfers at any time on a non-discriminatory basis.

By the Commission.

Florence E. Harmon

Florence E. Harmon
Acting Secretary

June 25, 2008

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
June 25, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13082

In the Matter of **Borough Corp.,** **Canticle Corp.,** **Emerald Acquisition Corp.,** **Erebus Corp.,** **Forward Acquisition Corp.,** **Hercules Acquisition Corp.,** **Jubilee Acquisition Corp.,** **Proteque Corp., and** **Tecnomatic International Corp.,** **Respondents.**	**ORDER INSTITUTING PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate 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 Borough Corp., Canticle Corp., Emerald Acquisition Corp., Erebus Corp., Forward Acquisition Corp., Hercules Acquisition Corp., Jubilee Acquisition Corp., Proteque Corp., and Tecnomatic International Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Borough Corp. (CIK No. 1088783) is a void Delaware corporation located in Washington, D.C. with a class of securities registered pursuant to Exchange Act Section 12(g). Borough is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2002, which reported a net loss of $4,830 since inception in 1999.

2. Canticle Corp. (CIK No. 1088784) is a void Delaware corporation located in Washington, D.C. with a class of securities registered pursuant to

Document 38 of 48

Section 12(g). Canticle is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 1999, which reported a net loss of $4,830 for the period ended September 30, 1999.

3. Emerald Acquisition Corp. (CIK No. 1100372) is a void Delaware corporation located in Washington, D.C. with a class of securities registered pursuant to Exchange Act Section 12(g). Emerald is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed its Form 10-SB registration statement on December 3, 1999, which reported a net loss of $1,330 from inception in 1999 to October 31, 1999. On August 20, 1993, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Northern District of Illinois, and the case was dismissed on March 31, 1998.

4. Erebus Corp. (CIK No. 1088814) is a void Delaware corporation located in Washington, D.C. with a class of securities registered pursuant to Exchange Act Section 12(g). Erebus is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed its Form 10-KSB for the period ended December 31, 1999, which reported a net loss of $4,830 since inception in 1999.

5. Forward Acquisition Corp. (CIK No. 1122111) is a void Delaware corporation located in Philadelphia, Pennsylvania with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Forward Acquisition is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB Amendment for the period ended June 30, 2002.

6. Hercules Acquisition Corp. (CIK No. 1122113) is a void Delaware corporation located in Philadelphia, Pennsylvania with a class of securities registered pursuant to Exchange Act Section 12(g). Hercules is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB Amendment for the period ended June 30, 2002.

7. Jubilee Acquisition Corp. (CIK No. 1107574) is a void Delaware corporation located in Washington, D.C. with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Jubilee Acquisition is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB Amendment for the period ended June 30, 2002.

8. Proteque Corp. (CIK No. 1122109) is a void Delaware corporation located in Vass, North Carolina with a class of securities registered pursuant to Exchange Act Section 12(g). Proteque 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 $231,718 for the prior three months.

9. Tecnomatic International Corp. (CIK No. 1102340) is a void Delaware corporation located in Washington, D.C. with a class of securities registered pursuant to

Exchange Act Section 12(g). Tecnomatic is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 2001.

B. DELINQUENT PERIODIC FILINGS

10. 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 at their most recent address shown in their most recent filing with the Commission, or did not receive the letters because of their failure to keep an updated address on file with the Commission as required by Commission rules.

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

12. As a result of their failure to file required periodic filings, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

III.

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

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

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

IV.

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

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

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

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

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

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

By the Commission.

Florence E. Harmon
Acting Secretary

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

Attachment

Appendix 1

Chart of Delinquent Filings
Borough Corp., et al.

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Borough Corp.					
	10-QSB	06/30/02	08/14/02	Not filed	70
	10-QSB	09/30/02	11/14/02	Not filed	67
	10-KSB	12/31/02	03/31/03	Not filed	63
	10-QSB	03/31/03	05/15/03	Not filed	61
	10-QSB	06/30/03	08/14/03	Not filed	58
	10-QSB	09/30/03	11/14/03	Not filed	55
	10-KSB	12/31/03	03/30/04	Not filed	51
	10-QSB	03/31/04	05/17/04	Not filed	49
	10-QSB	06/30/04	08/16/04	Not filed	46
	10-QSB	09/30/04	11/15/04	Not filed	43
	10-KSB	12/31/04	03/31/05	Not filed	39
	10-QSB	03/31/05	05/16/05	Not filed	37
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/14/05	Not filed	31
	10-KSB	12/31/05	03/31/06	Not filed	27
	10-QSB	03/31/06	05/15/06	Not filed	25
	10-QSB	06/30/06	08/14/06	Not filed	22
	10-QSB	09/30/06	11/14/06	Not filed	19
	10-KSB	12/31/06	04/02/07	Not filed	14
	10-QSB	03/31/07	05/15/07	Not filed	13
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/30/07	11/14/07	Not filed	7
	10-KSB	12/31/07	03/31/08	Not filed	3
	*10-Q**	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	24				
Canticle Corp.					
	10-KSB	12/31/99	03/30/00	Not filed	99
	10-QSB	03/31/00	05/15/00	Not filed	97
	10-QSB	06/30/00	08/14/00	Not filed	94
	10-QSB	09/30/00	11/14/00	Not filed	91
	10-KSB	12/31/00	04/02/01	Not filed	86
	10-QSB	03/31/01	05/15/01	Not filed	85
	10-QSB	06/30/01	08/14/01	Not filed	82
	10-QSB	09/30/01	11/14/01	Not filed	79
	10-KSB	12/31/01	04/01/02	Not filed	74

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Canticle Corp.					
	10-QSB	03/31/02	05/15/02	Not filed	73
	10-QSB	06/30/02	08/14/02	Not filed	70
	10-QSB	09/30/02	11/14/02	Not filed	67
	10-KSB	12/31/02	03/31/03	Not filed	63
	10-QSB	03/31/03	05/15/03	Not filed	61
	10-QSB	06/30/03	08/14/03	Not filed	58
	10-QSB	09/30/03	11/14/03	Not filed	55
	10-KSB	12/31/03	03/30/04	Not filed	51
	10-QSB	03/31/04	05/17/04	Not filed	49
	10-QSB	06/30/04	08/16/04	Not filed	46
	10-QSB	09/30/04	11/15/04	Not filed	43
	10-KSB	12/31/04	03/31/05	Not filed	39
	10-QSB	03/31/05	05/16/05	Not filed	37
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/14/05	Not filed	31
	10-KSB	12/31/05	03/31/06	Not filed	27
	10-QSB	03/31/06	05/15/06	Not filed	25
	10-QSB	06/30/06	08/14/06	Not filed	22
	10-QSB	09/30/06	11/14/06	Not filed	19
	10-KSB	12/31/06	04/02/07	Not filed	14
	10-QSB	03/31/07	05/15/07	Not filed	13
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/30/07	11/14/07	Not filed	7
	10-KSB	12/31/07	03/31/08	Not filed	3
	*10-Q**	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	34				
Emerald Acquisition Corp.					
	10-KSB	12/31/99	03/30/00	Not filed	99
	10-QSB	03/31/00	05/15/00	Not filed	97
	10-QSB	06/30/00	08/14/00	Not filed	94
	10-QSB	09/30/00	11/14/00	Not filed	91
	10-KSB	12/31/00	04/02/01	Not filed	86
	10-QSB	03/31/01	05/15/01	Not filed	85
	10-QSB	06/30/01	08/14/01	Not filed	82
	10-QSB	09/30/01	11/14/01	Not filed	79
	10-KSB	12/31/01	04/01/02	Not filed	74
	10-QSB	03/31/02	05/15/02	Not filed	73
	10-QSB	06/30/02	08/14/02	Not filed	70

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Emerald Acquisition Corp.					
	10-QSB	09/30/02	11/14/02	Not filed	67
	10-KSB	12/31/02	03/31/03	Not filed	63
	10-QSB	03/31/03	05/15/03	Not filed	61
	10-QSB	06/30/03	08/14/03	Not filed	58
	10-QSB	09/30/03	11/14/03	Not filed	55
	10-KSB	12/31/03	03/30/04	Not filed	51
	10-QSB	03/31/04	05/17/04	Not filed	49
	10-QSB	06/30/04	08/16/04	Not filed	46
	10-QSB	09/30/04	11/15/04	Not filed	43
	10-KSB	12/31/04	03/31/05	Not filed	39
	10-QSB	03/31/05	05/16/05	Not filed	37
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/14/05	Not filed	31
	10-KSB	12/31/05	03/31/06	Not filed	27
	10-QSB	03/31/06	05/15/06	Not filed	25
	10-QSB	06/30/06	08/14/06	Not filed	22
	10-QSB	09/30/06	11/14/06	Not filed	19
	10-KSB	12/31/06	04/02/07	Not filed	14
	10-QSB	03/31/07	05/15/07	Not filed	13
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/30/07	11/14/07	Not filed	7
	10-KSB	12/31/07	03/31/08	Not filed	3
	*10-Q**	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	34				
Erebus Corp.					
	10-QSB	03/31/00	05/15/00	Not filed	97
	10-QSB	06/30/00	08/14/00	Not filed	94
	10-QSB	09/30/00	11/14/00	Not filed	91
	10-KSB	12/31/00	04/02/01	Not filed	86
	10-QSB	03/31/01	05/15/01	Not filed	85
	10-QSB	06/30/01	08/14/01	Not filed	82
	10-QSB	09/30/01	11/14/01	Not filed	79
	10-KSB	12/31/01	04/01/02	Not filed	74
	10-QSB	03/31/02	05/15/02	Not filed	73
	10-QSB	06/30/02	08/14/02	Not filed	70
	10-QSB	09/30/02	11/14/02	Not filed	67
	10-KSB	12/31/02	03/31/03	Not filed	63
	10-QSB	03/31/03	05/15/03	Not filed	61

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Erebus Corp.					
	10-QSB	06/30/03	08/14/03	Not filed	58
	10-QSB	09/30/03	11/14/03	Not filed	55
	10-KSB	12/31/03	03/30/04	Not filed	51
	10-QSB	03/31/04	05/17/04	Not filed	49
	10-QSB	06/30/04	08/16/04	Not filed	46
	10-QSB	09/30/04	11/15/04	Not filed	43
	10-KSB	12/31/04	03/31/05	Not filed	39
	10-QSB	03/31/05	05/16/05	Not filed	37
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/14/05	Not filed	31
	10-KSB	12/31/05	03/31/06	Not filed	27
	10-QSB	03/31/06	05/15/06	Not filed	25
	10-QSB	06/30/06	08/14/06	Not filed	22
	10-QSB	09/30/06	11/14/06	Not filed	19
	10-KSB	12/31/06	04/02/07	Not filed	14
	10-QSB	03/31/07	05/15/07	Not filed	13
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/30/07	11/14/07	Not filed	7
	10-KSB	12/31/07	03/31/08	Not filed	3
	*10-Q**	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	33				
Forward Acquisition Corp.					
	10-QSB	09/30/02	11/14/02	Not filed	67
	10-KSB	12/31/02	03/31/03	Not filed	63
	10-QSB	03/31/03	05/15/03	Not filed	61
	10-QSB	06/30/03	08/14/03	Not filed	58
	10-QSB	09/30/03	11/14/03	Not filed	55
	10-KSB	12/31/03	03/30/04	Not filed	51
	10-QSB	03/31/04	05/17/04	Not filed	49
	10-QSB	06/30/04	08/16/04	Not filed	46
	10-QSB	09/30/04	11/15/04	Not filed	43
	10-KSB	12/31/04	03/31/05	Not filed	39
	10-QSB	03/31/05	05/16/05	Not filed	37
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/14/05	Not filed	31
	10-KSB	12/31/05	03/31/06	Not filed	27
	10-QSB	03/31/06	05/15/06	Not filed	25
	10-QSB	06/30/06	08/14/06	Not filed	22

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Forward Acquisition Corp.					
	10-QSB	09/30/06	11/14/06	Not filed	19
	10-KSB	12/31/06	04/02/07	Not filed	14
	10-QSB	03/31/07	05/15/07	Not filed	13
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/30/07	11/14/07	Not filed	7
	10-KSB	12/31/07	03/31/08	Not filed	3
	*10-Q**	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	23				
Hercules Acquisition Corp.					
	10-QSB	09/30/02	11/14/02	Not filed	67
	10-KSB	12/31/02	03/31/03	Not filed	63
	10-QSB	03/31/03	05/15/03	Not filed	61
	10-QSB	06/30/03	08/14/03	Not filed	58
	10-QSB	09/30/03	11/14/03	Not filed	55
	10-KSB	12/31/03	03/30/04	Not filed	51
	10-QSB	03/31/04	05/17/04	Not filed	49
	10-QSB	06/30/04	08/16/04	Not filed	46
	10-QSB	09/30/04	11/15/04	Not filed	43
	10-KSB	12/31/04	03/31/05	Not filed	39
	10-QSB	03/31/05	05/16/05	Not filed	37
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/14/05	Not filed	31
	10-KSB	12/31/05	03/31/06	Not filed	27
	10-QSB	03/31/06	05/15/06	Not filed	25
	10-QSB	06/30/06	08/14/06	Not filed	22
	10-QSB	09/30/06	11/14/06	Not filed	19
	10-KSB	12/31/06	04/02/07	Not filed	14
	10-QSB	03/31/07	05/15/07	Not filed	13
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/30/07	11/14/07	Not filed	7
	10-KSB	12/31/07	03/31/08	Not filed	3
	*10-Q**	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	23				

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Jubilee Acquisition Corp.					
	10-QSB	09/30/02	11/14/02	Not filed	67
	10-KSB	12/31/02	03/31/03	Not filed	63
	10-QSB	03/31/03	05/15/03	Not filed	61
	10-QSB	06/30/03	08/14/03	Not filed	58
	10-QSB	09/30/03	11/14/03	Not filed	55
	10-KSB	12/31/03	03/30/04	Not filed	51
	10-QSB	03/31/04	05/17/04	Not filed	49
	10-QSB	06/30/04	08/16/04	Not filed	46
	10-QSB	09/30/04	11/15/04	Not filed	43
	10-KSB	12/31/04	03/31/05	Not filed	39
	10-QSB	03/31/05	05/16/05	Not filed	37
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/14/05	Not filed	31
	10-KSB	12/31/05	03/31/06	Not filed	27
	10-QSB	03/31/06	05/15/06	Not filed	25
	10-QSB	06/30/06	08/14/06	Not filed	22
	10-QSB	09/30/06	11/14/06	Not filed	19
	10-KSB	12/31/06	04/02/07	Not filed	14
	10-QSB	03/31/07	05/15/07	Not filed	13
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/30/07	11/14/07	Not filed	7
	10-KSB	12/31/07	03/31/08	Not filed	3
	*10-Q**	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	23				
Proteque Corp.					
	10-KSB	12/31/01	04/01/02	Not filed	74
	10-QSB	03/31/02	05/15/02	Not filed	73
	10-QSB	06/30/02	08/14/02	Not filed	70
	10-QSB	09/30/02	11/14/02	Not filed	67
	10-KSB	12/31/02	03/31/03	Not filed	63
	10-QSB	03/31/03	05/15/03	Not filed	61
	10-QSB	06/30/03	08/14/03	Not filed	58
	10-QSB	09/30/03	11/14/03	Not filed	55
	10-KSB	12/31/03	03/30/04	Not filed	51
	10-QSB	03/31/04	05/17/04	Not filed	49
	10-QSB	06/30/04	08/16/04	Not filed	46
	10-QSB	09/30/04	11/15/04	Not filed	43
	10-KSB	12/31/04	03/31/05	Not filed	39
	10-QSB	03/31/05	05/16/05	Not filed	37

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Proteque Corp.					
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/14/05	Not filed	31
	10-KSB	12/31/05	03/31/06	Not filed	27
	10-QSB	03/31/06	05/15/06	Not filed	25
	10-QSB	06/30/06	08/14/06	Not filed	22
	10-QSB	09/30/06	11/14/06	Not filed	19
	10-KSB	12/31/06	04/02/07	Not filed	14
	10-QSB	03/31/07	05/15/07	Not filed	13
	10-QSB	06/30/07	08/14/07	Not filed	10
	10-QSB	09/30/07	11/14/07	Not filed	7
	10-KSB	12/31/07	03/31/08	Not filed	3
	*10-Q**	03/31/08	05/15/08	Not filed	1
Total Filings Delinquent	26				
Tecnomatic International Corp.					
	10-QSB	09/30/01	11/14/01	Not filed	79
	10-KSB	12/31/01	04/01/02	Not filed	74
	10-QSB	03/31/02	05/15/02	Not filed	73
	10-QSB	06/30/02	08/14/02	Not filed	70
	10-QSB	09/30/02	11/14/02	Not filed	67
	10-KSB	12/31/02	03/31/03	Not filed	63
	10-QSB	03/31/03	05/15/03	Not filed	61
	10-QSB	06/30/03	08/14/03	Not filed	58
	10-QSB	09/30/03	11/14/03	Not filed	55
	10-KSB	12/31/03	03/30/04	Not filed	51
	10-QSB	03/31/04	05/17/04	Not filed	49
	10-QSB	06/30/04	08/16/04	Not filed	46
	10-QSB	09/30/04	11/15/04	Not filed	43
	10-KSB	12/31/04	03/31/05	Not filed	39
	10-QSB	03/31/05	05/16/05	Not filed	37
	10-QSB	06/30/05	08/15/05	Not filed	34
	10-QSB	09/30/05	11/15/05	Not filed	31
	10-KSB	12/31/05	03/31/06	Not filed	27
	10-QSB	03/31/06	05/15/06	Not filed	25
	10-QSB	06/30/06	08/14/06	Not filed	22
	10-QSB	09/30/06	11/15/06	Not filed	19
	10-KSB	12/31/06	04/02/07	Not filed	14
	10-QSB	03/31/07	05/15/07	Not filed	13
	10-QSB	06/30/07	08/14/07	Not filed	10

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Tecnomatic International Corp.					
	10-QSB	09/30/07	11/14/07	Not filed	7
	10-KSB	12/31/07	03/31/08	Not filed	3
	*10-Q**	03/31/08	05/15/08	Not filed	1

Total Filings Delinquent 27

*Regulation S-B and its accompanying forms, including Forms 10-QSB and 10-KSB, are in the process of being removed from the federal securities laws. *See* Release No. 34-56994 (Dec. 19, 2007). The removal is taking effect over a transition period that will conclude on March 15, 2009, so by that date, all reporting companies that previously filed their periodic reports on Forms 10-QSB and 10-KSB will be required to use Forms 10-Q and 10-K instead. Forms 10-QSB and 10-KSB will no longer be available, though issuers that meet the definition of a "smaller reporting company" (generally, a company that has less than $75 million in public equity float as of the end of its most recently completed second fiscal quarter) will have the option of using new, scaled disclosure requirements that Regulation S-K now includes.

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 210, 228, 229 and 249

[RELEASE NOS. 33-8934; 34-58028; File No. S7-06-03]

RIN 3235-AJ64

INTERNAL CONTROL OVER FINANCIAL REPORTING IN EXCHANGE ACT PERIODIC REPORTS OF NON-ACCELERATED FILERS

AGENCY: Securities and Exchange Commission.

ACTION: Final rules.

SUMMARY: We are adopting amendments to temporary rules that were published on December 21, 2006, in Release No. 33-8760 [71 FR 76580]. Those temporary rules require companies that are non-accelerated filers to include in their annual reports, pursuant to rules implementing Section 404(b) of the Sarbanes-Oxley Act of 2002, an attestation report of their independent auditors on internal control over financial reporting for fiscal years ending on or after December 15, 2008. Under the amendments, a non-accelerated filer will be required to file the auditor's attestation report on internal control over financial reporting when it files an annual report for a fiscal year ending on or after December 15, 2009.

EFFECTIVE DATES: The amendments are effective [insert date 60 days after publication in the Federal Register], except Form 10-QSB will be effective from [insert date 60 days after publication in the Federal Register] to October 31, 2008; §228.308T and Form 10-KSB will be effective from [insert date 60 days after publication in the Federal Register] to March 15, 2009; and §§ 210.2-02T and 229.308T, Form 20-F, Form 40-F, Form 10-Q, and Form 10-K will be effective from [insert date 60 days after publication in the Federal Register] to June 30, 2010.

Document 39 of 48

FOR FURTHER INFORMATION CONTACT: Sean Harrison, Special Counsel, Office of Rulemaking, Division of Corporation Finance, at (202) 551-3430, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3628.

SUPPLEMENTARY INFORMATION: We are adopting amendments to the following forms and temporary rules: Rule 2-02T of Regulation S-X,[1] Item 308T of Regulations S-K[2] and S-B,[3] Item 4T of Form 10-Q,[4] Item 3A(T) of Form 10-QSB,[5] Item 9A(T) of Form 10-K,[6] Item 8A(T) of Form 10-KSB,[7] Item 15T of Form 20-F,[8] and Instruction 3T of General Instruction B.(6) of Form 40-F.[9]

I. BACKGROUND

In February 2008,[10] we proposed an extension of the Section 404(b) auditor attestation requirement for non-accelerated filers.[11] This proposal followed an action we took in December 2006[12] to extend the dates by which non-accelerated filers must begin to comply with the internal

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[1] 17 CFR 210-2.02T.

[2] 17 CFR 229.308T.

[3] 17 CFR 228.310T.

[4] 17 CFR 249.308a.

[5] 17 CFR 249.308b.

[6] 17 CFR 249.310.

[7] 17 CFR 249.310b.

[8] 17 CFR 249.220f.

[9] 17 CFR 249.240f.

[10] See Release No. 33-8889 (February 1, 2008) [73 FR 7450].

[11] Although the term "non-accelerated filer" is not defined in our rules, we use it throughout this release to refer to an Exchange Act reporting company that does not meet the Rule 12b-2 definition of either an "accelerated filer" or a "large accelerated filer."

[12] See Release No. 33-8760 (December 15, 2006) [71 FR 76580] (the "2006 Release").

control over financial reporting ("ICFR") requirements mandated by Section 404 of the Sarbanes-Oxley Act of 2002.[13] Specifically, we postponed for five months, from fiscal years ending on or after July 15, 2007, to fiscal years ending on or after December 15, 2007, the date by which non-accelerated filers must begin to comply with the management report requirement in Item 308(a) of Regulation S-K.[14] We also postponed to fiscal years ending on or after December 15, 2008, the date by which non-accelerated filers must begin to comply with the auditor attestation report requirement in Item 308(b) of Regulation S-K.[15] We indicated that we would consider further postponing the auditor attestation report compliance date after considering the anticipated revisions to the Public Company Accounting Oversight Board's ("PCAOB") Auditing Standard No. 2 ("AS No. 2").

In the 2006 Release, we cited two primary reasons for deferring implementation of the auditor attestation report requirement for an additional year after implementation of the management report requirement. First, we stated that the deferred implementation would afford non-accelerated filers and their auditors the benefit of anticipated changes by the PCAOB to AS No. 2, subject to Commission approval, as well as any implementation guidance that the PCAOB issued for auditors of smaller public companies.

Second, we expected a deferred implementation of the auditor attestation requirement to save non-accelerated filers the full potential costs associated with the auditor's initial attestation to, and report on, management's assessment of ICFR during the period that changes to AS No. 2

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[13] 15 U.S.C. 7262.

[14] 17 CFR 229.308(a). We effected the postponement, in part, by adding temporary Item 308T to Regulation S-K. We similarly added temporary Item 308T to Regulation S-B, but the Commission recently adopted amendments that will eliminate Regulation S-B effective March 15, 2009. See Release No. 33-8876 (December 19, 2007) [73 FR 934].

[15] 17 CFR 229.308(b).

were being considered and implemented, and the PCAOB was formulating guidance specifically for auditors of smaller public companies. Public commenters previously have asserted that the ICFR compliance costs are likely to be disproportionately higher for smaller public companies than larger ones, and that the auditor's fee represents a large percentage of those costs.[16]

On June 20, 2007, we approved the issuance of interpretive guidance regarding management's report on ICFR[17] and adopted rule amendments[18] to help public companies strengthen their ICFR evaluations while reducing unnecessary costs. The interpretive release provided guidance for management on how to conduct an evaluation of the effectiveness of a company's ICFR. The guidance sets forth an approach by which management can conduct a top-down, risk-based evaluation of ICFR.

In addition, on July 25, 2007, we approved the PCAOB's Auditing Standard No. 5 ("AS No. 5"), which replaced AS No. 2. The new standard sets forth the professional standards and related performance guidance for independent auditors to attest to, and report on, management's assessment of the effectiveness of ICFR. Our management guidance, in combination with AS No. 5, is intended to make evaluations of ICFR and ICFR audits more effective and efficient by being risk-based and scalable to a company's size and complexity.

On February 1, 2008, we proposed a one-year extension of the Section 404(b) auditor attestation requirement for non-accelerated filers in view of the fact that there were still some additional actions that the Commission and PCAOB intended to take with respect to

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[16] See, for example, letters of American Electronics Association, International Association of Small Broker-Dealers and Advisers, Small Business Entrepreneurship Council, and the Silicon Valley Leadership Group, Committee on Capital Markets Regulation on Release No. 33-8762 (December 20, 2006) [71 FR 77635], File No. S7-24-06.

[17] Release No. 33-8810 (Jun. 20, 2007) [72 FR 35324].

[18] Release No. 33-8809 (Jun. 20, 2007) [72 FR 35310]. The rule amendments, among other things, provided that an evaluation that complies with our interpretive guidance is one way to satisfy the annual ICFR evaluation requirement in Exchange Act Rules 13a-15(c) and 15d-15(c) [17 CFR 240.13a-15(c) and 240.15d-15(c)].

implementation of the Section 404 requirements, and of concerns expressed by some about the orderly and efficient implementation of the ICFR requirements.[19]

One of these actions is the PCAOB's issuance of final staff guidance on auditing ICFR of smaller public companies. On October 17, 2007, the PCAOB published preliminary staff guidance that demonstrates how auditors can apply the principles described in AS No. 5 and provides examples of approaches to particular issues that might arise in the audits of smaller, less complex public companies.[20] Topics discussed in the PCAOB's guidance include: entity-level controls, risk of management override, segregation of duties and alternative controls, information technology controls, financial reporting competencies, and testing controls with less formal documentation. The comment period on the PCAOB's guidance ended on December 17, 2007, and the PCAOB is working on the final guidance.

Another action involves a study that we are undertaking to help determine whether our new management guidance on evaluating ICFR and AS No. 5 are having the intended effect of facilitating more cost-effective ICFR evaluations and audits for smaller reporting companies. Our study plan includes gathering new data from a broad array of companies about the costs and benefits of compliance with the ICFR requirements. The study will pay special attention to those smaller companies that are complying with the ICFR requirements for the first time.

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[19] See, for example, the May 8, 2007, letter to Chairman Christopher Cox and Chairman Mark Olson from Senator John Kerry, Chairman, Senate Committee on Small Business and Entrepreneurship, and Senator Olympia Snowe, Ranking Member, Senate Committee on Small Business and Entrepreneurship, available at http://sbc.senate.gov/lettersout/070508-SEC-PCAOB-HearingFollowUp.pdf; hearing on "Sarbanes-Oxley Section 404: New Evidence on the Costs for Small Businesses," House Committee on Small Business (December 12, 2007); and the July 12, 2007, letter from Sharon Haeger, America's Community Bankers, on Release No. 34-55876 [72 FR 32340], File No. PCAOB 2007-02, available at http://www.sec.gov/comments/pcaob-2007-02/pcaob200702.shtml.

[20] See "An Audit of Internal Control that is Integrated with an Audit of the Financial Statements: Guidance for Auditors of Smaller Companies," (October 17, 2007), available at www.pcaobus.org.

One part of the study will consist of a web-based survey of all companies to which the Section 404 requirements apply. Participation in this survey will be voluntary. Another part of the study will involve the Commission staff conducting in-depth interviews of a small number of interested parties. We are targeting the fall of 2008 for the initial release of findings.

We have received letters from a total of 67 commenters on the proposal to further extend the Section 404(b) auditor attestation requirement for non-accelerated filers.[21] Approximately half of the commenters supported the proposed one-year extension,[22] and half opposed a further delay in compliance with the Section 404(b) requirements by non-accelerated filers.[23] Many of the commenters that supported the proposed extension agreed that the one-year deferral was appropriate in light of our upcoming study. Absent the extension that we are granting in this release, many non-accelerated filers would have begun to incur independent auditor costs for fiscal years ending on or after December 15, 2008, before we had the opportunity to observe whether further action to improve the effectiveness and efficiency of Section 404 implementation is warranted. In addition, several commenters that supported the proposed extension also believed the extension was necessary to provide additional time for companies and their auditors to consider the PCAOB's guidance on the ICFR audits of smaller public companies.[24] Another

[21] The public comments we received are available for inspection in the Commission's Public Reference Room at 100 F Street, NE, Washington DC 20549 in File No. S7-06-03. They are also available on-line at http://www.sec.gov/rules/proposed/s70603.shtml. Of the 67 commenters, 49 were graduate and undergraduate students at the University of Wisconsin-La Crosse. More than half of the students opposed the proposed extension.

[22] See, for example, letters from the U.S. Chamber of Commerce, First National Bank of Groton (NY), Mark Hart, Independent Community Bankers of America ("ICBA"), International Association of Small Broker Dealers and Advisors ("IASBD"), Kyle Kaja, George Merkl, New York State Society of Certified Public Accountants ("NYSSCPA"), Melissa Palmer, Maria Romundstad, the Office of Advocacy of the Small Business Administration ("SBA"), Small Business and Entrepreneurship Council ("SBEC"), David Tews and Jordan Walt.

[23] See, for example, letters from Kevin Burgess, California Public Employees' Retirement System ("CalPERS"), Council of Institutional Investors ("CII"), Daniel DeGier, Christopher Fearn, Jared Galassini and Anna Wildenberg.

[24] See, for example, letters from the U.S. Chamber of Commerce, ICBA and Nicole Nederloe.

commenter,[25] while neither supporting nor opposing the proposed extension, suggested that the Commission should limit the extension to companies that qualify as a "smaller reporting company" under Exchange Act Rule 12b-2.[26]

Many of the commenters opposed to the proposed extension thought that non-accelerated filers have had adequate time to prepare for full compliance with the Section 404 requirements.[27] Several commenters opposed to the proposed extension also claimed that it was unnecessary for the Commission to undertake a study because several studies on the topic already have been completed, including some studies that reported evidence from surveys.[28]

We believe that an additional one-year deferral of the auditor attestation requirement is appropriate so that non-accelerated filers do not incur unnecessary compliance costs. An additional one-year deferral will allow these companies additional time to consider the PCAOB's guidance on ICFR audits of smaller public companies when it is finalized, as well as additional time for the auditors of non-accelerated filers to incorporate such guidance in their planning and conduct of their ICFR audits for 2009. The planned study is designed to elicit information on the

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[25] See letter from Ernst & Young LLP ("E&Y").

[26] See 17 CFR 240.12b-2. Although there is considerable overlap between companies that meet the definition of a "smaller reporting company" in Exchange Act Rule 12b-2 and companies that are non-accelerated filers because they fall outside the definitions of "accelerated filer" and "large accelerated filer," the terms "smaller reporting company" and "non-accelerated filer" are not synonymous. For example, a company that has publicly issued a class of debt securities, but does not have a class of equity securities outstanding would be a non-accelerated filer even though it may not meet the definition of a "smaller reporting company." Many companies that are debt-only issuers, however, are subsidiaries of larger public companies that meet the definition of accelerated filer or large accelerated filer. Therefore, we do not believe it necessary for purposes of this extension to make a distinction between non-accelerated filers and smaller reporting companies.

[27] See, for example, the letters from CII, Jared Galassini, Joshua Pike, and Jennifer Welsh.

[28] See, for example, the letters from CII and Michael Tolvstad.

recent compliance experiences of companies that is not available in the various earlier studies, including those that use evidence from surveys.[29]

II. EXTENSION OF AUDITOR ATTESTATION COMPLIANCE DATE FOR NON-ACCELERATED FILERS

After consideration of the public comments that were received, we are adopting the one-year extension of the auditor attestation report requirement substantially as proposed. We are amending Item 308T of Regulations S-K and S-B, Rule 2-02T of Regulation S-X, and Forms 10-Q, 10-K, 20-F and 40-F to require non-accelerated filers to provide their auditor's attestation in their annual reports filed for fiscal years ending on or after December 15, 2009. A non-accelerated filer will continue to be required to state in its management report on ICFR that the company's annual report does not include an auditor attestation report.[30]

In the Proposing Release, we also requested comment on whether management's report on ICFR should be "filed" rather than "furnished" and not be subject to liability under Section 18 of the Exchange Act[31] during the second year of a non-accelerated filer's compliance with the ICFR requirements under Section 404(a) if we adopted the proposed extension. Two commenters argued that we should discontinue treating the management report on ICFR as "furnished" rather than "filed" because the protection was not needed for the second year of the

[29] A key objective of the planned survey is to enable the Commission staff to evaluate any response bias that might cause the responses to over-represent the experiences of a particular sub-sample of companies, as opposed to the companies that are affected by the Section 404 requirements more generally.

[30] See Items 308T(a)(4) of Regulations S-K and S-B.

[31] Section 18 of the Exchange Act [15 U.S.C. 78r] imposes liability on any person who makes or causes to be made in any application or report or document filed under the Act, or any rule thereunder, any statement that "was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact." As a result of the temporary Item 308T of Regulation S-K and S-B and the temporary amendments to Forms 20-F and 40-F, however, during the applicable periods, management's report would be subject to liability under this section only in the event that a non-accelerated filer specifically states that the report is to be considered "filed" under the Exchange Act or incorporates it by reference into a filing under the Securities Act or the Exchange Act.

Section 404(b) extension[32] Three commenters believed that we should continue to allow the management report on ICFR of non-accelerated filers to be "furnished" rather than "filed" because non-accelerated filers should not be subject to liability under Section 18 until such time that they have had their ICFR attested to by their auditor.[33]

We recognize that a non-accelerated filer that files only a management report on ICFR may become subject to more second-guessing as a result of separating the management and auditor reports. Management may conclude that the company's ICFR is effective when the management report is filed without the auditor's attestation report, but the company's auditor may come to a contrary conclusion in its report filed in a subsequent year, and as a result, the company's previous assessment may be called into question. To reduce the liability risk associated with such second-guessing, we believe that until such time as non-accelerated filers are required to comply with both the Section 404(a) and 404(b) requirements, it is reasonable to continue the temporary liability distinction and treat the management report as "furnished" rather than "filed." Therefore, we also have decided to extend the amendments that cause a non-accelerated filer's management report on ICFR to be "furnished" rather than "filed." Of course, material misstatements or omissions in management's report on ICFR, regardless of whether the report is "furnished" or "filed," are subject to liability under Section 10(b) and Rule 10b-5 under the Exchange Act.[34]

The revised compliance dates for the Section 404 internal control requirements are presented in the table below:

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[32] See letters from CalPERS and E&Y.

[33] See letters from the U.S. Chamber of Commerce, CommBancorp, Inc. and George Merkl.

[34] See 15 U.S.C. 78j(b) and 17 CFR 240.10b-5.

Filer Status		Compliance Dates for the Internal Control Over Financial Reporting Requirements	
		Management report on ICFR	Auditor attestation on management's report on ICFR
U.S. Issuer	Non-accelerated filer (public float under $75 million)	Annual reports for fiscal years ending on or after December 15, 2007	Annual reports for fiscal years ending on or after December 15, 2009
U.S. Issuer	Large accelerated filer and accelerated filer (public float above $75 million)	Annual reports for fiscal years ending on or after November 15, 2004	Annual reports for fiscal years ending on or after November 15, 2004
Foreign private issuer	Non-accelerated filer (public float under $75 million)	Annual reports for fiscal years ending on or after December 15, 2007	Annual reports for fiscal years ending on or after December 15, 2009
Foreign private issuer	Accelerated filer (public float above $75 million and below $700 million)	Annual reports for fiscal years ending on or after July 15, 2006	Annual reports for fiscal years ending on or after July 15, 2007
Foreign private issuer	Large accelerated filer (public float above $700 million)	Annual reports for fiscal years ending on or after July 15, 2006	Annual reports for fiscal years ending on or after July 15, 2006
U.S. or Foreign private issuer	Newly public company	Second annual report	Second annual report

III. PAPERWORK REDUCTION ACT

In connection with our original proposal and adoption of the rules and amendments implementing the Section 404 requirements,[35] we submitted cost and burden estimates of the collection of information requirements of the amendments to the Office of Management and

[35] See Release No. 33-8138 (October 22, 2002) [67 FR 66208] and Release No. 33-8238 (June 5, 2003) [68 FR 36636].

Budget ("OMB"). We published a notice requesting comment on the collection of information requirements in the proposing release for the rule amendments. We submitted these requirements to the OMB for review in accordance with the Paperwork Reduction Act of 1995 ("PRA")[36] and received approval of these estimates. We do not believe that the amendments will result in any change in the collection of information requirements of the amendments implementing Section 404 and we received no comments suggesting the amendments would result in any change. Therefore, we are not revising our PRA burden and cost estimates submitted to the OMB.

IV. COST-BENEFIT ANALYSIS

A. Benefits

The amendments will postpone for one year the date by which a non-accelerated filer must begin to include in its annual report an auditor attestation report on management's assessment of internal control over financial reporting. As a result, non-accelerated filers will be required to complete only management's assessment in the first and second year of their compliance with the Section 404 requirements.

We are undertaking a study to help assess whether the new management guidance and AS No. 5 are having the intended effect of facilitating more effective and efficient ICFR evaluations and audits for smaller reporting companies. Our interpretive guidance for management and AS No. 5 were designed to make management evaluations and ICFR audits more effective and efficient. We believe that an additional one-year deferral of the auditor attestation report requirement will benefit investors in non-accelerated filers by helping those smaller companies avoid incurring unnecessary compliance costs as we determine whether further action to improve

[36] 44 U.S.C. 3501 et seq. and 5 CFR 1320.11.

the effectiveness and efficiency of Section 404 implementation is warranted. In addition, we believe that investors in non-accelerated filers may experience benefits from the following economic effects of the extension:

- Auditors of non-accelerated filers will have significantly more time to conform their ICFR audit approach to meet the requirements of AS No. 5, and to consider the PCAOB's guidance for auditors of smaller public companies;[37] and
- Non-accelerated filers will have additional time to focus on their approach for evaluating and reporting on the effectiveness of ICFR. This may facilitate their efforts to develop best practices and efficiencies in preparing the management report prior to becoming subject to the auditor attestation report requirement.

B. Costs

Under the amendments, investors in non-accelerated filers will have to wait longer than they would in the absence of the deferral for the assurances provided by the attestation report by the companies' auditor on management's report on ICFR. For example, several commenters expressed concern that the amendments may reduce investor confidence in non-accelerated filers.[38] However, we believe that the risk that some investors may lose confidence in non-accelerated filers is small because the management reports on ICFR of these companies, while not subject to liability under Section 18 of the Exchange, will continue to be subject to other liability provisions of the Exchange Act.

The amendments may also increase the risk that, without the auditor's attestation, some non-accelerated filers may erroneously conclude that the company's ICFR is effective, when an

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[37] Several commenters also noted this benefit. See, for example, letters from the Chamber of Commerce and ICBA.

[38] See letters from CalPERS, Hang Bui, John DeGoey, Jared Galassini, Stacy Lulloff, Anthony Morgan, Joshua Pike, Brandon Wagner and Jennifer Welsh.

ICFR audit might reveal that it is not effective. Two commenters argued the amendments could increase the risk that a weakness in a company's ICFR would not be detected or might be concealed from investors.[39] In addition, some companies may conduct an assessment that is not as thorough, careful and as appropriate to the company's circumstances as they would perform if the auditor were also conducting an audit of ICFR.

No commenter provided cost estimates for the proposed extension. Several commenters, however, referred to costs estimates prepared by a number of sources regarding the costs of Section 404 compliance generally.[40] As mentioned above, we are undertaking our own study in part because these prior cost estimates do not reflect the recent efforts to make Section 404 compliance more efficient.

V. CONSIDERATION OF IMPACT ON THE ECONOMY, BURDEN ON COMPETITION AND PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION

Section 23(a)(2) of the Exchange Act[41] requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. In addition, Section 2(b)[42] of the Securities Act and Section 3(f)[43] of the Exchange Act require us, when engaging in rulemaking where we are required to consider or determine whether an action is

[39] See letters from E&Y and Michael Tolvstad.

[40] See, for example, letters from CII and the SBA.

[41] 15 U.S.C. 78w(a).

[42] 15 U.S.C. 77b(b).

[43] 15 U.S.C. 78c(f).

necessary or appropriate in the public interest, to also consider whether the action will promote efficiency, competition, and capital formation.

We believe that the additional one-year delay of the auditor attestation report requirement will promote efficiency and capital formation by helping reduce inefficiencies and transition costs for non-accelerated filers. Several commenters stated that the proposed extension would help smaller companies reduce the overall costs associated with the ICFR requirements.[44] In addition, the delay will provide us with the opportunity to evaluate whether the new management guidance and AS No. 5 are having the intended effect of facilitating more effective and efficient ICFR evaluations and audits and to observe whether further action is needed to improve the effectiveness and efficiency of Section 404 before non-accelerated filers begin to incur costs. We expect the additional one-year deferral of the auditor attestation requirement to increase efficiency by providing more time for non-accelerated filers to prepare for compliance with the Section 404 requirements and by affording these companies and their auditors time to consider the PCAOB's small company ICFR audit guidance. Increased efficiency may promote capital formation and thereby benefit investors. However, we acknowledge that the deferral of the auditor attestation requirement may cause some investors to lose confidence in non-accelerated filers, which could make it more difficult for these companies to raise capital in the public markets.

It is possible that a competitive impact could result from the differing treatment of non-accelerated filers and larger companies that already have been complying with the Section 404 requirements, but we did not receive any comments suggesting that this type of impact has occurred as a result of the prior extension or otherwise specifically addressing the effect of the extension on competition.

[44] See, for example, letters from U.S. Chamber of Commerce and ICBA.

VI. FINAL REGULATORY FLEXIBILITY ANALYSIS

We have prepared this Final Regulatory Flexibility Analysis ("FRFA") in accordance with Section 603 of the Regulatory Flexibility Act.[45] This FRFA relates to amendments to the following temporary provisions: Item 308T of Regulations S-K and S-B, Rule 2-02T of Regulation S-X, Item 4T of Form 10-Q, Item 3A(T) of Form 10-QSB, Item 9A(T) of Form 10-K, Item 8A(T) of Form 10-KSB, Item 15T of Form 20-F, and Instruction 3T of General Instruction B.(6) of Form 40-F. Prior to these amendments, a non-accelerated filer was scheduled to start providing its auditor's attestation report on ICFR in its annual report for a fiscal year ending on or after December 15, 2008. We are amending these forms and temporary rules to require a non-accelerated filer to start providing the auditor attestation report on ICFR in its annual reports for fiscal years ending on or after December 15, 2009.

A. Reasons for, and Objectives of, the Amendments

The Commission is undertaking a study to assess whether the new management guidance and AS No. 5 are having the intended effect of facilitating more effective and efficient ICFR evaluations and audits for smaller reporting companies. We are amending our forms and temporary rules to defer implementation of the auditor attestation report requirement for non-accelerated filers for an additional year for the following primary reasons:

- To enable non-accelerated filers more time to gain efficiencies in management's evaluation of the effectiveness of internal control over financial reporting;
- To provide the Commission with time to review the findings of its study and to consider whether further action to improve the effectiveness and efficiency of Section 404 implementation is warranted;

[45] 5 U.S.C. 603.

- To provide the PCAOB time to promulgate its guidance for ICFR audits of smaller public companies in final form; and
- To provide the auditors of non-accelerated filers additional time to consider such guidance.

The amendments aim to further the goals of the Sarbanes-Oxley Act to enhance the quality of public company disclosure concerning the company's internal control over financial reporting and increase investor confidence in the financial markets.

B. Significant Issues Raised by Public Comment

In the Proposing Release, we requested comment on the number of small entity issuers that may be affected, the existence or nature of the potential impact and how to quantify the impact of the amendments. As mentioned above, several commenters believed that the extension would help smaller companies reduce the overall costs associated with the ICFR requirements,[46] but other commenters argued that a further delay may affect investor confidence in the ICFR of smaller companies.[47] We did receive data from the Office of Advocacy of the Small Business Administration on the general costs of compliance related to implementation of the Section 404 requirements.[48] However, this data did not address the costs of delayed implementation, and we are conducting our own study to assess the costs that reflect our recent efforts to make Section 404 compliance more efficient.[49]

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[46] See footnote 44 above.

[47] See footnote 38 above.

[48] See letter from SBA.

[49] The SBA also recommended that we use the results of our Section 404 study to update the Final Regulatory Flexibility Act analysis of the internal control reporting requirements included in the original 2003 release adopting the rules implementing Section 404 (Release No. 33-8238 [68 FR 36636]). In evaluating the efficiency and effectiveness of the Section 404 requirements, we will look to the results of our study, as well as other information.

C. Small Entities Subject to the Amendments

The amendments will affect some issuers that are small entities. Exchange Act Rule 0-10(a)[50] defines an issuer, other than an investment company, to be a "small business" or "small organization" if it had total assets of $5 million or less on the last day of its most recent fiscal year. We estimate that there are approximately 1,100 issuers, other than registered investment companies, that may be considered small entities. The amendments will apply to any small entity that is subject to reporting under either Section 13(a) or 15(d) of the Exchange Act. One commenter recommended that we use the definition of "smaller reporting company"[51] in Securities Act Rule 405[52] and Exchange Act Rule 12b-2[53] to define "small entity" for purposes of the FRFA.[54] Although, we are not proposing any amendments to the definition of small entity in Exchange Act Rule 0-10(a) at this time, we will consider in the future whether any revisions to this definition are warranted.

We will also consider the results of our study when we conduct a review under Section 610 of the Regulatory Flexibility Act

[50] 17 CFR 240.0-10(a).

[51] A "small reporting company" is defined as an issuer that is not an investment company, an asset-backed issuer (as defined in 17 CFR 229.1101), or a majority-owned subsidiary of a parent that is not a smaller reporting company and that: (1) Had a public float of less than $75 million as of the last business day of its most recently completed second fiscal quarter, computed by multiplying the aggregate worldwide number of shares of its voting and non-voting common equity held by non-affiliates by the price at which the common equity was last sold, or the average of the bid and asked prices of common equity, in the principal market for the common equity; or (2) In the case of an initial registration statement under the Securities Act or Exchange Act for shares of its common equity, had a public float of less than $75 million as of a date within 30 days of the date of the filing of the registration statement, computed by multiplying the aggregate worldwide number of such shares held by non-affiliates before the registration plus, in the case of a Securities Act registration statement, the number of such shares included in the registration statement by the estimated public offering price of the shares; or (3) In the case of an issuer whose public float as calculated under (1) or (2) was zero, had annual revenues of less than $50 million during the most recently completed fiscal year for which audited financial statements are available.

[52] 17 CFR 230.405.

[53] 17 CFR 240.12b-2.

[54] See letter from SBA.

D. Reporting, Recordkeeping, and other Compliance Requirements

The amendments will alleviate reporting and compliance burdens by postponing by an additional year the date by which non-accelerated filers must begin to comply with the auditor attestation report on ICFR in their annual reports.

E. Agency Action to Minimize Effect on Small Entities

The Regulatory Flexibility Act directs us to consider alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. In connection with the amendments, we considered the following alternatives:

- Establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- Clarifying, consolidating or simplifying compliance and reporting requirements under the rules for small entities;
- Using performance rather than design standards; and
- Exempting small entities from all or part of the requirements.

In connection with the amendments, we considered several of these alternatives. One commenter recommended that we should consider a two-year extension for larger non-accelerated filers and a three-year extension for non-accelerated filers that had market capitalizations of $25 million or less.[55] The amendments establish a different compliance and reporting timetable for non-accelerated filers and small entities from that of other companies.

As discussed above, the amendments are designed to allow non-accelerated filers to avoid incurring unnecessary compliance costs before we have the benefit of analyzing the results of our Section 404 study, and to provide non-accelerated filers and their auditors with time to

[55] See letter from IASBD.

consider, and integrate the concepts in the forthcoming PCAOB smaller company ICFR audit guidance. We anticipate that one year should adequate.

We believe that the amendments will promote the primary goal of enhancing the quality of reporting and increasing investor confidence in the fairness and integrity of the securities markets. Exempting small entities entirely from the requirements of Section 404(b) may be contrary to this goal.

An exemption from the amendments delaying compliance with the auditor attestation requirement, on the other hand, would be inconsistent with one of the goals of our study to determine whether further action to improve the effectiveness and efficiency of Section 404 implementation is warranted before smaller companies have begun to incur independent auditor costs to perform integrated audits of their financial statements and ICFR.

VII. STATUTORY AUTHORITY AND TEXT OF THE AMENDMENTS

The amendments described in this release are adopted under the authority set forth in Section 19 of the Securities Act, Sections 3, 12, 13, 15, 23 and 36 of the Exchange Act, and Sections 3(a) and 404 of the Sarbanes-Oxley Act.

List of Subjects

17 CFR Part 210

Accountants, Accounting, Reporting and recordkeeping requirements, Securities.

17 CFR Part 228

Reporting and recordkeeping requirements, Securities, Small businesses.

17 CFR Parts 229 and 249

Reporting and recordkeeping requirements, Securities.

TEXT OF AMENDMENTS

For the reasons set out in the preamble, the Commission is amending title 17, chapter II, of the Code of Federal Regulations as follows:

PART 210 - FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for Part 210 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w(a), 78ll, 78mm, 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37(a), 80b-3, 80b-11, 7202, 7218 and 7262, unless otherwise noted.

2. Section 210.2-02T is amended by:

a. Removing paragraphs (a) and (b), and redesignating paragraphs (c) and (d) as paragraphs (a) and (b);

b. Revising the date "December 15, 2008" in newly redesignated paragraph (a) to read "December 15, 2009"; and

c. Revising newly redesignated paragraph (b).

The revision reads as follows:

§210.2-02T Accountants' reports and attestation reports on internal control over financial reporting.

* * * * *

(b) This section expires on June 30, 2010.

PART 228 – INTEGRATED DISCLOSURE SYSTEM FOR SMALL BUSINESS ISSUERS

3. The authority citation for Part 228 continues to read, in part, as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77jjj, 77nnn, 77sss, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-29, 80a-30, 80a-37, 80b-11, and 7201 et seq., and 18 U.S.C. 1350.

* * * * *

4. Section 228.308T is amended by revising the "Note to Item 308T" and paragraph (c) to read as follows:

§228.308T (Item 308T) Internal control over financial reporting.

Note to Item 308T: This is a special temporary section that applies only to a fiscal period ending on or after December 15, 2007 but before March 15, 2009.

* * * * *

(c) This temporary Item 308T, and accompanying note and instructions, will expire on March 15, 2009.

PART 229 – STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975 – REGULATION S-K

5. The authority citation for Part 229 continues to read, in part, as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-9, 80a-20, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38(a), 80a-39, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

6. Section 229.308T is amended by revising the "Note to Item 308T" and paragraph (c) to read as follows:

§229.308T (Item 308T) Internal control over financial reporting.

Note to Item 308T: This is a special temporary section that applies only to a registrant that is neither a "large accelerated filer" nor an "accelerated filer" as those terms are defined in §240.12b-2 of this chapter and only with respect to a fiscal period ending on or after December 15, 2007, but before December 15, 2009.

* * * * *

(c) This temporary Item 308T, and accompanying note and instructions, will expire on June 30, 2010.

PART 249 – FORMS, SECURITIES EXCHANGE ACT OF 1934

7. The general authority citation for Part 249 is revised to read as follows:

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

* * * * *

8. Form 20-F (referenced in §249.220f), Part II, Item 15T is amended by:

a. Revising the date "December 15, 2008" in paragraph (2) to the "Note to Item 15T" to read "December 15, 2009"; and

b. Revising the date "June 30, 2009" in paragraph (d) to read "June 30, 2010".

Note: The text of Form 20-F does not, and this amendment will not, appear in the Code of Federal Regulations.

9. Form 40-F (referenced in §249.240f) is amended by:

a. Revising the date "December 15, 2008" in "Instruction 3T(2)" to the "Instructions to paragraphs (b), (c), (d) and (e) of General Instruction B.(6)" to read "December 15, 2009"; and

b. Revising the date "June 30, 2009" in the paragraph following "Instruction 3T" to the "Instructions to paragraphs (b), (c), (d) and (e) of General Instruction B.(6)" to read "June 30, 2010".

Note: The text of Form 40-F does not, and this amendment will not, appear in the Code of Federal Regulations.

10. Form 10-Q (referenced in §249.308a) is amended by revising Item 4T to Part I to read as follows:

Note: The text of Form 10-Q does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 10-Q

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PART I – FINANCIAL INFORMATION

* * * * *

Item 4T. Controls and Procedures.

(a) If the registrant is neither a large accelerated filer nor an accelerated filer as those terms are defined in §240.12b-2 of this chapter, furnish the information required by Items 307 and 308T(b) of Regulation S-K (17 CFR 229.307 and 229.308T(b)) with respect to a quarterly report that the registrant is required to file for a fiscal year ending on or after December 15, 2007, but before December 15, 2009.

(b) This temporary Item 4T will expire on June 30, 2010.

* * * * *

11. Form 10-QSB (referenced in §249.308b) is amended by revising Item 3A(T) to Part I to read as follows:

Note: The text of Form 10-QSB does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 10-QSB

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PART I – FINANACIAL INFORMATION

* * * * *

Item 3A(T). Controls and Procedures.

(a) Furnish the information required by Items 307 and 308T(b) of Regulation S-B (17 CFR 228.307 and 228.308T(b)) with respect to a quarterly report that the small business issuer is required to file for a fiscal year ending on or after December 15, 2007, but before October 31, 2008.

(b) This temporary Item 3A(T) will expire on October 31, 2008.

* * * * *

12. Form 10-K (referenced in §249.310) is amended by:

a. Revising the date "December 15, 2008" in paragraph (a) to Item 9A(T) to Part II to read "December 15, 2009"; and

b. Revising the date "June 30, 2009" in paragraph (b) to Item 9A(T) to Part II to read "June 30, 2010".

Note: The text of Form 10-K does not, and this amendment will not, appear in the Code of Federal Regulations.

13. Form 10-KSB (referenced in §249.310b) is amended by revising the dates "December 15, 2008" in paragraph (a), and "June 30, 2009" in paragraph (b) to Item 8A(T) to Part II to read "March 15, 2009".

Note: The text of Form 10-KSB does not, and this amendment will not, appear in the Code of Federal Regulations.

By the Commission.

Florence E. Harmon

Florence E. Harmon
Acting Secretary

June 26, 2008

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210, 229, and 249

[Release Nos. 33-8935; 34-58030; File No. S7-15-08]

RIN 3235-AK00

MODERNIZATION OF THE OIL AND GAS REPORTING REQUIREMENTS

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Commission is proposing revisions to its oil and gas reporting requirements which exist in their current form in Regulation S-K and Regulation S-X under the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as Industry Guide 2. The revisions are intended to provide investors with a more meaningful and comprehensive understanding of oil and gas reserves, which should help investors evaluate the relative value of oil and gas companies. In the three decades that have passed since adoption of these requirements, there have been significant changes in the oil and gas industry. The proposed amendments are designed to modernize and update the oil and gas disclosure requirements to align them with current practices and changes in technology. The proposed amendments would also codify Industry Guide 2 in Regulation S-K, with several additions to, and deletions of, current Industry Guide items. They would further harmonize oil and gas disclosures by foreign private issuers with the proposed disclosures for domestic issuers.

DATES: Comments should be received on or before [insert 60 days after publication in the Federal Register].

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

Document 40 of 48

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 S7-15-08 on the subject line; or
- Use the Federal e-Rulemaking Portal http://www.regulations.gov. Follow the instructions for submitting comments.

Paper comments:

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

All submissions should refer to File Number S7-15-08. 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/concept.shtml). Comments also are 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: Questions on this Proposing Release should be directed to Ray Be, Special Counsel, Office of Rulemaking at (202) 551-3430; Mellissa Campbell Duru, Attorney-Advisor, Dr. W. John Lee, Academic Petroleum

Engineering Fellow, or Brad Skinner, Senior Assistant Chief Accountant, Office of Natural Resources and Food at (202) 551-3740; Leslie Overton, Associate Chief Accountant, Office of Chief Accountant for the Division of Corporation Finance at (202) 551-3400, Division of Corporation Finance; or Mark Mahar, Associate Chief Accountant, or Jonathan Duersch, Assistant Chief Accountant, Office of the Chief Accountant at (202) 551-5300; U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3628.

SUPPLEMENTAL INFORMATION: We are proposing amendments to Rule 4-10[1] of Regulation S-X[2] and Items 102, 801 and 802[3] of Regulation S-K.[4] We also propose to add new Subpart 1200, including Items 1201 through 1209, to Regulation S-K.

TABLE OF CONTENTS

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[1] 17 CFR 210.4-10.

[2] 17 CFR 210.

[3] 17 CFR 229.102, 17 CFR 229.801, and 17 CFR 229.802.

[4] 17 CFR 229.

I. Introduction

A. Background

On December 12, 2007, the Commission published a Concept Release on possible revisions to the disclosure requirements relating to oil and gas reserves.[5] The release solicited comment on the oil and gas reserves disclosure requirements specified in Rule 4-10 of Regulation S-X[6] and Item 102 of Regulation S-K.[7] The Commission adopted these disclosure requirements in 1978 and 1982, respectively.[8] Since that time, there have been significant changes in the oil and gas industry and markets, including technological advances, and changes in the types of projects in which oil and gas companies invest their capital.[9] Prior to our issuance of the Concept Release, many industry participants had expressed concern that our disclosure rules are no longer in

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5 See Release No. 33-8870 (Dec. 12, 2007) [72 FR 71610].

6 17 CFR 210.4-10. See Release No. 33-6233 (Sept. 25, 1980) [45 FR 63660] (adopting amendments to Regulation S-X, including Rule 4-10). The precursor to Rule 4-10 was Rule 3-18 of Regulation S-X, which was adopted in 1978. See Accounting Series Release No. 253 (Aug. 31, 1978) [43 FR 40688]. See also Accounting Series Release No. 257 (Dec. 19, 1978) [43 FR 60404] (further amending Rule 3-18 of Regulation S-X and revising the definition of proved reserves).

7 Item 102 of Regulation S-K [17 CFR 229.102]. In 1982, the Commission adopted Item 102 of Regulation S-K. Item 102 contains the disclosure requirements previously located in Item 2 of Regulation S-K. See Release No. 33-6383 (March 16, 1982) [47 FR 11380]. The Commission also "recast . . . the disclosure requirements for oil and gas operations, formerly contained in Item 2(b) of Regulation S-K, as an industry guide." See Release No. 33-6384 (Mar. 16, 1982) [47 FR 11476].

8 The disclosure requirements were introduced pursuant to a directive in the Energy Policy and Conservation Act of 1975 (the "EPCA"). The EPCA directed the Commission to "take such steps as may be necessary to assure the development and observance of accounting practices to be followed in the preparation of accounts by persons engaged, in whole or in part, in the production of crude oil or natural gas in the United States." See 42 U.S.C. 6201-6422.

9 See, for example, Daniel Yergin and David Hobbs: "The Search for Reasonable Certainty in Reserves Disclosure," Oil and Gas Journal (July 18, 2005).

alignment with current industry practices and therefore have limited usefulness to the market and investors.[10]

B. Issuance of the Concept Release

The Concept Release addressed the potential implications for the quality, accuracy and reliability of oil and gas disclosure if the Commission were to:

- Revise the definition of "proved reserves" in our rules, in particular, the criteria used to assess and measure resources that can be classified as proved reserves; and
- Expand the categories of resources that may be disclosed in Commission filings to include resources other than proved reserves.

In addition, the Concept Release questioned whether our revised disclosure rules should be modeled on any particular resource classification framework currently being used within the oil and gas industry. We also asked how any revised disclosure rules could be made flexible enough to address future technological innovation and changes within the oil and gas industry. The Concept Release sought further comment on whether the Commission should require independent third party assessments of reserves estimates that a company includes in its filings.

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10 See, for example, Greg Courturier, "Standard & Poor's Urges SEC to Change Disclosure Rules," International Oil Daily (Dec. 3, 2007); Steve Levine, "Tracking the Numbers: Oil Firms Want SEC to Loosen Reserves Rules," Wall Street Journal Online (Feb. 7, 2006); Christopher Hope, "Oil Majors Back Attack on SEC Rules," The Daily Telegraph (London) (Feb. 24, 2005); Barrie McKenna, "Rules undervalue reserves report says: Volumes buried in Canada's oil sands not counted by SEC's measure," The Globe & Mail (Canada) (Feb. 24, 2005); and "Deloitte Calls on Regulators to Update Rules for Oil and Gas Reserves Reporting," Business Wire Inc. (Feb. 9, 2005).

In response to the Concept Release, commenters submitted 80 comment letters which addressed all or some of the 15 questions that were raised by the release.[11] We received comment letters from a variety of industry participants such as accounting firms, consultants, domestic and foreign oil and gas companies, federal government agencies, individuals, law firms, professional associations, public interest groups, and rating agencies.

C. General Overview of the Comment Letters Received on Key Issues

Almost all commenters supported some form of revision to the current oil and gas disclosure requirements, particularly given the length of time that has elapsed since the requirements were initially adopted. Commenters diverged significantly, however, in their views about the extent and type of revisions that we should make to our disclosure system. For example, commenters expressed varied opinions regarding whether we should adopt revisions that would result in a principles-based disclosure regime rather than a rules-based disclosure regime. Those who favored a principles-based approach noted that such an approach would be inherently more flexible than a rules-based approach and would allow for greater adaptability as technological advancements and changes occur in the industry.[12] Other commenters, however, expressed concern that a principles-based model is more subjective than a rules-based approach and could result in less consistent and comparable disclosure in the filings made by oil and gas companies.[13]

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11 The public comments we received are available for inspection in the Commission's Public Reference Room at 100 F St. NE , Washington, DC 20549 in File No. S7-29-07. They are also available on-line at http://www.sec.gov/comments/s7-29-07/s72907.shtml.

12 See, for example, letters from BHP Biliton Petroleum ("BHP"), John R. Etherington ("J. Etherington"), and White & Case, LLP ("White & Case").

13 See, for example, letters from Apache Corp. ("Apache"), Moody's Investor's Service ("Moody's) and Oil Change International and the Center for Corporate Policy ("Oil Change").

Virtually all of the commenters supported a revision of the definition of proved reserves in some form or another. Most remarked that the definition of proved reserves should be broadened to allow unconventional resources such as oil shales and bitumen to be classified as proved reserves.[14] In addition, while commenters were split on the use of a single fiscal year-end spot price to value the reserves held by an oil and gas company, a majority advocated the use of a different pricing standard to reduce the effects of short-term price volatility.[15]

There were mixed views on whether the Commission should permit disclosure of reserves other than proved reserves in Commission filings. Commenters supporting the inclusion of disclosures about probable and possible reserves in Commission filings suggested that such disclosure would allow investors to gain a more comprehensive understanding of the resources held by an oil and gas company.[16] Commenters opposing disclosure of probable and possible reserves thought that disclosure about these reserves categories would be less reliable than disclosure about proved reserves. Many of these

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14 See letters from American Association of Petroleum Geologists ("AAPG"), American Clean Skies Foundation ("ACSF"), Apache, American Petroleum Institute ("API"), Center for Audit Quality ("Audit Quality"), BP Plc ("BP,") Brookwood Petroleum Advisors Ltd. ("Brookwood"), CFA Institute Centre for Financial Market Integrity ("CFA"), Chesapeake Energy Corporation ("Chesapeake"), China National Offshore Oil Corporation ("CNOCC"), CIBC World Markets ("CIBC"), Denbury Resources ("Denbury"), Department of Energy ("DOE"), Deutsche Bank, Devon Energy Corporation ("Devon"), EnCana, Energy Information Administration (of DOE) ("EIA"), Energy Literacy Project ("Energy Literacy"), Eni S.p.A. ("Eni"), Ernst & Young ("E&Y"), J. Etherington, ExxonMobil, Grant Thornton, Imperial Oil Ltd. ("Imperial"), Independent Petroleum Association of America ("IPAA"), Dan Kelly ("D. Kelly"), McBride, Douglas-Morningstar Consultants ("D. McBride"), Moody's, Nexen Inc. ("Nexen"), Oil Change, Dan Olds ("D. Olds"), Petrobras, Petro-Canada, PriceWaterhouseCoopers ("PWC"), Robert Pinkerton ("R. Pinkerton"), Robinson Petroleum Consulting ("Robinson"), Ross Petroleum Ltd. ("Ross"), Derek Ryder ("D. Ryder"), Sasol Ltd ("Sasol"), Shell International ("Shell"), Society of Petroleum Engineers ("SPE"), Standard & Poor's ("S&P"), StatoilHydro, Total, S.A. ("Total"), Ashish Verma ("A. Verma"), Robert Wagner ("R. Wagner"), White & Case, and Fred Ziehe ("F. Ziehe").

15 See letters from Chesapeake, Devon, and Imperial.

16 See, for example, letters from Chesapeake, Oil Change, D. Olds, Ross, D. Ryder, and R. Wagner.

commenters were concerned about liability issues associated with such disclosure and the loss of comparability of disclosure between companies.[17]

Several of the comment letters addressed whether third parties should be required to independently evaluate the reserves reported by a company in its filings. There was a divergence in opinion on this issue. Some commenters suggested that an evaluation requirement is necessary to ensure the reliability of the reserves disclosure included in companies' filings.[18] Other commenters, however, believed that a company's internal staff is often in the best position to accurately evaluate the reserves of the company.[19] Some of the commenters that opposed a third-party evaluation requirement noted that there likely would be practical impediments to establishing that type of requirement, such as the lack of availability of qualified professionals to perform the evaluations and the lack of a regulatory or professional body to enforce universal standards that would govern the activities of third-party reserves evaluators or auditors.[20]

Finally, numerous commenters expressed support for the adoption of an alternate resource classification system that would allow for disclosure of a wider range of reserves and resources in Commission filings. Most of these commenters advocated the use of the Petroleum Resources Management System (PRMS) for this purpose.[21] PRMS

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17 See, for example, letters from Hugh Anderson ("H. Anderson"), Apache, API, ExxonMobil, Imperial, and Shell.

18 See letters from Fitch Ratings ("Fitch") and White & Case.

19 See letters from API, Denbury, ExxonMobil, Imperial, Nexen, Shell, and Talisman Energy ("Talisman").

20 See, for example, letters from the AAPG, API, Devon, and R. Wagner.

21 See comment letters from the API, Deloitte & Touche, LLP ("D&T"), DOE, ExxonMobil and Netherland, Sewell & Associates ("Netherland"). The Petroleum Resources Management System classification system defines a broad range of reserves categories, contingent resources and prospective resources. See Society of Petroleum Engineers, the World Petroleum Council,

was prepared in 2007 by the oil and gas reserves committee of the Society of Petroleum Engineers and jointly sponsored by the World Petroleum Council, the American Association of Petroleum Geologists and the Society of Petroleum Evaluation Engineers.[22] Other commenters proposed that we consider the rules adopted by regulators in Canada or the resource classification framework currently being created under the auspices of the United Nations Economic Commission for Europe and the United Nations Economic and Social Council in revising our rules.[23] We address the public comments on specific issues in more detail in the relevant sections below.

II. Revisions and Additions to the Definition Section in Rule 4-10 of Regulation S-X

A. Introduction

The proposed revisions and additions to the definition section in Rule 4-10 of Regulation S-X would update our reserves definitions to reflect changes in the oil and gas industry and markets and new technologies that have occurred in the decades since the current rules were adopted. Among other things, the proposed revisions to these

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American Association of Petroleum Geologists, and the Society of Petroleum Evaluation Engineers, Petroleum Resources Management System, SPE/WPC/AAPG/SPEE (2007).

22 See letters from AAPG, SPE, and the Society of Petroleum Evaluation Engineers ("SPEE"). See also Petroleum Resources Management System, SPE/WPC/AAPG/SPEE (2007).

23 See letters from Devon, Robinson, and White & Case. The Canadian system is outlined in National Instrument 51-101, "Standards of Disclosure for Oil and Gas Activities," and the related "Canadian Oil and Gas Evaluation Handbook." See http://www.albertasecurities.com/securitieslaw/Regulatory%20Instruments/5/2232/AMENDED%20NI%2051-101%20_FULL%20VERSION_.pdf. The United Nations Economic Commission for Europe and the United Nations Economic and Social Council are working together to establish an international classification system to classify resources in both the oil and gas and mining industries. See United Nations Framework Classification System for Fossil Energy and Mineral Resources, United Nations Economic Council For Europe (March, 2006) available at http://www.unece.org/ie/se/pdfs/UNFC/UNFCemr.pdf.

definitions address three issues that have been of particular interest to companies, investors, and securities analysts:

- The exclusion of activities related to the extraction of bitumen and other "non-traditional" resources from the definition of oil and gas producing activities;
- The limitations regarding the types of technologies that an oil and gas company may rely upon to establish the levels of certainty required to classify reserves; and
- The limitation in the current rules that permits oil and gas companies to disclose only their proved reserves.

In addition, the proposed revisions would change the use of single-day year-end pricing to determine economic producibility of oil and gas reserves. The proposed revisions of, and additions to, the Rule 4-10 definitions attempt to address these issues without sacrificing clarity and comparability, which provide protection and transparency to investors.

Many commenters on the Concept Release suggested that we adopt the PRMS definitions and classification system to the greatest extent possible.[24] They noted that PRMS is rapidly becoming the leading standard for international petroleum resources classifications. Others suggested that we adopt the definitions and classifications used in Canadian National Instrument 51-101 (NI 51-101), adopted in 2003, because they have

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24 See letters from API, BHP, Brookwood, CFA, China National Offshore Oil Corporation ("CNOOC"), CIBC World Markets ("CIBC"), D&T, Deutsche Bank, DOE, EIA, EnCana, Energy Literacy, Eni, ExxonMobil, Netherland, Newfield Exoploration ("Newfield"), D. Olds, Petrobras, Petro-Canada, Questar Market Resources ("Questar"), Sasol, Shell, Leigh Ann Smothers ("L.

been tested in practice as part of a regulatory framework and because they are broadly consistent with PRMS.[25]

We have based many of our proposed new and revised definitions classifications on both PRMS and NI 51-101. The language in NI 51-101 lends itself to a regulatory framework more easily than the language in PRMS, which is primarily a management tool, and we have been guided by the language in NI 51-101 in several instances. Although the proposed definitions are not totally consistent with either PRMS or NI 51-101, they are significantly more consistent with those standards than our existing rules.

One important difference between the proposed amendments and PRMS or NI 51-101 is that the proposed amendments would continue to require the use of historical prices and costs used to promote comparability. In contrast, NI 51-101 and PRMS afford a reserves estimator more flexibility in choosing among alternative pricing schedules. While this flexibility has its benefits, it impedes comparability of different companies' disclosures. Another significant difference is that the proposed amendments, like the current rules, would require reserves to be "economically producible," meaning that estimated revenues must exceed costs, whereas other classification systems require an extractive project to be "commercial," meaning that a company's investment evaluation guidelines must be met (for example, the extraction project rate of return must exceed some prescribed minimum). There are many different investment evaluation guidelines in use today. However, we believe that our proposed criteria would provide

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Smothers"), SPE, SPEE, Talisman, Total, TRACS International ("TRACS"), Ultra Petroleum Corporation ("Ultra"), White & Case, and Geoff Zakaib ("G. Zakaib").

25 See letters from Devon, Robinson, and White & Case. NI 51-101 constitutes the Canadian regulatory system for oil and gas company disclosures.

greater comparability among companies' disclosures so that investors can better understand the relative merits of their different investment choices.

In addition, NI 51-101 and PRMS provide definitions of various categories of resources beyond reserves, such as contingent and prospective resources, whereas our proposed rules do not. Given that we are not proposing to allow disclosure of resources that do not qualify as reserves in Commission filings, we are not proposing definitions of other various classifications of resources.

After considering the comments received on the Concept Release, we are proposing to revise the definition of proved reserves. Furthermore, as a result of those changes and also observations made by commenters, we are proposing to revise associated definitions and the disclosures made by issuers regarding the extent, characteristics, and location of their reserves.

B. Year-End Pricing

1. 12-month average price

Most commenters on the Concept Release recommended that we replace our current use of a single-day, fiscal year-end spot price to determine whether resources are economically producible based on current economic conditions with a different test.[26] Some believed that reliance on a single-day spot price is subject to significant volatility

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[26] See letters from AAPG, American Clean Skies Foundation ("ACSF"), H. Anderson, Apache, API, BHP, BP, Brookwood, Canadian Association of Petroleum Producers ("CAPP"), CFA, Chesapeake, CIBC CNOOC, Davis Family Energy Partners ("Davis"), Denbury, Deutsche Bank, Devon, EIA, EnCana, Energy Literacy, Eni, Etherington, J., ExxonMobil, Grant Thornton, Imperial, IPAA, Robbin Jones ("R. Jones"), D. Kelly, Long Consultants ("Long"), D. McBride, MIT Center for Energy and Environmental Policy Research ("MIT"), Moody's , Netherland, Newfield, Nexen, D. Olds, Oil Change, Petrobras, Petro-Canada, Robinson, Ross, D. Ryder, S&P, Sasol, Shell, Southwestern, SPE, StatoilHydro, Total, TRACS, Ultra, Walter van de Vijver ("W. van DeVijver"), R. Wagner, White & Case, and F. Ziehe.

and results in frequent adjustment of reserves.[27] These commenters expressed the view that variations in single-day prices provide temporary alterations in reserve quantities that are not meaningful or may lead investors to incorrect conclusions, do not represent the general price trend, and do not provide a meaningful basis for determination of reserve or enterprise value.[28]

Of those who commented on this issue, most recommended using a 12-month average price instead of the single-day price.[29] However, others recommended using one of the following alternative pricing options:

- A futures price or the average futures price over a specified period of time;[30]
- Management's forecasted price;[31]
- Average price over three months;[32]
- Average price over two years;[33] or

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27 See letters from API, Chesapeake, CIBC, ExxonMobil, Imperial, R. Jones, S&P, Ultra, and R. Wagner.

28 See letters from Chesapeake, Devon, and Imperial.

29 See letters from H. Anderson, Apache, API, BHP, BP, CAPP, Chesapeake, CIBC, CNOOC, Devon, DOE, EnCana, Eni, ExxonMobil Imperial, IPAA, R. Jones, D. McBride, Moody's, Netherland, Nexen, Oil Change, D. Olds, Petro-Canada, D. Ryder, Shell, StatoilHydro, Total, TRACS, R. Wagner, and F. Ziehe.

30 See letters from Apache, CFA, Chesapeake, Davis, EIA, IPAA, Southwestern, StatoilHydro, and TRACS.

31 See letters from AAPG, J. Etherington, Grant Thornton, Robinson, Ross, StatoilHydro, and W. van de Vijver.

32 See letter from CFA.

33 See letter from Deutsche Bank.

- Probabilistic future pricing with ranges and explanations for the pricing basis.[34]

Each of the options above, involving historical price averages, futures prices, futures price averages, and price forecasts developed, or relied on, by management, has advantages and disadvantages. For example, historical price averages provide a high level of comparability among oil and gas companies and are relatively easy to compute because the underlying data is readily available to companies. However, they may not reflect the prices that a company could reasonably expect to receive for its production in the future.

Prices based on oil and gas futures are forward-looking, and therefore may better approximate the economic value of the reserves as they are ultimately produced and sold. These prices, however, are not necessarily available for all products in all geographic areas and would require adjustments. To provide comparability of disclosures among oil and gas companies, we likely would have to specify certain private-sector publications for use in such pricing. Price forecasts developed by management of an oil and gas company would provide investors with better insight into the prices that management of the company foresees and, therefore, the prices upon which management bases its investment and operating decisions, but may provide limited comparability between companies.

We propose to revise the definitions in Rule 4-10 of Regulation S-X to change the price used in calculating reserves from a single-day closing price measured on the last day of the company's fiscal year to an average price for the 12 months prior to the end of

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34 See letter from Energy Literacy.

the company's fiscal year.[35] This pricing standard is consistent with the PRMS's default guidelines for the term "current economic conditions." This price would be calculated as the unweighted arithmetic average of the closing price on the last day of each month in that 12-month period. Using historical pricing maximizes comparability between companies, which is the primary objective of the oil and gas disclosure. This proposal is intended to maintain reserves disclosure comparability while mitigating the risk that an anomalous single pricing date will distort the proved reserves estimates. It therefore may provide a better basis for economic producibility than single-day pricing.

We recognize that use of historical pricing may not capture management's outlook on the future as well as futures prices or management's planning prices. As noted in detail elsewhere in this release,[36] in order to allow for such disclosures, we are proposing to add a disclosure item that would specifically permit an oil and gas company, at its option, to include a sensitivity case analysis in its filings that would show total reserves estimates based on futures prices, management's planning prices, or other price schedules in addition to the pricing mechanism specifically required.[37]

<u>Request for Comment</u>

- Should the economic producibility of a company's oil and gas reserves be based on a 12-month historical average price? Should we consider an historical average price over a shorter period of time, such as three, six, or

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35 See proposed Rule 4-10(a)(24)(v).

36 See Section III.B.3.ii of this release.

37 See proposed Item 1202(c).

nine months? Should we consider a longer period of time, such as two years? If so, why?

- Should we require a different pricing method? Should we require the use of futures prices instead of historical prices? Is there enough information on futures prices and appropriate differentials for all products in all geographic areas to provide sufficient reporting consistency and comparability?
- Should the average price be calculated based on the prices on the last day of each month during the 12-month period, as proposed? Is there another method to calculate the price that would be more representative of the 12-month average, such as prices on the first day of each month? Why would such a method be preferable?
- Should we require, rather than merely permit, disclosure based on several different pricing methods? If so, which different methods should we require?
- Should we require a different price, or supplemental disclosure, if circumstances indicate a consistent trend in prices, such as if prices at year-end are materially above or below the average price for that year? If so, should we specify the particular circumstances that would trigger such disclosure, such as a 10%, 20%, or 30% differential between the average price and the year-end price? If so, what circumstances should we specify?

2. Trailing year-end

Numerous commenters recommended the use of an average price over a period ending some time before the company's fiscal year end.[38] They noted that, with accelerated filing deadlines, it becomes difficult for the larger companies subject to those deadlines to make the required calculations accurately and with the best available data.[39] Most of these commenters recommended that the pricing period end three months prior to the end of the company's fiscal year (for example, a company with a December 31, 2007 fiscal year end, would use the average historical price for the period between October 1, 2006 and September 30, 2007 to calculate its reserves estimates).[40] We are not proposing such a lag in the time between the close of the pricing period and the end of the fiscal year. However, we solicit comment on this issue.

<u>Request for Comment</u>

- Should the price used to determine the economic producibility of oil and gas reserves be based on a time period other than the fiscal year, as some commenters have suggested? If so, how would such pricing be useful? Would the use of a pricing period other than the fiscal year be misleading to investors?
- Is a lag time between the close of the pricing period and the end of the company's fiscal year necessary? If so, should the pricing period close

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38 See letters from AAPG, API, BP, CAPP, CIBC, Deutsche Bank, EnCana, Eni, ExxonMobil, Imperial, D. McBride, Moody's Netherland, Nexen, D. Ryder, Shell, Total, R. Wagner, and F. Ziehe.

39 See letters from CAPP and Shell.

40 See letters from AAPG, API, BP, CAPP, CIBC, Deutsche Bank, EnCana, Eni, ExxonMobil, Imperial, D. McBride, Moody's, Netherland, Nexen, D. Ryder, Shell, Total, R. Wagner, and F. Ziehe.

one month, two months, three months, or more before the end of the fiscal year? Explain why a particular lag time is preferable or necessary. Do accelerated filing deadlines for the periodic reports of larger companies justify using a pricing period ending before the fiscal year end?

3. Prices used for accounting purposes

Notwithstanding our proposal to change the single-day, year-end pricing for the estimation of reserves, we are not proposing to change the prices that are used for accounting purposes. Specifically, companies using either the successful efforts accounting method described in Statement of Financial Accounting Standard No. 19 (SFAS 19) prescribed by the Financial Accounting Standards Board (FASB) or the full cost accounting method, set forth in Rule 4-10(c)[41] of Regulation S-X, would continue to depreciate property, plant, and equipment related to oil and gas producing activities using a units-of-production basis over proved developed reserves or proved reserves, as applicable, using single-day, year-end rates. In addition, companies using the full cost accounting method would continue to use the single-day, year-end rate for purposes of determining the limitation on capitalized costs (i.e., the ceiling test).

However, to provide consistency between the reserves disclosures required by proposed new Subpart 1200 and SFAS 69, we believe that the information required by SFAS 69 should be prepared using the average price as described above. This would result in two different presentations of proved reserves using two different economic producibility assumptions. For purposes of Subpart 1200, a company would use a value for proved reserves based on average prices. Conversely, for purposes of applying the

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41 17 CFR 210.4-10(c).

successful efforts method and the full cost accounting method, a company would use a value of proved reserves based on a single-day, year-end price. We intend to discuss such possible changes with FASB.

Request for Comment

- Should we require companies to use the same prices for accounting purposes as for disclosure outside of the financial statements?
- Is there a basis to continue to treat companies using the full cost accounting method differently from companies using the successful efforts accounting method? For example, should we require, or allow, a company using the successful efforts accounting method to use an average price but require companies using the full cost accounting method to use a single-day, year-end price?
- Should we require companies using the full cost accounting method to use a single-day, year-end price to calculate the limitation on capitalized costs under that accounting method, as proposed? If such a company were to use an average price and prices are higher than the average at year end or at the time the company issues its financial statements, should that company be required to record an impairment charge?
- Should the disclosures required by SFAS 69 be prepared based on different prices than the disclosures required by proposed Section 1200?
- If proved reserves, for purposes of disclosure outside of the financial statements, other than supplemental information provided pursuant to SFAS 69, are defined differently from reserves for purposes of

determining depreciation, should we require disclosure of that fact, including quantification of the difference, if the effect on depreciation is material?

- What concerns would be raised by rules that require the use of different prices for accounting and disclosure purposes? For example, is it consistent to use an average price to estimate the amount of reserves, but then apply a single-day price to calculate the ceiling test under the full cost accounting method? Would companies have sufficient time to prepare separate reserves estimates for purposes of reserves disclosure on one hand, and calculation of depreciation on the other? Would such a requirement impose an unnecessary burden on companies?
- Will our proposed change to the definitions of proved reserves and proved developed reserves for accounting purposes have an impact on current depreciation amounts or net income and to what degree?
- If we change the definitions of proved reserves and proved developed reserves to use average pricing for accounting purposes, what would be the impact of that change on current depreciation amounts and on the ceiling test? Would the differences be significant?

C. Extraction of Bitumen and Other Non-Traditional Resources

Our current definition of "oil and gas producing activities" explicitly excludes sources of oil and gas from "non-traditional" or "unconventional" sources, that is, sources that involve extraction by means other than "traditional" oil and gas wells.[42] These other sources include bitumen extracted from oil sands, as well as oil and gas extracted from coalbeds and shales, even though some of these resources are sometimes extracted through wells, as opposed to mining and surface processing. However, such sources are increasingly providing energy resources to the world due in part to advancements in extraction and processing technology.[43] As noted earlier, many commenters supported such disclosure.[44]

The proposed revised definition of "oil and gas producing activities" would include the extraction of the non-traditional resources described above.[45] The proposal is intended to shift the focus of the definition of oil and gas producing activities to the final product of such activities, regardless of the extraction technology used. The proposed definition would state specifically that oil and gas producing activities include the extraction of marketable hydrocarbons, in the solid, liquid, or gaseous state, from oil sands, shale, coalbeds[46] or other nonrenewable natural resources which can be upgraded

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42 See 17 CFR 210.4-10(a)(1)(ii)(D).

43 According to one commenter, some estimates indicate that such resources already provide 40% of the natural gas produced in the United States. See letter from Chesapeake Energy.

44 See letters from AAPG, ACSF, Apache, API, Audit Quality, BP, Brookwood, CFA, Chesapeake, CIBC, CNOOC, Denbury, Deutsche Bank, Devon, DOE, EIA, EnCana, Energy Literacy, Eni, J. Etherington, ExxonMobil, E&Y, Grant Thornton, Imperial, IPAA, D. Kelly, D. McBride, Moody's, Nexen, Oil Change, D. Olds, Petrobras, Petro-Canada, R. Pinkerton, PWC, Robinson, Ross, D. Ryder, S&P, Sasol, Shell, SPE, StatoilHydro, Total, A. Verma, R. Wagner, White & Case, and F. Ziehe.

45 See proposed Rule 4-10(a)(16).

46 Although the proposed definition would encompass activities such as extracting coalbed methane from a deposit of coal, it would not include the extraction of the coal itself, even if the company intends to use that coal as feedstock into processing activities that result in oil and gas products, such as coal gasification. We recognize that as technologies progress, it may become appropriate to include such processes as oil and gas producing activities.

into natural or synthetic oil or gas, and activities undertaken with a view to such extraction.

However, the proposed definition would continue to exclude activities relating to:

- Transporting, refining, processing (other than field processing of gas to extract liquid hydrocarbons), or marketing oil and gas;
- The production of natural resources other than oil, gas, or natural resources from which natural or synthetic oil and gas can be extracted; and
- The production of geothermal steam.

Consistent with historical treatment, we continue to believe that, once a resource is extracted from the ground, it should not be considered oil and gas reserves. Thus, the current definition of the term "oil and gas producing activities" does not, and the proposed definition would not, permit companies that only transport, process, and/or market oil or gas to disclose, as reserves, amounts of oil or gas received from, and extracted from the ground by, another company. In addition, if a company extracting the resources also builds its own processing plant on-site or near the extraction location (other than field processing of gas to extract liquid hydrocarbons), we do not believe it would be appropriate for that company to use the price of its processed product to determine the economic producibility of the unprocessed product. For example, if a company builds a bitumen processing plant to convert raw bitumen into synthetic crude oil, its calculation for the economic producibility of reserves from that location should be based on the prices for the raw bitumen, as though it were providing the bitumen to a third party processor. This will facilitate comparability among companies.

We recognize, however, that excluding the listed activities from the definition of "oil and gas producing activities" would not permit a company to reflect the result of building its own processing plant on the price estimates and other considerations that may be used in making the company's business decisions. Such a processing plant can significantly enhance the value of the upgraded product, enabling the company to use lower costs (or higher prices) in its internal decision-making. As noted elsewhere in this release, we are proposing to allow companies to voluntarily present an analysis of the sensitivity of reserves estimates based on varying prices, including the expected product prices used by management for its own planning purposes.[47] Such supplemental disclosure would permit companies to disclose other pricing and cost considerations, including advantages gained by internal processing of raw products that may add value to the final product sold by the company.

Request for Comment

- Should we consider the extraction of bitumen from oil sands, extraction of synthetic oil from oil shales, and production of natural gas and synthetic oil and gas from coalbeds to be considered oil and gas producing activities, as proposed? Are there other non-traditional resources whose extraction should be considered oil and gas producing activities? If so, why?
- The extraction of coal raises issues because it is most often used directly as mined fuel, although hydrocarbons can be extracted from it. As noted above, we propose to include the extraction of coalbed methane as an oil

47 See proposed Item 1202(c).

and gas producing activity. However, the actual mining of coal has traditionally been viewed as a mining activity. In most cases, extracted coal is used as feedstock for energy production rather than refined further to extract hydrocarbons. However, as technologies progress, certain processes to extract hydrocarbons from extracted coal, such as coal gasification, may become more prevalent. Applying rules to coal based on the ultimate use of the resource could lead to different disclosure and accounting implications for similar coal mining companies based solely on the coal's end use. How should we address these concerns? Should all coal extraction be considered an oil and gas producing activity? Should it all be considered mining activity? Should the treatment be based on the end use of the coal? Please provide a detailed explanation for your comments.

- Similar issues could arise regarding oil shales, although to a significantly less extent, because those resources currently are used as direct fuel only in limited applications. How should we treat the extraction of oil shales?
- If adopted, how would the proposed changes affect the financial statements of producers of non-traditional resources and mining producers?

D. Reasonable Certainty and Proved Oil and Gas Reserves

The current definition of the term "proved reserves" states that these reserves are "the estimated quantities of crude oil, natural gas, and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions."[48] Although "reasonable certainty" is, and has been, the standard used in the definition of proved oil and gas reserves, the current rules do not define that term. As a result, the meaning of the term "reasonable certainty" has been the subject of significant disagreement within the industry relating to the level of probability necessary to meet this standard. Although some believe that this standard is clear and has established a consistent guideline for establishing proved reserves,[49] others do not believe that this has been the case.[50] To avoid ambiguity, we propose to add a definition of the term "reasonable certainty" to Rule 4-10 of Regulation S-X.[51]

We propose to define the term "reasonable certainty" as "much more likely to be achieved than not." In addition, we would clarify that, when deterministic methods[52] are used to estimate oil and gas reserves, as changes due to increased availability of geoscience (geological, geophysical, and geochemical), engineering, and economic data are made to estimated ultimate recovery (EUR)[53] with time, reasonably certain EUR is much more likely to increase than to either decrease or remain constant. The proposed definition also would explain that, when probabilistic methods are used to estimate

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48 See Rule 4-10(a)(2) of Regulation S-X [17 CFR 210.4-10(a)(2)].

49 See letters from R. Jones and Moody's.

50 See letters from D. Olds, Raymond Schutte ("R. Schutte"), L. Smothers, R. Wagner, and Sir Philip Watts ("P. Watts").

51 See proposed Rule 4-10(a)(26).

52 See Section II.D.2 of this release for a discussion regarding deterministic methods and probabilistic methods.

53 We propose to define the term "estimated ultimate recovery" as the sum of reserves remaining as of a given date plus the cumulative production as of that date. See proposed Rule 4-10(a)(11).

reserves, reasonable certainty means that there is at least a 90% probability that the quantities actually recovered will equal or exceed the stated volume.[54]

<u>Request for Comment</u>

- Is the proposed definition of "reasonable certainty" as "much more likely to be achieved than not" a clear standard? Is the standard in the proposed definition appropriate? Would a different standard be more appropriate?
- Is the proposed 90% threshold appropriate for defining reasonable certainty when probabilistic methods are used? Should we use another percentage value? If so, what value?

1. New technology

The current rules limit the use of alternative technologies as the basis for determining a company's reserves disclosures. For example, under the current rules, a company generally must use actual production or flow tests to meet the "reasonable certainty" standard necessary to establish the proved status of its reserves. However, in the past, the Commission's staff has recognized that flow tests can be impractical in certain areas, such as the Gulf of Mexico, where environmental restrictions effectively prohibit these types of tests. The staff has not objected to disclosure of reserves estimates for these restricted areas using alternative technologies. Some commenters noted that a case-by-case exemption from the flow test requirement imposes unequal standards for establishing reasonable certainty based on geographic location.[55]

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[54] This is consistent with the PRMS definition of "proved reserves."

[55] See letters from Petrobras, D. Ryder, and White & Case.

In addition, we recognize that technology will continue to develop, improving the quality of information that can be obtained from existing tests and creating entirely new tests that we cannot yet envision. We propose to add a definition of the term "reliable technology" to Rule 4-10 of Regulation S-X to clarify the types of technology that can be used to establish reasonable certainty. We propose to define "reliable technology" as "technology (including computational methods) that, when applied using high quality geoscience and engineering data, is widely accepted within the oil and gas industry, has been field tested and has demonstrated consistency and repeatability in the formation being evaluated or in an analogous formation. Consistent with current industry practice, expressed in probabilistic terms, reliable technology has been proved empirically to lead to correct conclusions in 90% or more of its applications."[56]

The proposed definition is intended to permit broader use of new technologies to establish the proper classification for reserves and to lessen the need for frequent updates to our reserves definitions as technology continues to evolve. Because companies would now be able to select the technology that it uses, we are proposing to require a company to disclose the technology used to establish the appropriate level of certainty for material properties in a company's first filing with the Commission and for material additions to reserves estimates in subsequent filings.[57] Such disclosure should identify the particular portion of the reserves estimates for which a particular technology was used, including identification of the geographic area, country, field or basin to the extent necessary for

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56 See proposed Rule 4-10(a)(27).

57 See proposed Item 1202(a)(4) and proposed Item 1209(a)(2).

investors to determine whether use of that technology was appropriate under the circumstances.

Request for Comment

- Is our proposed definition of "reliable technology" appropriate? Should we change any of its proposed criteria, such as widespread acceptance, consistency, or 90% reliability?
- Is the open-ended type of definition of "reliable technology" that we propose appropriate? Would permitting the company to determine which technologies to use to determine their reserves estimates be subject to abuse? Do investors have the capacity to distinguish whether a particular technology is reasonable for use in a particular situation? What are the risks associated with adoption of such a definition?
- Is the proposed disclosure of the technology used to establish the appropriate level of certainty for material properties in a company's first filing with the Commission and for material additions to reserves estimates in subsequent filings appropriate? Should we require disclosure of the technology used for all properties? Should we require companies currently filing reports with the Commission to disclose the technology used to establish appropriate levels of certainty regarding their currently disclosed reserves estimates?

2. Probabilistic methods

We propose to add definitions of the terms "deterministic estimate" and "probabilistic estimate."[58] These two terms relate to the two alternative methods by which a company may estimate its reserves amounts. We understand that both methods are, to varying degrees, currently used by the industry. Our proposed definitions are consistent with industry practice. We propose to define the term "deterministic estimate" to mean an estimate that is based on using a single "most appropriate" value for each variable in the estimation of reserves, such as the company's determination of the oil or gas in place in a reservoir, multiplied by the fraction of that oil or gas that can be recovered. In addition, we propose to define the term "probabilistic estimate" as an estimate that is obtained when the full range of values that could reasonably occur from each unknown parameter (from the geoscience, engineering, and economic data) is used to generate a full range of possible outcomes and their associated probabilities of occurrence. Although companies currently can use either method to produce reserves estimates, we believe that these proposed definitions will promote consistent usage of the terms "probabilistic estimate" and "deterministic estimate."

Some of the commenters suggested that we require the use of probabilistic estimates to establish proved reserves because these methods are derived through extensive statistical computer calculations using a wide range of potential values for parameters that affect the reserves estimate, such as possible recovery factors for a

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58 See proposed Rules 4-10(a)(6) and (a)(19). These definitions are based on the Canadian Oil and Gas Evaluation Handbook (COGEH). This handbook was developed by the Calgary Chapter of the Society of Petroleum Evaluation Engineers and the Petroleum Society of CIM to establish standards to be used within the Canadian oil and gas industry in evaluating oil and gas reserves and resources.

particular field or type of field, and so would be more rigorous than deterministic methods.[59] Conversely, the quality of an estimate derived through deterministic methods depends more heavily on the experience and judgment of the reserves estimator to select the most appropriate value for those parameters. Although we recognize that probabilistic methods can be useful in certain circumstances, requiring the use of probabilistic estimates could significantly increase the costs of reserves estimate preparation, without significant increases in reliability of the results in many cases. One commenter was concerned that companies may not have sufficient staff to calculate all reserves estimates through probabilistic methods.[60] Thus, the proposed definition of "reasonable certainty" would continue to allow companies to estimate reserves amounts using either deterministic or probabilistic methods, leaving companies to determine which method is more appropriate for their particular situations.[61]

Request for Comment

- Are the proposed definitions of "deterministic estimate" and "probabilistic estimate" appropriate? Should we revise either of these definitions in any way? If so, how?
- Are the statements regarding the use of deterministic and probabilistic estimates in the proposed definition of "reasonable certainty" appropriate? Should we change them in any way? If so, how?

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59 See letters from AAPG, EIA, Long, D. Olds, Rose, and SPE.

60 See letter from D. Olds.

61 See proposed Rule 4-10(a)(26).

- Should an oil and gas company have the choice of using deterministic or probabilistic methods for reserves estimation, or should we require one method? If we were to require a single method, which one should it be? Why? Would there be greater comparability between companies if only one method was used?
- Should we require companies to disclose whether they use deterministic or probabilistic methods for their reserves estimates?

3. Other revisions related to proved oil and gas reserves

The current definition of the term "proved oil and gas reserves" also incorporates certain specific concepts such as "lowest known hydrocarbons" which limit a company's ability to claim proved reserves in the absence of information on fluid contacts in a well penetration,[62] notwithstanding the existence of other engineering and geoscientific evidence.[63] Consistent with our proposal to permit the use of new technologies to establish the reasonable certainty of proved reserves, the proposed revisions to the definition of "proved oil and gas reserves" also include provisions for establishing levels of lowest known hydrocarbons and highest known oil through reliable technology other than well penetrations.

Similarly, the proposed definition would permit a company to claim proved reserves beyond drilling units that immediately offset developed drilling locations if the company can establish with reasonable certainty that these reserves are economically

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62 In certain circumstances, a well may not penetrate the area at which the oil makes contact with water. In these cases, the company would not have information on the fluid contact and must use other means to estimate the lower boundary depths for the reservoir in which oil is located.

63 See Rule 4-10(a)(2)(i) [17 CFR 210.4-10(a)(2)(i)].

producible.[64] These revisions are designed to permit the use of alternative technologies to establish proved reserves in lieu of requiring companies to use specific tests. In addition, they would establish a uniform standard of reasonable certainty that could be applied to all proved reserves, regardless of location or distance from producing wells.

Finally, we propose adding a sentence to the definition that would state that, in order for reserves to be proved, the project to extract the hydrocarbons must have commenced or it must be reasonably certain that the operator will commence the project within a reasonable time. This revision is designed to prevent a company from including, in proved reserves, projects in undeveloped areas for which it does not have the intent to develop.

Request for Comment

- Should we permit the use of technologies that do not provide direct information on fluid contacts to establish reservoir fluid contacts, provided that they meet the definition of "reliable technology," as proposed?
- Should there be other requirements to establish that reserves are proved? For example, for a project to be reasonably certain of implementation, is it necessary for the issuer to demonstrate either that it will be able to finance the project from internal cash flow or that it has secured external financing?

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64 See proposed Rule 4-10(a)(24)(ii). See Section II.G for a more detailed discussion regarding this proposed revision.

E. Unproved Reserves—"Probable Reserves" and "Possible Reserves"

We propose to define the terms "probable reserves" and "possible reserves" because we are proposing to permit companies to disclose these categories of reserves estimates.[65] When producing an estimate of the amount of oil and gas that is recoverable from a particular reservoir, a company can make three types of estimates:

- An estimate that is reasonably certain;
- An estimate that is as likely as not to be achieved; and
- An estimate that might be achieved, but only under more favorable circumstances than are likely.

These three types of estimates are known in the industry as proved, probable, and possible reserves estimates. By proposing to permit disclosure of all three of these classifications of reserves, our objective is to enable companies to provide investors with more insight into the potential reserves base that managements of companies may use as their basis for decisions to invest in resource development.

Some commenters on the Concept Release were concerned that disclosing reserves categories that are less certain than proved reserves could increase the risk of confusion and litigation.[66] Therefore, we are proposing to make these disclosures voluntary.[67] Numerous oil and gas companies currently disclose unproved reserves on their Web sites and in press releases. This practice does not appear to have created confusion in the market. However, we understand commenters' concerns that probable

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65 See proposed Rule 4-10(a)(18) and (17), respectively.

66 See letters from Devon and Imperial.

67 See proposed Item 1202.

and possible reserves estimates are less certain than proved reserves estimates and so may create increased litigation risk. By making these disclosures voluntary, a company could decide on its own whether to provide the market with this disclosure, despite possible increased litigation risk. In addition, to address the concerns regarding the uncertainty of estimates of unproved reserves, we also are proposing to require disclosure about the person primarily responsible for preparing the company's reserves estimates and, if applicable, about the person primarily responsible for conducting a reserves audit.[68] The proposal would clarify that a "person" may be a business entity or an individual. We address this proposed disclosure in more detail in Section III.B.3.v of this release.

We propose to define the term "probable reserves" as those additional reserves that are less certain to be recovered than proved reserves but which, in sum with proved reserves, are as likely as not to be recovered.[69] The proposed definition would provide guidance for the use of both deterministic and probabilistic methods. The proposed definition would clarify that, when deterministic methods are used, it is as likely as not that actual remaining quantities recovered will equal or exceed the sum of estimated proved plus probable reserves. Similarly, when probabilistic methods are used, there should be at least a 50% probability that the actual quantities recovered will equal or exceed the proved plus probable reserves estimates. This proposed definition was derived from the PRMS definition of the term "probable reserves."

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68 See proposed Item 1202(a)(6).

69 See proposed Rule 4-10(a)(18).

Our proposed definition of "possible reserves" would include those additional reserves that are less certain to be recovered than probable reserves.[70] It would clarify that, when deterministic methods are used, the total quantities ultimately recovered from a project have a low probability to exceed the sum of proved, probable, and possible reserves. When probabilistic methods are used, there should be at least a 10% probability that the actual quantities recovered will equal or exceed the sum of proved, probable, and possible estimates. As with the proposed definition of probable reserves, the proposed definition of possible reserves is based on the PRMS definition of the term "possible reserves."

Request for Comment

- Should we permit a company to disclose its probable or possible reserves, as proposed? If so, why?
- Should we require, rather than permit, disclosure of probable or possible reserves? If so why?
- Should we adopt the proposed definitions of probable reserves and possible reserves? Should we make any revisions to those proposed definitions? If so, how should we revise them?
- Are the proposed 50% and 10% probability thresholds appropriate for estimating probable and possible reserves quantities when a company uses probabilistic methods? Should probable reserves have a 60% or 70% probability threshold? Should possible reserves have a 15% or 20% probability threshold? If not, how should we modify them?

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70 See proposed Rule 4-10(a)(17).

F. Definition of "Proved Developed Oil and Gas Reserves"

As noted above, we are proposing to expand the scope of oil and gas producing activities to include resources extracted by technologies other than traditional oil and gas wells, such as mining processes. Similarly, we propose to expand the definition of the term "proved developed oil and gas reserves" to include extraction of resources using technologies other than production through wells.[71] The proposed new definition would state that "proved developed oil and gas reserves" are proved reserves that:

- In projects that extract oil and gas through wells, can be expected to be recovered through existing wells with existing equipment and operating methods; and
- In projects that extract oil and gas in other ways, can be expected to be recovered through extraction technology installed and operational at the time of the reserves estimate.

<u>Request for Comment</u>

- Should we revise the definition of proved developed oil and gas reserves, as proposed? Should we make any other revisions to that definition? If so, how should we revise it?

G. Definition of "Proved Undeveloped Reserves"

1. Proposed replacement of certainty threshold

We propose to amend the definition of the term "proved undeveloped reserves" (PUDs) by replacing the requirement that productivity be "certain" for areas beyond the

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71 See proposed Rule 4-10(a)(22).

immediate area of known proved reserves with a "reasonably certain" requirement.[72] Currently, the definition of the term "proved undeveloped reserves" imposes a "reasonable certainty" standard for reserves in drilling units immediately adjacent to the drilling unit containing a producing well and a "certainty" standard for reserves in drilling units beyond the immediately adjacent drilling units.[73]

Some commenters believed that requiring "certainty" beyond offsetting, or adjacent, units is not appropriate.[74] They believed that there should be a single criterion—reasonable certainty—to characterize all proved reserves, including proved undeveloped reserves. Two commenters noted that the offsetting unit requirement is a purely mathematical and arbitrary standard for ease of calculation and does not reflect the actual geological characteristics of the reservoir.[75] Other commenters argued that PUDs should be determined by the totality of the engineering and geoscience data available, including seismic data, appropriate analogs, and assessment of reservoir characteristics.[76] One commenter believed that the "one offsetting unit" rule is outdated and does not acknowledge new technology.[77]

The proposed definition would permit the use of evidence gathered from reliable technology that establishes reasonable certainty of economic producibility at any distance from productive units (that is, in units adjacent to the productive units as well as units

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72 See proposed Rule 4-10(a)(25).

73 See 17 CFR 210.4-10(a)(4). A drilling unit refers to the spacing required between wells to prevent wasting resources and optimize recovery. These units are typically determined by the local jurisdiction.

74 See letters from AAPG, API, Denbury, Devon, and DOE.

75 See letters from CNOOC and Ultra.

76 See letters from API, Devon, DOE, and ExxonMobil.

77 See letter from Ultra.

beyond those adjacent units).[78] It would further clarify that proved reserves can be claimed in a conventional accumulation[79] or a continuous accumulation in a given area beyond immediately offset drilling units where economic producibility is reasonably certain, based on engineering, geoscience, and economic data and reliable technology, including actual drilling statistics in the area.[80] However, the proposed definition would prohibit a company from assigning proved status to undrilled locations if a development plan has not been adopted indicating that the locations are scheduled to be drilled within five years, unless it discloses unusual circumstances that justify a longer time, such as particularly complex projects in remote areas that require more time to develop.[81]

Request for Comment

- Are the proposed revisions appropriate? Would the proposed expansion of the PUDs definition create potential for abuses?
- Should we replace the current "certainty" threshold for reserves in drilling units beyond immediately adjacent drilling units with a "reasonable certainty" threshold as proposed?
- Is it appropriate to prohibit a company from assigning proved status to undrilled locations if the locations are not scheduled to be drilled more than five years, absent unusual circumstances, as proposed? Should the proposed time period be shorter or longer than five years? Should it be three years? Should it be longer, such as seven or ten years?

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78 See proposed Rule 4-10(a)(25)(i).

79 See Section II.G.2 for a discussion of continuous accumulations and conventional accumulations.

80 See proposed Rule 4-10(a)(25)(i)(B).

81 See proposed Rule 4-10(a)(25)(ii).

- Should the proposed definition specify the types of unusual circumstances that would justify a development schedule longer than five years for reserves that are classified as proved undeveloped reserves?

2. Proposed definitions for continuous and conventional accumulations

We propose to adopt definitions for the terms "continuous accumulations" and "conventional accumulations" to assist companies in determining the extent of PUDs associated with these two types of accumulations.[82] PUDs have caused estimation difficulties in the past. The fundamental difficulty in making these estimates is calculating the volume of a resource beyond the immediate area in which wells have been drilled (or beyond the immediate area in which other extraction technology has been installed and is operational) that should be included in the proved category. The answer can be vastly different for continuous accumulations, as opposed to conventional accumulations. Because of this potential difference, we believe that it is important to define these two distinct categories of accumulations in the proposed rules.

The proposed definition of "continuous accumulations" would encompass resources that are pervasive throughout large areas, have ill-defined boundaries, and typically lack or are unaffected by hydrocarbon-water contacts near the base of the accumulation.[83] Examples include, but are not limited to, accumulations of natural bitumen (oil sands), gas hydrates, and self-sourced accumulations such as coalbed methane, shale gas, and oil shale deposits. Typically, such accumulations require specialized extraction technology (e.g., removal of water from coalbed methane

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[82] See proposed Rule 4-10(a)(4) and (a)(5).

[83] See proposed Rule 4-10(a)(4).

accumulations, large fracturing programs for shale gas, steam, or solvents to mobilize bitumen for in-situ recovery, and, in some cases, mining activities). Moreover, the extracted petroleum may require significant processing prior to sale (e.g., bitumen upgraders). This proposed definition is based on the PRMS definition of the term "unconventional resources."

Conversely, we propose to define "conventional accumulations" as discrete oil and gas resources related to localized geological structural features or stratigraphic conditions, with the accumulation typically bounded by a hydrocarbon-water contact near its base, and which are significantly affected by the tendency of lighter hydrocarbons to "float" or accumulate above the heavier water.[84] This proposed definition is based on the PRMS definition of the term "conventional resources."

Request for Comment

- Should we provide separate definitions of conventional and continuous accumulations, as proposed? Would separate disclosure of these accumulations be helpful to investors?
- Should we revise our proposed definition of "continuous accumulations" in any way? For example, should the proposed definition provide examples of such accumulations? If so, how should we revise it?
- Should we revise our proposed definition of "conventional accumulations" in any way? If so, how should we revise it?

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[84] See proposed Rule 4-10(a)(5).

3. Proposed treatment of improved recovery projects

The proposed definition of proved undeveloped reserves also would be broadened to permit a company to include quantities of oil that can be recovered through improved recovery projects in its proved undeveloped reserves estimates. Currently, a company can include such quantities only where techniques have been proved effective by actual production from projects in the area and in the same reservoir. The proposed amendments would expand this definition to permit the use of techniques that have been proved effective by actual production from projects in an analogous reservoir in the same geologic formation in the immediate area or by other evidence using reliable technology that establishes reasonable certainty.[85]

Request for Comment

- Should we expand the definition of proved undeveloped reserves to permit the use of techniques that have been proven effective by actual production from projects in an analogous reservoir in the same geologic formation in the immediate area or by other evidence using reliable technology that establishes reasonable certainty?

H. Proposed Definition of Reserves

To add clarity to the definition of the term "proved reserves," we also propose to add a definition of the term "reserves."[86] We propose to describe more completely the criteria that an accumulation of oil, gas, or related substances must satisfy to be considered reserves (of any classification), including non-technical criteria such as legal

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85 See proposed Rule 4-10(a)(25)(iii).

86 See proposed Rule 4-10(a)(28).

rights. We propose to define reserves as the estimated remaining quantities of oil and gas and related substances anticipated to be recoverable, as of a given date, by application of development projects to known accumulations based on:

- Analysis of geoscience and engineering data;
- The use of reliable technology;
- The legal right to produce;
- Installed means of delivering the oil, gas, or related substances to markets, or the permits, financing, and the appropriate level of certainty (reasonable certainty, as likely as not, or possible but unlikely) to do so; and
- Economic producibility at current prices and costs.

The definition would clarify that reserves are classified as proved, probable, and possible according to the degree of uncertainty associated with the estimates. This proposed definition is based on the PRMS definition of the term "reserves."

Request for Comment

- Is the proposed definition of "reserves" appropriate? Should we change it in any way? If so, how?

I. Other Proposed Definitions and Reorganization of Definitions

We are proposing additional definitions primarily to support and clarify the proposed definitions of the key terms discussed above. These supplementary definitions include:

- "Analogous formation in the immediate area," which appears in the definition of proved reserves;[87]
- "Condensate";[88]
- "Development project";[89]
- "Estimated ultimate recovery," which appears in the definition of proved reserves;[90] and
- "Resources," which are often confused with reserves.[91]

Most of these supporting terms and their proposed definitions are based on similar terms in the PRMS. The proposed definition of "resources" is based on the Canadian Oil and Gas Evaluation Handbook (COGEH).

We also are proposing to alphabetize the definitional terms in Rule 4-10(a), including existing and proposed definitions. Currently, the terms defined in Rule 4-10(a) are organized by placing the key terms ahead of supporting terms. The proposals would significantly increase the number of terms defined in this section. With the proposed addition of numerous new definitions, we believe that alphabetizing these definitions would make specific definitions easier to find.

Request for Comment

- Are these additional proposed definitions appropriate? Should we revise them in any way?

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87 See proposed Rule 4-10(a)(2).

88 See proposed Rule 4-10(a)(3).

89 See proposed Rule 4-10(a)(8).

90 See proposed Rule 4-10(a)(11).

91 See proposed Rule 4-10(a)(30).

- Are there other terms that we have used in the proposal that need to be defined? If so, which terms and how should we define them?
- Should we alphabetize the definitions, as proposed? Would any undue confusion result from the re-ordering of existing definitions?

III. Proposed Amendments to Codify the Oil and Gas Disclosure Requirements in Regulation S-K

The Concept Release primarily solicited comment on certain key definitions in the oil and gas disclosure regime, and whether oil and gas companies should be permitted to disclose probable and possible reserves. In this release, we are proposing, and soliciting comment on, a broader scope of amendments. In particular, we are proposing to update and codify Securities Act and Exchange Act Industry Guide 2: Disclosure of Oil and Gas Operations (Industry Guide 2).[92] Industry Guide 2 sets forth most of the disclosures that an oil and gas company provides regarding its reserves, production, property, and operations. Regulation S-K references Industry Guide 2 in Instruction 8 to Item 102 (Description of Property), Item 801 (Securities Act Industry Guides), and Item 802 (Exchange Act Industry Guides). However, Industry Guide 2 itself does not appear in Regulation S-K or in the Code of Federal Regulations. We propose to codify the contents of Industry Guide 2 in Regulation S-K.

Included in the proposals are several new disclosure items that we believe are necessary in light of the proposed amendments to the definitions in Rule 4-10, such as disclosure of technology used to determine levels of certainty because we propose to permit companies to choose the appropriate technology for that purpose. We also are

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92 Exchange Act Industry Guide 2 merely references, and therefore is identical to, Securities Act Industry Guide 2.

proposing to eliminate several disclosures in Industry Guide 2 because we believe that they are no longer necessary, such as reporting of production through processing plant ownership. We address these proposals in detail below.

A. Proposed Revisions to Items 102, 801, and 802 of Regulation S-K

The instructions to Item 102 of Regulation S-K, in conjunction with Items 801 and 802 of Regulation S-K, currently reference the industry guides. Because we are proposing to move the disclosures from Industry Guide 2 into a new Subpart 1200 of Regulation S-K, we propose to revise the instructions to Item 102 to reflect this change.[93] We also propose eliminating the references in Items 801 and 802 to Industry Guide 2 because that industry guide will cease to exist if the proposals described in this release are adopted.[94]

In addition, Instruction 5 to Item 102 of Regulation S-K currently prohibits the disclosure of reserves other than proved oil and gas reserves. Because we are proposing to permit disclosure of probable and possible oil and gas reserves, we would revise Instruction 5 to limit its applicability to extractive enterprises other than oil and gas producing activities, such as mining activities.[95] Similarly, Instruction 3 of Item 102, regarding production, reserves, locations, development and the nature of the company's interests, would no longer need to apply to oil and gas producing activities if the proposals are adopted, so we also propose to limit that instruction to mining activities.[96]

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93 See proposed Instructions 4 and 8 to Item 102.

94 See proposed Item 801 and 802.

95 See proposed Instruction 5 to Item 102. Extractive enterprises include enterprises such as mining companies that extract resources from the ground.

96 See proposed Instruction 3 to Item 102.

Finally, we propose to eliminate Instruction 4 to Item 102 regarding the ability of the Commission's staff to request supplemental information, including reserves reports. This instruction is duplicative of Securities Act Rule 418[97] and Exchange Act 12b-4,[98] regarding the staff's general ability to request supplemental information.

Request for Comment

- Is the proposed amendment to Instruction 3, limiting it to extractive activities other than oil and gas activities, appropriate? Should we simply call them mining activities?
- Are there any other aspects of Item 102 that we should revise? If so, what are they and how should they be revised?

B. Proposed New Subpart 1200 to Regulation S-K Codifying Industry Guide 2 Regarding Disclosures by Companies Engaged in Oil and Gas Producing Activities

1. Overview

We are proposing to add a new Subpart 1200 to Regulation S-K that would codify the disclosure requirements related to companies engaged in oil and gas producing activities. This proposed subpart would largely include the existing requirements of Industry Guide 2. However, we have revised these requirements to update them, provide better clarity with respect to the level of detail required in oil and gas disclosures, including the geographic areas by which disclosures need to be made, and provide formats for tabular presentation of these disclosures. In addition, the proposed Subpart

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97 17 CFR 230.418.

98 17 CFR 240.12b-4.

1200 would contain the following new disclosure requirements, many of which have been requested by industry participants:

- Disclosure of reserves from non-traditional sources (i.e., bitumen, shale, coalbed methane) as oil and gas reserves;
- Optional disclosure of probable and possible reserves;
- Optional disclosure of oil and gas reserves' sensitivity to price;
- Disclosure of the development of proved undeveloped reserves, including those that are held for five years or more and an explanation of why they should continue to be considered proved;
- Disclosure of technologies used to establish additions to reserves estimates;
- Disclosure regarding material changes due to technology, prices, and concession conditions;
- Disclosure of the objectivity and qualifications of the business entity or individual preparing or auditing the reserves estimates;
- Filing a report prepared by the third party if a company represents that it is relying on a third party to prepare the reserves estimates or conduct a reserves audit; and
- Disclosure based on a new definition for the term "by geographic area."

We discuss each of these proposed new Items below.

2. Proposed Item 1201 (General instructions to oil and gas industry-specific disclosures)

We propose to add new Item 1201 to Regulation S-K. This item would set forth the general instructions to Subpart 1200. The proposed item would contain three paragraphs that would:

- Instruct companies for which oil and gas producing activities are material to provide the disclosures specified in Subpart 1200;[99]
- Clarify that, although a company must present specified Subpart 1200 information in tabular form, the company may modify the format of the table for ease of presentation, to add additional information or to combine two or more required tables; and
- State that the definitions in Rule 4-10(a) of Regulation S-X apply to Subpart 1200.

Request for Comment

- Are the proposed general instructions to Subpart 1200 clear and appropriate? Are there any other general instructions that we should include in this proposed Item?
- For disclosure items requiring tabulated information, should we require companies to adhere to a specified tabular format, instead of permitting companies to reorganize, supplement, or combine the tables?

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[99] This paragraph would maintain the existing exclusion in Industry Guide 2 for limited partnerships and joint ventures that conduct, operate, manage, or report upon oil and gas drilling or income programs, that acquire properties either for drilling and production, or for production of oil, gas, or geothermal steam or water.

- In particular, should we permit a company to disclose reserves estimates from conventional accumulations in the same table as it discloses its reserves estimates from continuous accumulations?

3. **Proposed Item 1202 (Disclosure of reserves)**

Existing Instruction 3 to Item 102 of Regulation S-K requires disclosure of an extractive enterprise's proved reserves. With respect to oil and gas producing companies, we are proposing to replace this Instruction by adding a new Item 1202 to Regulation S-K that would contain a similar disclosure requirement regarding a company's proved reserves.[100] However, the proposed new Item would expand on the requirements of Item 102 by specifically permitting the disclosure of probable and possible reserves and permitting the disclosure of reserves from continuous accumulations. Proposed Item 1202 would organize reserves disclosure into the following three tables:

- An oil and gas reserves from conventional accumulations table;
- An oil and gas reserves from continuous accumulations table; and
- An optional sensitivity analysis table.

i. **Oil and gas reserves tables**

Proposed Item 1202 would require disclosure, in the aggregate and by geographic area,[101] of reserves estimated using prices and costs under existing economic conditions, for each product type, in the following categories:

- Proved developed reserves;
- Proved undeveloped reserves;

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100 See proposed Item 1202.

101 See Section II.B.3.iv for a discussion about geographic area specificity.

- Total proved reserves;
- Probable reserves (optional); and
- Possible reserves (optional).

The proposed Item would provide for separate tables for reserves in conventional accumulations[102] and continuous accumulations.[103] However, a company may combine these two tables.[104] If a company does so, it must present different products in different columns. For example, because refining and processing, other than field processing of gas to extract liquid hydrocarbons, are not oil and gas producing activities, we believe that a company that extracts and processes oil sands into synthetic crude oil should report the first salable product, bitumen, as its reserves. The activity of processing bitumen into synthetic crude oil at a plant, even if on or near the extraction location, is a refining process. Forms of these two proposed tables are set forth below:

Summary of Oil and Gas Reserves in Conventional Accumulations as of Fiscal-Year End Based on Average Fiscal-Year Prices

	Reserves	
	Oil	Natural Gas
Reserves category	(mbbls)	(mmcf)
PROVED		
Developed		
Continent A		
Continent B		
15% Country A		
15% Country B		
10% Field A in Country B		
Other Fields in Country B		
Other Countries in Continent B		
Undeveloped		
Continent A		

102 See proposed Item 1202(a).

103 See proposed Item 1202(b).

104 See proposed Item 1201(b).

Continent B		
15% Country A		
15% Country B		
10% Field A in Country B		
Other Fields in Country B		
Other Countries in Continent B		
TOTAL PROVED		
PROBABLE		
POSSIBLE		

Summary of Oil and Gas Reserves from Continuous Accumulations as of Fiscal-Year End Based on Average Fiscal-Year Prices

	Reserves		
	Product A[105]	**Product B**	**Product C**
Reserves category	(measure)	(measure)	(measure)
PROVED			
Developed			
Country A			
Country B			
10% Field A in Country B			
Other Fields in Country B			
Undeveloped			
Country A			
Country B			
10% Field A in Country B			
Other Fields in Country B			
TOTAL PROVED			
PROBABLE			
POSSIBLE			

105 The product should be based on the product that is the result of the oil and gas producing activity, such as bitumen, which is extracted from oil sands.

A company may, but would not be required, to disclose probable or possible reserves in these tables. If a company discloses probable or possible reserves, it must provide the same level of geographic detail as with proved reserves. The proposal would require a company to update such reserves tables as of the close of each fiscal year. The table would be categorized by the products (Product A, Product B, etc.) that are the result of oil and gas producing activities. Thus, an oil and gas company should not disclose, as reserves, products that are not the result of oil and gas producing activities, including refined or processed products such as synthetic crude oil.[106] Of course, a company may provide supplemental disclosure regarding the amount of synthetic crude oil or other refined or processed product that may be extracted ultimately from the product of oil and gas producing activities. The proposal would also clarify that, if the company discloses amounts of a product in barrels of oil equivalent, it must disclose the basis for such equivalency.

The reserves to be reported in these proposed tables would be aggregations (to the company total level) of reserves determined for individual wells, reservoirs, properties, fields, or projects. Regardless of whether the reserves were determined using deterministic or probabilistic methods, the reported reserves should be simple arithmetic sums of all estimates at the well, reservoir, property, field, or project level within each reserves category.

The proposed items would require companies that previously have not disclosed reserves estimates in a filing with the Commission to disclose the technologies used to

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106 Rule 4-10(a)(16)(ii) specifically excludes from oil and gas producing activities refining and processing (other than field processing of gas to extract liquid hydrocarbons) of oil and gas.

establish the appropriate level of certainty for reserves estimates from material properties included in the total reserves disclosed. However, the particular properties would not need to be identified. Similarly, proposed Item 1209 would note that companies should discuss the technologies used to establish the appropriate level of certainty for material additions to, or increases in, reserves estimates.[107] The proposal would not require a company to disclose the technologies used to determine levels of certainty for reserves disclosed prior to effectiveness of the proposed amendments, if adopted, because the current definitions limit technologies to prescribed types, such as production or flow tests or actual observation of oil-water contacts in the wellbore.

If probable or possible reserves are disclosed, the proposed item would also require the company to disclose the relative risks related to such reserves estimations. Because we are proposing to permit disclosure of probable and possible reserves, an instruction to this proposed Item would revise existing Instruction 5 to Item 102 of Regulation S-K to continue to prohibit disclosure of estimates of oil or gas resources other than reserves, and any estimated values of such resources, in any document publicly filed with the Commission, unless such information is required to be disclosed in the document by foreign or state law.[108] We continue to believe that such resources are too speculative and may lead investors to incorrect conclusions. However, consistent with Instruction 5, a company could disclose such estimates in a Commission filing related to an acquisition, merger, or consolidation if the company previously provided those

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107 See proposed Item 1209.

108 See proposed Instruction 5 to Item 102.

estimates to a person that is offering to acquire, merge, or consolidate with the company or otherwise to acquire the company's securities.[109]

Request for Comment

- Should we permit companies to disclose their probable reserves or possible reserves? Is the probable reserves category, the possible reserves category (or both categories) too uncertain to be included as disclosure in a company's public filings? Should we only permit disclosure of probable reserves? What are the advantages and disadvantages of permitting disclosure of probable and possible reserves, from the perspective of both an oil and gas company and an investor in an oil and gas company that chooses to provide such disclosure? Would investors be concerned by such disclosure? Would they understand the risks involved with probable or possible reserves?
- Would the proposed disclosure requirements provide sufficient disclosure for investors to understand how companies classified their reserves? Should the proposed Item require more disclosure regarding the technologies used to establish certainty levels and assumptions made to determine the reserves estimates for each classification?
- Should companies be required to provide risk factor disclosure regarding the relative uncertainty associated with the estimation of probable and possible reserves?

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109 Id.

- Should we allow filers to report sums of proved and probable reserves or sums of proved, probable, and possible reserves? Or, to avoid misleading investors, should we allow only disclosure of each category of reserves by itself and not in sum with others, as proposed?
- Should we require disclosure of probable or possible reserves estimates in a company's public filings if that company otherwise discloses such estimates outside of its filings?
- Should we require all reported reserves to be simple arithmetic sums of all estimates, as proposed? Alternatively, should we allow probabilistic aggregation of reserves estimated probabilistically up to the company level? If we do so, will company reserves estimated and aggregated deterministically be comparable to company reserves estimated and aggregated probabilistically?
- Should we revise the proposed form and content of the table? If so, how should we revise the table's form or content?
- Should we eliminate the current exception regarding the disclosure of estimates of resources in the context of an acquisition, merger, or consolidation if the company previously provided those estimates to a person that is offering to acquire, merge, or consolidate with the company or otherwise to acquire the company's securities? If so, would this create a significant imbalance in the disclosures being made to the possible acquirer, as opposed to the company's shareholders?

ii. Optional reserves sensitivity analysis table

Our current rules require determining whether oil or gas is economically producible based on the price on the last day of the fiscal year. As discussed in Section II.B.1 above, this single-day price has been the subject of some criticism from commenters in the past because it is sensitive to short-term price volatility and does not account for seasonal variations in the prices of different products. Although we are proposing to require that reserves estimates be based on a 12-month average of historical prices, we are proposing to permit companies to include an optional reserves sensitivity analysis table in their filings that would show what the reserves estimates would be if based on different price and cost criteria, such as a range of prices and costs that may reasonably be achieved, including standardized futures prices or management's own forecasts. The company would be free to choose the different scenario or scenarios, if any, that it wishes to disclose in the table. If the company chooses to provide such disclosure, it would be required to disclose the price and cost schedules and assumptions on which the alternate reserves estimates are based. Similarly, companies should remember that Item 303 of Regulation S-K (Management's Discussion and Analysis of Financial Condition and Results of Operations)[110] requires discussion of known trends and uncertainties, which may include changes to prices and costs. A form of this optional reserves sensitivity analysis table is set forth below.

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[110] See Item 303 of Regulation S-K [17 CFR 229.303].

Sensitivity of Reserves to Prices
By Principal Product Type and Price Scenario

Price Case	Proved Reserves			Probable Reserves			Possible Reserves		
	Oil	Gas	Product A	Oil	Gas	Product A	Oil	Gas	Product A
	mbbls	mmcf	measure	mbbls	mmcf	measure	mbbls	mmcf	measure
Scenario 1									
Scenario 2									

Request for Comments

- Should we adopt such an optional reserves sensitivity analysis table? Would such a table be beneficial to investors? Is such a table necessary or appropriate?
- Should we require a sensitivity analysis if there has been a significant decline in prices at the end of the year? If so, should we specify a certain percentage decline that would trigger such disclosure?
- Should we revise the proposed form and content of the table? If so, how should we revise the table's form or content?
- As noted above in this release, SFAS 69 currently uses single-day, year-end prices to estimate reserves, while the reserves estimates in the proposed tables would be based on 12-month average year-end prices. If the FASB elects not to change its SFAS 69 disclosures to be based on 12-month average year-end prices, should we require reconciliation between the proposed Item 1202 disclosures and the SFAS 69 disclosures? What other means should we adopt to promote comparability between these disclosures?

iii. Geographic specificity with respect to reserves disclosures

There have been differing interpretations among oil and gas companies as to the level of specificity required when a company is breaking out its reserves disclosures based on geographic area as required by Instruction 3 of Item 102 of Regulation S-K.[111] Some companies currently broadly organize their reserves only by hemisphere or continent. SFAS 69 requires reserves disclosure to be separately disclosed for the company's home country and foreign geographic areas. It defines "foreign geographic areas" as "individual countries or groups of countries as appropriate for meaningful disclosure in the circumstances." Since SFAS 69 was issued, the operations of oil and gas companies have become much more diversified globally. For many large U.S. oil and gas producers, the majority of reserves are now overseas, with material amounts in individual countries and even individual fields or basins. We think that greater specificity than simply disclosing reserves within "groups of countries" would benefit investors and currently are necessary to meet the requirements of Item 102 of Regulation S-K, in cases where a particular country, sedimentary basin, or field constitutes a significant portion of a company's reserves, particularly if that country, sedimentary basin, or field is subject to unique risks, such as political instability. Thus, instructions to proposed Item 1202 would state that, in general, disclosures need only be broken out by continent, except where:

- A particular country contains 15% or more of the company's global oil reserves or gas reserves, or

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[111] 17 CFR 229.102.

- A particular sedimentary basin or field contains 10% or more of the company's global oil reserves or gas reserves.[112]

This proposed amendment would differ from the existing guidance in SFAS 69, which would permit disclosure based on broader geographic areas. In addition, under the proposals, a company would be permitted, but not required, to provide more detailed disclosure, such as countries or fields containing less than the specified percentages.

Request for Comment

- Should we provide the proposed guidance about the level of specificity required when a company discloses its oil and gas reserves by "geographic area"?
- Are the proposed 15% and 10% thresholds appropriate? Should either, or both, of these percentages be different? For example, should both be 15%? Should both be 10%? Would 5% or 20% be a more appropriate threshold for either or both?
- What would be the impact to investors if companies are permitted to omit disclosures based on the individual field or basin due to concerns related to competitive sensitivities? Would investors be harmed if disclosure based on the individual field or basin is omitted due to concerns related to competitive sensitivities? Is there a better way to provide disclosure that a company heavily dependent on a particular field or basin may be subject to risks related to the concentration of its reserves?

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112 See proposed Instruction to Item 1202.

- Would greater specificity cause competitive harm? Is so, how can the rules mitigate the risk of harm?
- In the event that the FASB does not amend SFAS 69, should we require companies to supplement their SFAS 69 disclosure with greater geographic specificity? If the FASB does not amend SFAS 69, should we require that companies reconcile the differences between the reserves estimates shown in the SFAS 69 disclosure with the estimates presented in the proposed tables?

iv. Separate disclosure of conventional and continuous accumulations

Under proposed Item 1202, companies would be required to disclose reserves from conventional accumulations separately from reserves in continuous accumulations. Several commenters on the Concept Release believed that it is important to disclose such reserves separately.[113] Although proposed Item 1201 would permit a company to combine these two tables, it would not permit a company to combine columns of different tables. Thus, for example, if a company decided to combine the two tables, it would have to represent reserves in conventional natural gas reservoirs separately from gas reserves in coalbeds or gas shales.

Request for Comment

- Should we require separate disclosure of conventional accumulations and continuous accumulations, as proposed?

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113 See letters from Brookwood, D. McBride, Moody's, and Oil Change.

- Should we permit combining of columns if the product of the oil and gas producing activity is the same, such as natural gas, regardless of whether the reserves are in conventional or continuous accumulations?

v. Preparation of reserves estimates or reserves audits

In the Concept Release, we sought comment on whether the rules should require a company to retain an independent third party to prepare, or conduct a reserves audit on, the company's reserves estimates. Most commenters urged the Commission not to adopt such a requirement.[114] Some believed that a company's internal staff, particularly at larger companies, is in a better position to prepare those estimates.[115] In addition, commenters pointed out a potential lack of qualified third party engineers and other professionals to conduct the increase in work that would need to be accomplished if we adopted such a requirement.[116] Others were concerned about the added costs that would be associated with such a requirement.[117] However, some commenters believed that the participation of an independent third party would provide heightened assurance regarding the accuracy of the reserves estimates.[118]

In light of the commenters' concerns, we are not proposing to require an independent third party to prepare the reserves estimates or conduct a reserves audit. However, several commenters noted that it is important that persons preparing or auditing

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114 See letters from API, BHP, BP, CFA, CNOOC, Denbury, Devon, Eni, Energy Literacy, ExxonMobil, Imperial, R. Jones, D. McBride, Newfield, Nexen, Petro-Canada, Ross, D. Ryder, Sasol, Shell, Talisman, Total, and W. van de Vijver.

115 See letters from API, Denbury, ExxonMobil, Imperial, Nexen, Shell, and Talisman.

116 See letters from AAPG, API, BP, Devon, ExxonMobil, Imperial, D. McBride, Newfield, D. Ryder, and Sasol.

117 See letters from Sasol and Nexen.

118 See letters from CIBC, EnCana, Fitch, D. Kelly, Petrobras, Robinson, Ultra, and White & Case.

the reserves estimates be objective and qualified to perform the work that they are doing.[119] In addition, because we are proposing to broaden permissible technologies for establishing levels of certainty of reserves, we believe that the proper application of such technologies in particular situations requires a heightened level of judgment. Therefore, we propose to require disclosure regarding the qualifications of the person primarily responsible for preparing the reserves estimates or, if the company represents that a reserves audit was conducted, conducting a reserves audit.[120] In addition, we propose to require disclosure regarding the objectivity of third parties that conduct such service for an oil and gas company and measures taken to assure the independence and objectivity of employees. We based these qualifications largely on the reserves audit guidance of the Society of Petroleum Engineers (SPE).[121] In particular, we propose to require the company to disclose the following information about the technical person[122] primarily responsible for preparing the reserves estimate or, if the company represents that such a reserves audit was conducted, conducting the reserves audit:

(1) If the person is an employee of the company,

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119 See letters from Brookwood, Denbury, D. McBride, Petro-Canada, Robinson, and Total.

120 See proposed Item 1202(a)(6).

121 See Standards Pertaining to the Estimating and Auditing of Oil and Gas Reserves Information of the SPE (SPE Reserves Auditing Standards).

122 With regard to the objectivity of a technical person, the "person" could be an individual or an entity, as appropriate. However, with regard to the qualifications of a person, the disclosure would relate to the individual who is primarily responsible for the technical aspects of the reserves estimation or audit. Thus, this individual is not necessarily the individual generally overseeing the estimation or audit, but the individual who is primarily responsible for the actual calculations and estimation or audit.

- The fact that an employee of the company had primary responsibility for preparing the reserves estimate (but the employee would not have to be identified); and
- Measures taken to assure the independence and objectivity of the estimate;

(2) If the person is not an employee of the company,

- The identity of the person;
- The nature and amount of all work that the person has performed for the company during the past three fiscal years, other than preparing the reserves estimate or conducting the reserves audit, as well as all compensation and fees (in any form) paid to that person for all such services; and
- Whether the person has any other interests in the company or other conflict of interests;

(3) Whether the person (regardless of whether an employee or third party) primarily responsible for the estimating or auditing of reserves:

- Has a minimum of three years of practical experience in petroleum engineering or petroleum production geology, with at least one full year of this experience being in the estimation and evaluation of reserves if the person was in charge of preparing the reserves estimates;
- Has a minimum of ten years of practical experience in petroleum engineering or petroleum production geology, with at least five

years of this experience being in the estimation and evaluation of reserves and the conducting of reserves audits if that person conducted a reserves audit of the registrant's reserves estimates;

- Has received, and is maintaining in good standing, a registered or certified professional engineer's license or a registered or certified professional geologist's license, or the equivalent thereof, from an appropriate governmental authority or a recognized self-regulating professional organization; and
- Has a bachelor's or advanced degree in petroleum engineering, geology, or other discipline of engineering or physical science, and if so, the specific degree earned by the person; and

(4) Any memberships, in good standing, of the person (regardless of whether an employee or third party) with a self-regulatory organization of engineers, geologists, other geoscientists, or other professionals whose professional practice includes reserves evaluations or reserves audits, that:

- Admits members primarily on the basis of their educational qualifications;
- Requires its members to comply with the professional standards of competence and ethics prescribed by the organization that are relevant to the estimation, evaluation, review, or audit of reserves data; and
- Has disciplinary powers, including the power to suspend or expel a member.

For purposes of the proposed disclosure, the "person" could be either an individual or an entity. If the person is an entity, then the disclosures regarding technical qualifications in the paragraphs (3) and (4) would apply to the individual within the entity who is responsible for the technical aspects of the reserves estimation or audit. To the extent that the person does not have all of the technical qualifications above, the company would be required to discuss the reasons why it believes that the person is otherwise qualified to prepare the estimates or conduct the reserves audit, as applicable, and any risks associated with reserves estimates not prepared or audited by persons with such qualifications.[123]

Request for Comments

- Should we require companies to disclose whether the person primarily responsible for preparing reserves estimates or conducting reserves audits meets the specified qualification standards, as proposed? Should we, instead, simply require companies to disclose such a person's qualifications?
- Should we require disclosure regarding a person's objectivity when a company prepares its reserves estimates in-house? Should the proposed disclosures regarding objectivity be required only if a company hires a third party to prepare its reserve estimates or conduct a reserves audit, as proposed?
- If a company prepares its reserves estimates in-house, should we require disclosure of any procedures that the company has taken to preserve that

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123 See proposed Item 1202(a)(6)(v).

person's objectivity? Should we require disclosure of whether the internal person meets specified objectivity criteria? For example, should we apply the some of the same criteria that we propose to apply to third party preparers? If so, which ones?

- Consistent with the SPE's auditing guidance regarding internal auditors, should we require companies to disclose whether that person (1) is assigned to an internal-audit group which is (a) accountable to senior level management or the board of directors of the company and (b) separate and independent from the operating and investment decision making process of the company and (2) is granted complete and unrestricted freedom to report, to one or more principal executives or the board of directors, any substantive or procedural irregularities of which that person becomes aware?
- Should we require disclosure with other specific independence or objectivity standards and, if so, what?
- Should we revise any of the proposed provisions regarding a person's objectivity or technical qualifications? Should the proposal require disclosure of other criteria that would have bearing on determining whether the person is objective or qualified?
- Should a company be required to present risk factor disclosure if its reserves estimates were not prepared by a person meeting the objectivity and technical qualifications?

- Because of the inherent uncertainty regarding estimates of probable and possible reserves, should we require the proposed disclosure only if a company chooses to disclose probable or possible reserves?
- Should we require that a third party prepare reserves estimates or conduct a reserves audit if a company chooses to disclose probable or possible reserves estimates?
- Should we require the proposed disclosure only if the company is using technologies other than those which are allowed in our current definitions to establish levels of certainty?

vi. Contents of third party preparer and reserves audit reports

Currently, if the company represents that it relied on a third party for a portion of its filing, it must obtain consent from that third party.[124] In order to clarify which portion of the disclosures the third party is expertising, we propose that, if a company represents that its estimates of reserves are based on estimates prepared by a third party, the company must file a report of the third party as an exhibit to the relevant registration statement or report.[125] The proposal would require that report to include the following disclosure:

- The purpose for which the report is being prepared and for whom it is prepared;
- The effective date of the report and the date on which the report was completed;

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124 See 17 CFR 229.601(b)(23).

125 See proposed Item 1202(a)(7).

- The proportion of the company's total reserves covered by the report and the geographic area in which the covered reserves are located;
- The assumptions, data, methods, and procedures used to conduct the reserves audit, including the percentage of company's total reserves reviewed in connection with the preparation of the report, and a statement that such assumptions, data, methods, and procedures are appropriate for the purpose served by the report;
- A discussion of primary economic assumptions;
- A discussion of the possible effects of regulation on the ability of the registrant to recover the estimated reserves;
- A discussion regarding the inherent risks and uncertainties of reserves estimates;
- A statement that the third party has used all methods and procedures as it considered necessary under the circumstances to prepare the report; and
- The signature of the third party.

Similarly, if the company represents that a third party conducted a reserves audit of the reserves estimates, the company would be required to file a report of the third party as an exhibit to the relevant registration statement or report. We are not proposing that these reports be the full "reserves report" that is often very detailed and voluminous. Rather these proposed reports would summarize the scope of work performed by, and conclusions of, the third party. The proposed contents of these reports mirror the guidance issued by the Society of Petroleum Evaluation Engineers regarding the preparation of such reports.

We propose to define the term "reserves audit" as the process of reviewing certain of the pertinent facts interpreted and assumptions made that have resulted in an estimate of reserves prepared by others and the rendering of an opinion about the appropriateness of the methodologies employed, the adequacy and quality of the data relied upon, the thoroughness of the reserves estimation process, the classification of reserves appropriate to the relevant definitions used, and the reasonableness of the estimated reserves quantities.[126] The proposed definition would state that, in order to disclose that a "reserves audit" has been conducted, the report resulting from this review must represent an examination of at least 80% of the portion of the company's reserves covered by the reserves audit. This definition is largely derived from the SPE's reserves auditing guidelines.[127]

We propose to require that the report associated with such a reserves audit must include the following disclosure, based on the Society of Petroleum Evaluation Engineers's audit report guidelines:

- The purpose for which the report is being prepared and for whom it is prepared;
- The effective date of the report and the date on which the report was completed;
- The proportion of the company's total reserves covered by the report and the geographic area in which the covered reserves are located;

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126 See proposed Item 1202(a)(9).

127 Consistent with the SPE's auditing guidelines, we note that a "reserves audit" is significantly different from a financial audit. See SPE Reserves Auditing Standards.

- The assumptions, data, methods, and procedures used to conduct the reserves audit, including the percentage of company's total reserves reviewed in connection with the preparation of the report, and a statement that such assumptions, data, methods, and procedures are appropriate for the purpose served by the report;
- A discussion of primary economic assumptions;
- A discussion of the possible effects of regulation on the ability of the registrant to recover the estimated reserves;
- A discussion regarding the inherent risks and uncertainties of reserves estimates;
- A statement that the third party has used all methods and procedures as it considered necessary under the circumstances to prepare the report;
- A brief summary of the third party's conclusions with respect to the reserves estimates; and
- The signature of the third party.

Request for Comment

- Should we require a company to file reports from third party reserves preparers and reserves auditors containing the proposed disclosure when the company represents that a third party prepared its reserves estimates or conducted a reserves audit? As an alternative, should we not require that the third party's report be filed, but that the company must provide a description of the third party's report? If so, should we specify that the company's description of the third party's report should contain the information that we propose to require in the third party's report?

- Should we specify the disclosures that need to be included in third party reports? If so, is the disclosure that we have proposed for the reserves estimate preparer's and reserves auditor's reports appropriate? Should these reports contain more or less information? If they should include more information, what other information should they include? If less, what proposed information is not necessary?
- In an audit, should we specify the minimum percentage of reserves that should be examined and determined to be reasonable? If so, what should that percentage be? Should it be 50%, 75%, 90% or some other percentage? If so, why?
- If the company engages multiple third parties to conduct reserves audits on different portions of its reserves, should the definition of reserves audit be conditioned on each third party evaluating at least 80% of the reserves covered by its reserves audit, as proposed? Is the scope of a reserves audit defined by geographic areas? If so, should the definition of a reserves audit be based on the third party's evaluation of 80% of the reserves located in the geographic areas covered by the reserves audit?
- Would disclosure that a company has hired a third party to audit only a portion of its reserves be confusing to investors? Is there a danger that investors will not be able to ascertain the extent of the reserves audit? Should we require that a company could not disclose that it has conducted

a reserves audit unless 80% of all of its reserves have been evaluated by a third party or, if the company hires multiple third parties, by all of the third parties collectively?

- Is the proposed definition of "reserves audit" appropriate? Should we revise this proposed definition in any way?

vii. Solicitation of comments on process reviews

The Society of Petroleum Engineer's reserves auditing standards reference a third type of review, which it calls a "process review."[128] It defines a process review as an investigation by a person who is qualified by experience and training equivalent to that of a reserves auditor to address the adequacy and effectiveness of an entity's internal processes and controls relative to reserves estimation. However, it notes that a process review should not include an opinion relative to the reasonableness of the reserves quantities and should be limited to the processes and control system reviewed. The SPE's standards state that, although such reviews may provide value to the entity, an external or internal process review is not of sufficient rigor to establish appropriate classifications and quantities of reserves and should not be represented to the public as being equivalent to an audit of reserves. We are not proposing requiring disclosure of whether a company has conducted a process review, as defined by the SPE. In so doing, we note the SPE's admonition that such reviews are not as rigorous as a reserves audit. We are not proposing to prohibit disclosure of such process reviews because we believe that they may be beneficial to companies and shareholders. However, in order to help prevent confusion between the different levels of third-party participation, companies

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128 See SPE Reserves Auditing Standards.

should clearly disclose the level and scope of work that was performed. In addition, a company should avoid using language which may lead investors to erroneously believe that a higher level of third-party review was performed.

Request for Comment

- Should we require disclosure of whether a company has conducted a process review? Notwithstanding the relative lack of rigor of a process review compared to a reserves audit, would investors find such information useful?
- The proposal does not prohibit disclosure of process reviews. Is there a danger that the public may be confused by such disclosure? Should we prohibit disclosure of any type of reserves-related activity other than the preparation of the reserves estimates or a reserves audit?

4. Proposed Item 1203 (Proved undeveloped reserves)

We are proposing to require disclosure of the aging of proved undeveloped reserves (PUDs). Some of the commenters responding to the Concept Release expressed concerns regarding companies that carry alleged PUDs for lengthy time periods.[129] Long holding periods of such reserves raise the question whether the company has a bona fide intention or the capability to develop those reserves, even though the company has determined them to be economically producible. Several commenters recommended that we require a company to remove PUDs that have remained so classified for five years or

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[129] See letters from CIBC, Devon, EIA, D. McBride, Robinson, D. Ryder, and SPE.

longer.[130] PRMS guidelines indicate that five years is a benchmark for a reasonable timeframe to initiate the development of reserves, although they recognize that this timeframe depends on the specific circumstances. However, others suggested that a company should be able to characterize PUDs as such for longer than a five-year period if there are exceptional circumstances (such as extensive offshore projects) that justify continued inclusion of such reserves in the proved category.[131]

We propose to address these concerns through disclosure. We believe that the need for such disclosure is heightened as a result of our proposed amendments that would ease the requirements for recognizing PUDs and thereby increase the amount of PUDs disclosed in filings, even though the properties representing such proved reserves have not yet been developed and therefore do not provide the company with cash flow. Proposed Item 1203 would require an oil and gas company to prepare a table showing, for each of the last five fiscal years and by product type, proved reserves estimated using current prices and costs in the following categories:

- Proved undeveloped reserves converted to proved developed reserves during the year; and
- Net investment required to convert proved undeveloped reserves to proved developed reserves during the year.[132]

A form of the proposed PUDs development table is set forth below:

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130 See letters from Devon, EIA, D. McBride, D. Olds, SPE, and Ultra. This is consistent with PRMS guidance. See Section 2.1.3.2 of PRMS.

131 See letters from Denbury, Devon, EIA, D. McBride, D. Olds, Robinson, SPE, and StatoilHydro.

132 See proposed Item 1204.

Conversion of Proved Undeveloped Reserves

Fiscal Year	Proved Undeveloped Reserves Converted to Proved Developed Reserves			Investment in Conversion of Proved Undeveloped Reserves to Proved Developed Reserves, $
	Oil	Gas	Product A	
	(mbbls)	(mmcf)	(measure)	
2004				
2005				
2006				
2007				
2008				

This table would allow investors to assess how a company is managing its PUDs. In addition, proposed Item 1203 would require disclosure, by product type, of any PUDs which have remained undeveloped for five years or more and the reasons for the lack of development. The proposed item would also require a company to disclose its plans to develop PUDs and to further develop proved oil and gas reserves. Finally, the company would be required to discuss any material changes to PUDs.

Request for Comment

- Should we adopt the proposed table? Alternatively, should we simply require companies to reclassify their PUDs after five years?
- Should the table require disclosure of other categories of changes to the status of PUDs, such as acquisitions, removals, and production? Should we add any categories?
- Some of the abuse related to PUD disclosure may be related to companies' desire to show proved reserves in light of our prohibition on disclosure of probable reserves. Would the proposed rules permitting disclosure of

probable reserves reduce the incentive to categorize reserves as PUDs? If so, is the proposed table necessary?

- Should we require disclosure of the reasons for maintaining PUDs that have been classified as PUDs for more than five years, as proposed? If not, why not?
- Should we require a company to disclose its plans to develop PUDs and to further develop proved oil and gas reserves, as proposed? If not, why not?
- Should we require the company to discuss any material changes to PUDs that are disclosed in the table? If not, why not?

5. Proposed Item 1204 (Oil and gas production)

Item 3 of Industry Guide 2 currently requires disclosure, by geographic area, of oil and gas production. We propose codifying that requirement in proposed Item 1204 of Regulation S-K.[133] In addition, the proposed Item would require such disclosure to be made in tabular form for ease of presentation. As a practical matter, it appears that most companies already provide this disclosure in tabular form. A form of the proposed table is set forth below:

Oil and Gas Production, Sales Prices, and Production Costs

Location	Oil			Gas			Product A		
	Production (mbbls)	Sales Price ($US/bbl)	Production Cost ($US/boe)	Production (mmcf)	Sales Price ($US/mcf)	Production Cost ($US/mcfe)	Production (measure)	Sales Price ($US/ measure)	Production Cost ($US/ measure)
Geographic Area A									
2005									
2006									
2007									
Geographic Area B									

133 See proposed Item 1204.

Geographic Area C									

The disclosure that proposed Item 1204 would require is very similar to the disclosure called for by existing Industry Guide 2, but would be modified in two respects. First, proposed Item 1204 would use the definition of the term "geographic area" in proposed Item 1201(d), rather than use the current reference to SFAS 69, which only requires disclosure by country or, if appropriate, groups of countries.[134]

In addition, we propose to eliminate existing instructions to Item 3 of Industry Guide 2 that we believe are no longer necessary. These instructions relate to the following topics:

- Separate reporting of production through processing plant ownership;
- Inclusion of only marketable production of gas on an "as sold" basis, including the exclusion of flared gas, injected gas, and gas consumed in operations;
- Determination of transfer price of oil and gas; and
- Means to calculate average production costs.

We believe that these instructions are no longer necessary in light of changes in the oil and gas industry and markets and relate to issues that are commonly understood and do not require additional instruction. Several of these instructions have very limited application.

Request for Comments

- Should we adopt the proposed table?

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[134] See SFAS 69.

- Should the disclosure be made based on the proposed definition of "geographic area," or should we continue to follow the definition set forth in SFAS 69?
- Should we eliminate the instructions listed above, as proposed? If not, which instructions should we retain? Please explain why those instructions continue to be useful.

6. Proposed Item 1205 (Drilling and other exploratory and development activities)

Item 6 of Industry Guide 2 currently calls for disclosure of drilling activities by geographic area. We propose to codify this disclosure as Item 1205 of Regulation S-K, in tabular form.[135] A form of the proposed table is set forth below:

Drilling Activities
[Geographic area]

	Exploratory Wells		Development Wells		Extension Wells	
	Gross	Net	Gross	Net	Gross	Net
Oil						
Fiscal Year						
Fiscal Year -1						
Fiscal Year -2						
Natural Gas						
Fiscal Year						
Fiscal Year -1						
Fiscal Year -2						
Product A						
Fiscal Year						
Fiscal Year -1						
Fiscal Year -2						
Suspended						
Fiscal Year						
Fiscal Year -1						
Fiscal Year -2						
Dry						
Fiscal Year						
Fiscal Year -1						
Fiscal Year -2						
Total						

135 See proposed Item 1205.

We are also proposing several revisions to the existing disclosures. First, the existing item calls for disclosure by geographic area. We propose to clarify that, for purposes of this item, disclosure should be made pursuant to the definition of "geographic area" set forth in proposed Item 1201(d). Second, we propose to add two categories of wells:

- Extension wells and
- Suspended wells.

Currently, Industry Guide 2 only calls for disclosure of the drilling of exploratory and development wells. However, we believe that distinguishing between extension well drilling and exploratory drilling is important because exploratory drilling typically is associated with the discovery of new fields, and thus new sources of oil and gas, rather than merely the extension of an existing field. Thus, we believe that disclosure of extension wells should be distinct from disclosure about exploratory wells.

Similarly, companies sometimes suspend drilling of a well before completion. Because the definition of a dry well requires that the company report the well as abandoned, these suspended drilling projects are not reflected as drilling activities under the current disclosure requirements. Although suspension of drilling does not necessarily mean that the company has abandoned the well, such activities can consume significant capital resources. Thus, we propose to include this category of drilling activity in the disclosure item.

Proposed new Item 1205 would also require disclosure of any other exploratory or development activities that the company has conducted over the prior three years, including implementation of mining methods for the extraction of oil or gas. We recognize that resources in continuous accumulations often require extraction methods that differ significantly from the extraction methods used in connection with traditional oil or gas wells. This proposed new disclosure would provide investors with information about an oil and gas company's full spectrum of exploratory and development activities.

Request for Comment

- Should we adopt the proposed table? Should the disclosures be made based on the definition of "geographic area" in proposed Item 1201(d)?
- Should we require separate disclosure about the two new proposed categories of wells—extension wells and suspended wells? Does distinguishing these types of wells from exploratory wells and dry wells provide enough clarity regarding the types of exploratory or development activities?

7. Proposed Item 1206 (Present activities)

Proposed Item 1206 would codify existing Item 7 of Industry Guide 2, which calls for disclosure of present activities, including the number of wells in the process of being drilled (including wells temporarily suspended), waterfloods in process of being installed, pressure maintenance operations, and any other related activities of material importance.[136] We are proposing no substantive changes to the existing disclosure item except clarification that the meaning of the term "geographical area" would be based on the proposed definition of that term in proposed Item 1201(d).[137]

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136 See proposed Item 1206.

137 See proposed Item 1206(a).

Request for Comment

- Should the disclosure of present activities be made based on the definition of "geographic area" in proposed Item 1201(d)?
- Should we adopt any other changes to the disclosures currently set forth in existing Item 7 of Industry Guide 2 that we propose to codify in Item 1206?

8. Proposed Item 1207 (Delivery commitments)

Proposed Item 1207 would codify existing Item 8 of Industry Guide 2, which calls for disclosure of arrangements under which the company is required to deliver specified amounts of oil or gas and how the company intends to meet such commitments.[138] We are not proposing any substantive changes to the disclosure currently called for by Item 8. However, we are proposing a significant amount of restructuring and rewording of the disclosure item to make it easier to understand. These proposed changes largely involve separating embedded lists into separate subparagraphs and general plain English revisions but are not intended to change the substance of the disclosures.

Request for Comment

- Are the proposed revisions appropriate? Do the proposed revisions make any unintended substantive changes to the existing disclosures?
- Should we adopt any substantive changes to the disclosures currently set forth in Item 8 of Industry Guide 2 that we propose to codify in Item 1207?

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138 See proposed Item 1207.

- Is this disclosure requirement still necessary? Do oil and gas companies still enter into such delivery commitments? Are they material?

9. Proposed Item 1208 (Oil and gas properties, wells, operations, and acreage)

Proposed Item 1208 would codify existing Items 4 and 5 of Industry Guide 2. The proposed item also would require new disclosures not currently called for by Industry Guide 2 that are described below.

i. Enhanced description of properties disclosure requirement

Item 102 of Regulation S-K provides a very broad, general description of the properties and facilities that a company must disclose in its filings. We propose to add a paragraph to Item 1208 that better illustrates the types of properties and the types of disclosures for those properties that apply to oil and gas companies.[139] The proposed paragraph would require a company to do the following:

- Identify and describe generally its material properties, plants, facilities, and installations;
- Identify the geographic area in which they are located;
- Indicate whether they are located onshore or offshore; and
- Describe any statutory or other mandatory relinquishments, surrenders, back-ins, or changes in ownership.

139 See proposed Item 1208(a).

Request for Comment

- Are the proposed disclosure enhancements regarding oil and gas properties appropriate? Would this enhanced disclosure be helpful to investors?
- Should the disclosures be made based on the definition of "geographic area" in proposed Item 1201(d)?
- Do we need to define any of the terms in the proposed language?

ii. Wells and acreage

Proposed Item 1208 would require separate tabular disclosure of the number of the registrant's producing wells, expressed in terms of both gross wells and net wells, by geographic area.[140] These disclosures are currently called for by Items 4 and 5 of Industry Guide 2. This proposed table would illustrate oil wells and gas wells in both conventional and continuous accumulations and other wells for products from continuous accumulations. A form of the proposed table is set forth below:

Wells

Location	Producing Wells	
	Gross	Net
Geographic Area A		
Oil Wells		
Natural Gas Wells		
Product A Wells		
Total		
Geographic Area B		
Oil Wells		
Natural Gas Wells		
Product A Wells		
Total		

140 See proposed Item 1208(b) and (c).

Similarly, it would require tabular disclosure, by geographic area, of the company's total gross and net developed acres (that is, acres spaced or assignable to productive wells) and undeveloped acres, including leases and concessions.[141] A form of the proposed table is set forth below:

Acreage

	Developed Acres		Undeveloped Acres	
	Gross	Net	Gross	Net
Geographic Area A				
Geographic Area B				
Geographic Area C				
Total				

Request for Comment

- Is the proposed table appropriate? Is there a better way to disclose such information?
- Should the disclosures be made based on the definition of "geographic area" in proposed Item 1201(d)?
- Is it necessary to disclose wells and acreage in conventional accumulations separate from wells and acreage in continuous accumulations, as proposed?
- Is this disclosure requirement still necessary? Is disclosure of the number of wells and acreage material? Should we require the disclosures related to wells and acreage only if there is a high concentration of production or reserves attributable to a few wells or limited acreage? If so, should we specify what that concentration would be?

[141] See proposed Item 1208(e) and (f).

iii. New proposed disclosures regarding extraction techniques and acreage

As noted previously, some oil and gas resources require extraction techniques other than traditional oil and gas wells. Because we are adding non-traditional resources, such as bitumen, to the definition of oil and gas producing activities, we believe that it is appropriate for companies to describe the techniques that the company is using to extract the resources if it is not using a well. Thus, we are proposing to add a new requirement for companies extracting hydrocarbons through means other than wells to provide a discussion of such operations.[142] This disclosure requirement has been drafted broadly to allow for unanticipated developments in extraction technologies.

Proposed Item 1208 also would require a company to disclose, for unproved properties:

- The existence, nature (including any bonding requirements), timing, and cost (specified or estimated) of any work commitments; and
- By geographic area, the net area of unproved property for which the registrant expects its rights to explore, develop, and exploit to expire within one year.[143]

Finally, the proposed Item would continue to require disclosure of areas of acreage concentration, and, if material, the minimum remaining terms of leases and concessions.[144]

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142 See proposed Item 1208(d).

143 See proposed Item 1208(g).

144 See proposed Item 1208(h).

Request for Comment

- Should we require more specific disclosure regarding extraction activities that do not involve wells? Should this proposed item remain open-ended to permit description of unanticipated technologies?
- Is the proposed disclosure for unproved properties appropriate? Should the proposed disclosure for unproved properties be set forth in proposed Item 1208? Should we move such disclosure to the reserves table in proposed Item 1202, where reserves are discussed?

10. Proposed Item 1209 (Discussion and analysis for registrants engaged in oil and gas activities)

We propose to add new Item 1209, which would provide topics that a company should address either as part of Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)[145] or in a separate section. First, the proposed Item would require companies to discuss material changes in proved reserves and, if disclosed, probable and possible reserves, and the sources to which such changes are attributable, including changes made due to:

- Changes in prices;
- Technical revisions; and
- Changes in the status of any concessions held (such as terminations, renewals, or changes in provisions).

We note that SFAS 69 currently requires reconciliation of changes to reserves estimates. This proposal is intended to supplement the SFAS 69 disclosure because SFAS 69

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145 See 17 CFR 229.303.

currently does not provide for these categories of changes. We believe such disclosure would be helpful because developments in the oil and gas industry and markets, including more liquid commodities markets and expansion of interests in foreign countries involving concessions, have made distinguishing changes resulting from these factors more important.

The proposed Item also would require companies to discuss technologies used to establish the appropriate level of certainty for any material additions to, or increases in, reserves estimates. Finally, the proposed Item would list matters that a company should consider in discussing known trends, demands, commitments, uncertainties, and events that are reasonably likely to have a material effect on the company. These matters include, but are not limited to, the following:

- Prices and costs;
- Performance of currently producing wells, including water production from such wells and the need to use enhanced recovery techniques to maintain production from such wells;
- Performance of any mining-type activities for the production of hydrocarbons;
- The registrant's recent ability to convert proved undeveloped reserves to proved developed reserves, and, if disclosed, probable reserves to proved reserves and possible reserves to probable or proved reserves;
- Anticipated capital expenditures directed toward conversion of proved undeveloped reserves to proved developed reserves, and, if disclosed,

probable reserves to proved reserves and possible reserves to probable or proved reserves;

- Anticipated exploratory activities, well drilling, and production;
- The minimum remaining terms of leases and concessions;
- Material changes to any line item in the tables described in Items 1202 through 1208 of Regulation S-K; and
- Potential effects of different forms of rights to resources, such as production sharing contracts, on operations.

The MD&A is typically presented in a self-contained section of the registration statement or report. However, the disclosure requirements that would comprise proposed new Subpart 1200 of Regulation S-K would cause a substantial amount of an oil and gas company's disclosure to appear in tabular format, providing an outline of much of a company's operations. Because the tables will present many of the types of changes that management often discusses in its MD&A, we believe it may be more helpful to investors to locate such discussion close to the tables themselves. Thus, to the extent that any discussion or analysis of known trends, demands, commitments, uncertainties, and events that are reasonably likely to have a material effect on the company is directly relevant to a particular disclosure required by Subpart 1200, the company would be able to include that discussion or analysis with the relevant table, with appropriate cross-references, rather than including it in its general MD&A section.[146]

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[146] See proposed Item 1209(b).

Request for Comment

- Proposed Item 1209 is not intended to increase a company's disclosure requirements, but specify disclosures already required generally by MD&A. Is such an item helpful?
- Are the proposed topics that an oil and gas company should consider discussing as part of MD&A, whether in the main MD&A section or in conjunction with the relevant table, appropriate? Are there other topics that an oil and gas company should consider discussing?
- Should we permit such discussions in conjunction with the relevant table as proposed? Would this aid comparability of the disclosures? Or should we keep MD&A as a self-contained section?

IV. Proposed Conforming Changes to Form 20-F

Form 20-F is the form on which foreign private issuers file their annual reports and Exchange Act registration statements. Currently, Form 20-F contains instructions that are similar to those in Item 102 of Regulation S-K. However, rather than referring to Industry Guide 2 for disclosures regarding oil and gas producing activities, Form 20-F contains its own "Appendix A to Item 4.D—Oil and Gas" (Appendix A) that provides guidance for oil and gas disclosures for foreign private issuers.[147] Appendix A is significantly shorter, and provides far less guidance regarding disclosures, than proposed Subpart 1200 or Industry Guide 2.

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147 See Appendix A to Item 4.D—Oil and Gas of Form 20-F [17 CFR 249.220f].

We believe that the proposed Subpart 1200 would be appropriate disclosure for all public companies engaged in oil and gas producing activities, including foreign private issuers. The added guidance in Subpart 1200 should promote more consistent and comparable disclosures among oil and gas companies. It is our understanding that many of the larger foreign private issuers already provide disclosure in their filings with the Commission comparable to the disclosure provided by domestic companies. Thus, we are proposing to revise Form 20-F to incorporate Subpart 1200 with respect to oil and gas disclosures and delete Appendix A to Item 4.D in that form.[148] We propose to revise the Instructions to Item 4 of Form 20-F to refer to Subpart 1200 instead of Appendix A.[149]

Thus, the proposal would continue to require the same type of disclosure currently required by Appendix A regarding reserves and production. In addition, the proposal would require foreign private issuers to comply with the following disclosures currently in Industry Guide 2 that we propose to codify in Subpart 1200 of Regulation S-K:

- Drilling and other exploratory and development activities (Item 1205);
- Present activities (Item 1206);
- Delivery commitments (Item 1207); and
- Oil and gas properties, wells, operations, and acreage (Item 1208).

Finally, applying the proposed Subpart 1200 on foreign private issuers would impose the completely new disclosures that we are proposing for domestic companies in this release, including the following:

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148 We are not proposing changes to Form 40-F, which is the form on which Canadian companies reporting under the multi-jurisdictional disclosure system file Exchange Act registration statements and annual reports with the Commission, because the disclosures regarding oil and gas activities for those companies are not currently governed by our rules.

149 See proposed Instruction 2 to Item 4.

- Reserves from non-traditional sources (i.e., bitumen, shale, coalbed methane);
- Optional disclosure of probable and possible reserves;
- Optional disclosure of oil and gas reserves' sensitivity to price;
- Proved undeveloped reserves held for five years or more and an explanation of why they should continue to be considered proved;
- Technologies used to establish additions to reserves estimates;
- Material changes due to technology, prices, and concession conditions;
- The objectivity and qualifications of any third party primarily responsible for preparing or auditing the reserves estimates, if the company represents that it has enlisted a third party to conduct a reserves audit;
- The qualifications and measures taken to ensure the independence and objectivity of any employee primarily responsible for preparing or auditing the reserves estimates; and
- Filing of the report of a third party if a company represents that it is relying on a third party to prepare the reserves estimates or conduct a reserves audit.

Appendix A currently allows a foreign private issuer to exclude required disclosures about reserves and agreements if its home country prohibits the disclosures. Because these considerations still apply to such foreign private issuers, we propose to move that provision from Appendix A, which we propose to delete, to the Instructions to Item 4 of Form 20-F.[150]

Also, similar to our revisions to Item 102 of Regulation S-K, we propose to limit the Instruction to Item 4.D of Form 20-F to extractive enterprises conducting activities other than oil and gas producing activities because Subpart 1200 would cover companies conducting oil and gas producing activities.[151]

Request for Comment

- Should we delete Appendix A and refer to Subpart 1200 with respect to Form 20-F, as proposed? Why? Should we expand the requirements of Form 20-F to require more disclosure than currently required by Appendix A, as proposed? Conversely, should we only update Appendix A to reflect the proposed new definitions and formats for disclosing reserves and production?
- Would the proposed reference to Subpart 1200 in Form 20-F significantly change the information currently disclosed by foreign private issuers? If so how? Would such a change be appropriate?
- Is the proposed exception for foreign laws that prohibit disclosure about reserves and agreements appropriate? Do such laws affect domestic companies as well? Should Subpart 1200 have a general instruction with respect to such foreign laws?

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150 Id.

151 See proposed Instruction 4.D of Form 20-F.

- Are the proposed revisions to Instructions to Item 4.D appropriate with respect to foreign private issuers that have extractive activities other than oil and gas producing activities?

V. Impact of Proposed Amendments on Accounting Literature

A. Consistency with FASB and IASB Rules

Several commenters noted that changing the definition of the term "proved reserves" in Rule 4-10(a) of Regulation S-X would affect both the full cost accounting treatment of Rule 4-10(c) and the successful efforts accounting treatment of Statement of Financial Accounting Standard No. 19 (SFAS 19).[152] One commenter suggested the Commission consider the impact on the required immediate expensing of seismic tests under SFAS 19.[153] In addition, a revised definition could affect the primary inputs to the standardized measure, such as static operating conditions, year-end prices and costs and the 10% discount rate, which would affect the full cost ceiling under the full cost accounting treatment.[154] These changes could also affect how costs are expensed.[155] Companies should clearly explain the changes in their filings.[156] Commenters recommended that the Commission coordinate corresponding rule changes with the FASB and IASB to ensure consistency of the rules.[157] Some commenters remarked that the IASB is currently considering establishing a set of guidelines for oil and gas

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152 See letters from D&T, Grant Thornton, and KPMG.

153 See letter from Audit Quality.

154 See letters from Audit Quality, KPMG, and PWC.

155 See letter from KPMG.

156 Id.

157 See letters from Audit Quality, CFA, KPMG, and PWC.

extractive activities, including a definition of oil and gas reserves, and recommended that the Commission align its regulations with those guidelines. We intend to discuss our rulemaking project with the FASB and IASB and work with them to harmonize the rules upon effectiveness of the proposed rules, if adopted.

B. Change in Accounting Principle or Estimate

One commenter noted that the proposals would raise the question of whether a change in the definition of proved reserves is a change in accounting principle (which requires retroactive revision of past years) or a change in an estimate caused by a change in accounting principle under SFAS 154.[158] The proposed change in the definition of proved reserves and the change from using single-day year-end price to an average price should be viewed as a change in accounting principle, or a change in the method of applying an accounting principle, that is inseparable from a change in accounting estimate. Therefore, this change would be considered a change in accounting estimate pursuant to Statement of Financial Accounting Standard No. 154 "Accounting Changes and Error Corrections" (SFAS 154) and would be accounted for prospectively.

<u>Request for Comment</u>

- Are the proposed changes more properly characterized as a change in accounting principle or a change in estimate under SFAS 154?
- Would it be appropriate to consider the changes as a change in accounting principle, but specify that no retroactive revision of past years would be required?

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158 See letter from Audit Quality.

- If we required retroactive revision of past years, would companies have the historical engineering and scientific data to make such revisions? If not, are there alternatives to retroactive revision that we should consider?

C. Differing Capitalization Thresholds Between Mining Activities and Oil and Gas Producing Activities

As noted elsewhere in this release, extraction of products such as bitumen would be considered oil and gas producing activities, and not mining activities, if we adopt the proposals. Under current U.S. accounting guidance, costs associated with proven plus probable mining reserves may be capitalized for operations extracting products through mining methods, like bitumen. Under the proposed rules, bitumen extraction and operations that produce oil or gas through mining methods would be included under oil and gas accounting rules, which only permit capitalization of costs associated with proved reserves.[159] Moreover, the mining guidelines do not provide specified percentages for establishing levels of certainty for proven or probable reserves for mining activities. It is possible that these differences could result in changing reserves estimates for these resources during the transition to the new rules, if adopted.

Request for Comment

- How should we address these inconsistencies between oil and gas accounting rules and mining accounting rules?
- Should we permit companies that extract, through mining methods, materials from which oil and gas can be produced to continue to capitalize costs under mining rules, or should we require them to capitalize costs

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159 See Rule 4-10(c) of Regulation S-X [17 CFR 210.4-10(c)].

based on oil and gas rules? Are there circumstances involved with mining operations, different from oil and gas operations, that justify capitalization of costs of proved plus probable reserves, as opposed to only costs of proved reserves?

D. Price Used to Determine Proved Reserves for Purposes of Capitalizing Costs

Statement of Financial Accounting Standard No. 19 "Financial Accounting and Reporting by Oil and Gas Producing Companies" (SFAS 19) requires the units-of-production method to be used for amortizing acquisition costs of proved properties and development costs. As noted above, we are not proposing to change the use of the period end price assumption when determining reserves for accounting purposes. Changes in the definition of reserves and the price used to determine whether resources are reserves (i.e., whether they are economically producible) would impact the determination of the quantity of reserves, and therefore would impact the amount of amortization expense that is recorded in the income statement. It is expected that, for most companies, based on the relationship between the amount of proved reserves and the production in a given period, the impact of such a change on the financial statements would not be significant and would not have a significant impact on comparability between periods.

Request for Comment

- Would the effect of such changes be material or have a material effect on historical amortization levels?
- Would the effect of such changes be material or have a material effect on comparability? Please provide any empirical evidence to support your conclusion.

- Would it be appropriate to continue to require the use of the year-end price for purposes of determining reserves for purposes of amortization expense while using a different price for purposes of disclosing reserves estimates in Commission filings? This would result in a different value associated with the use of the term "proved reserves" for purposes of disclosure, as opposed to the use of that term for purposes of accounting. Would this be confusing? Should we use a different term? Should we otherwise clarify the two different meanings of that term in different contexts?

VI. Impact of the Proposed Codification of Industry Guide 2 on Other Industry Guides

There currently are six Securities Act Industry Guides:

- Guide 2—Disclosure of oil and gas operations;
- Guide 3—Statistical disclosure by bank holding companies;
- Guide 4—Prospectuses relating to interests in oil and gas programs;
- Guide 5—Preparation of registration statements relating to interests in real estate limited partnerships;
- Guide 6—Disclosures concerning unpaid claims and claim adjustment expenses of property-casualty insurance underwriters; and
- Guide 7—Description of property by issuers engaged, or to be engaged, in significant mining operations.

There also are four Exchange Act Industry Guides:

- Guide 2—Disclosure of oil and gas operations;
- Guide 3—Statistical disclosure by bank holding companies;

- Guide 4—Disclosures concerning unpaid claims and claim adjustment expenses of property-casualty underwriters; and
- Guide 7—Description of property by issuers engaged, or to be engaged, in significant mining operations.

As discussed above, the specific disclosures that relate to oil and gas operations currently are set forth in both Securities Act and Exchange Act Industry Guide 2, as well as Securities Act Industry Guide 4. The codification of the Industry Guide 2 disclosures that we are proposing in this release should not have any impact on the manner in which the other Industry Guides are applied to company disclosures. Those guides will remain in effect in their current form and companies in the industries to which the guides relate will continue to include disclosure in response to the guides in their Securities Act and Exchange Act filings. In the future, the staff plans to review and update each of the Industry Guides; as part of the initiative to update a particular guide, we would propose to codify it as a new subpart of Regulation S-K.

Request for Comment

- Is it appropriate to codify Industry Guide 2 separately from the other industry guides? Should we merely amend Industry Guide 2 and codify it with all of the other industry guides when they have been updated?
- Would the codification of Industry Guide 2 overrule or otherwise affect any of the disclosures required in the other Industry Guides?

VII. Solicitation of Comment Regarding the Application of Interactive Data Format to Oil and Gas Disclosures

Many oil and gas companies already present much of their oil and gas disclosure in tabular form. In this release, we propose to require that disclosure in tabular form.

Such tabular disclosure appears to be conducive to presentation in an interactive data format that uses a standard list of electronic tags that a variety of software applications can recognize and process. We recently proposed to require that financial statement information be presented in interactive data format in addition to the currently required format.[160] We seek comment on the desirability of rules that would permit, or require, oil and gas companies to present the tabular disclosures in proposed Subpart 1200 in interactive data format in addition to the currently required format. We note that at this time, there is no well-developed standard list of electronic tags for the tabular disclosure proposed in this release.

Request for Comment

- Should we adopt rules that require oil and gas disclosures to be provided in interactive data format? Instead of requiring such formatting, should we only permit the filing of oil and gas disclosures in interactive data format? What are the principal factors that we should consider in making these decisions?
- If we require oil and gas disclosures to be filed in interactive data format, should we provide for a voluntary phase-in period to create a well-developed standard list of electronic tags? Without a requirement, would the development of products for using interactive data meet the needs of investors, analysts, and others who seek to use interactive data? Would a large percentage of oil and gas companies provide interactive data voluntarily and follow the same standard, if not required to do so?

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160 See Release No. 33-8924 (May 30, 2008) [73 FR 32794].

- Would investors, analysts, and others find presentation of oil and gas disclosures helpful if presented in interactive data format? In what ways would such users of the information find such a format beneficial?
- As we note above, there is not currently a well-developed standard list of electronic tags for the oil and gas disclosures. Are there any obstacles to creating a useful standard list of electronic tags for the oil and gas disclosures? Is the type of data presented in the proposed table conducive to interactive data format? Would it be particularly difficult to create standard electronic tags for any of the proposed data? Would there be any obstacles to providing comparable data in interactive format?
- Would it be useful for the data in the proposed tables to interact with other data in Commission filings? If so, which data?
- If we adopt rules requiring oil and gas disclosures in interactive data format, should we require the use of the eXtensible Business Reporting Language (XBRL) standard? Are any other standards becoming more widely used or otherwise superior to XBRL? What would the advantages of any such other standards be over XBRL?

VIII. Proposed Implementation Date

We propose to require companies to begin complying with the proposed disclosure requirements, if adopted, for registration statements filed on or after January 1, 2010, and for annual reports on Forms 10-K and 20-F for fiscal years ending on December 31, 2009, and after. We believe that this time period would be appropriate to enable companies to familiarize themselves with the new rules. We would require that all companies begin complying with the disclosure requirements at the same time to maximize comparability of disclosure. Therefore, we would not permit early adoption of the proposed disclosure requirements.

<u>Request for Comment</u>

- Should we provide a delayed compliance date, as proposed above? If so, is the proposed date appropriate? Should we provide more or less time for companies to familiarize themselves with the proposed amendments?
- If we provide a delayed compliance date, should we permit early adoption by companies?

IX. General Request for Comment

We request and encourage any interested person to submit comments regarding:

- The proposed rule changes and additions that are the subject of this release;
- Additional or different changes; or
- Other matters that may have an effect on the proposals contained in this release.

We request comment from the point of view of registrants, investors, and other users of information about the disclosures that should be required with regard to oil and gas companies and the corresponding definitions of terms used in those disclosure requirements.

X. Paperwork Reduction Act

A. Background

The proposed rules and amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[161] We are submitting these to the Office of Management and Budget for review and approval in accordance with the Paperwork Reduction Act.[162] The titles for this information are:

(1) "Regulation S-K" (OMB Control No. 3235-0071);[163]

(2) "Industry Guides" (OMB Control No. 3235-0069);

(4) "Form S-1" (OMB Control No. 3235-0065);

(5) "Form S-4" (OMB Control Number 3235-0324);

(6) "Form F-1" (OMB Control Number 3235-0258);

(7) "Form F-4" (OMB Control Number 3235-0325);

(8) "Form 10" (OMB Control No. 3235-0064);

(9) "Form 10-K" (OMB Control No. 3235-0063); and

(10) "Form 20-F" (OMB Control No. 3235-0063).

We adopted all of the existing regulations and forms pursuant to the Securities Act and the Exchange Act. These regulations and forms set forth the disclosure requirements for annual reports[164] and registration statements that are prepared by issuers

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161 44 U.S.C. 3501 et seq.

162 44 U.S.C. 3507(d) and 5 CFR 1320.11.

163 The paperwork burden from Regulation S-K and the Industry Guides is imposed through the forms that are subject to the disclosures in Regulation S-K and the Industry Guides and is reflected in the analysis of those forms. To avoid a Paperwork Reduction Act inventory reflecting duplicative burdens, for administrative convenience we estimate the burdens imposed by each of Regulation S-K and the Industry Guides to be a total of one hour.

164 The pertinent annual reports are those on Forms 10-K and 20-F.

to provide investors with the information they need to make informed investment decisions in registered offerings and in secondary market transactions.

Our proposed amendments to these existing forms are intended to modernize and update our reserves definitions to better reflect changes in the oil and gas industry and markets and new technologies that have occurred in the decades since the current rules were adopted, including expanding the scope of permissible technologies for establishing certainty levels of reserves, reserves classifications that a company can disclose in a Commission filing, and the types of resources that can be included in a company's reserves, as well as providing information regarding the objectivity and qualifications of any third party primarily responsible for preparing or auditing the reserves estimates, if the company represents that it has enlisted a third party to conduct a reserves audit, and the qualifications and measure taken to assure the independence and objectivity of any employee primarily responsible for preparing or auditing the reserves estimates. The proposals also are intended to codify, modernize, and centralize the disclosure items for oil and gas companies into Regulation S-K. Finally, the proposals are intended to harmonize oil and gas disclosures by foreign private issuers with disclosures by domestic companies. Overall, the proposed amendments attempt to provide improved disclosure about an oil and gas company's business and prospects without sacrificing clarity and comparability, which provide protection and transparency to investors.

The hours and costs associated with preparing disclosure, filing forms, and retaining records constitute reporting and cost burdens imposed by the collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

Much, but not all, of the information collection requirements related to annual reports and registration statements would be mandatory. There would be no mandatory retention period for the information disclosed, and the information disclosed would be made publicly available on the EDGAR filing system.

B. Summary of Information Collections

The proposals would increase existing disclosure burdens for annual reports on Forms 10-K[165] and 20-F and registration statements on Forms 10, 20-F, S-1, S-4, F-1, and F-4 by creating the following new disclosure requirements, many of which were requested by industry participants:

- Disclosure of reserves from non-traditional sources (i.e., bitumen, shale, coalbed methane) as oil and gas reserves;
- Optional disclosure of probable and possible reserves;
- Optional disclosure of oil and gas reserves' sensitivity to price;
- Disclosure of the development of proved undeveloped reserves, including those that are held for five years or more and an explanation of why they should continue to be considered proved;
- Disclosure of technologies used to establish additions to reserves estimates;

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165 The proposed disclosure requirements regarding oil and gas properties and activities are in Form 10-K as well as the annual report to security holders required pursuant to Rule 14a-3(b) [17 CFR 240.14a-3(b)]. Form 10-K permits the incorporation by reference of information in the Rule 14a-3(b) annual report to security holders to satisfy the disclosure requirements of Form 10-K. The analysis that follows assumes that companies would either provide the proposed disclosure in a Form 10-K only, if the company is not subject to the proxy rules, or would incorporate the required disclosure into the Form 10-K by reference to the Rule 14a-3(b) annual report to security holders if the company is subject to the proxy rules. This approach takes into account the burden from the proposed disclosure requirements that are included in both the Form 10-K and in Regulation 14A or 14C.

- Disclosure regarding material changes due to technology, prices, and concession conditions;
- The objectivity and qualifications of any third party primarily responsible for preparing or auditing the reserves estimates, if the company represents that it has enlisted a third party to conduct a reserves audit;
- The qualifications and measures taken to assure the independence and objectivity of any employee primarily responsible for preparing or auditing the reserves estimates;
- If a company represents that it is relying on a third party to prepare the reserves estimates or conduct a reserves audit, filing a report prepared by the third party; and
- Disclosure based on a new definition of the term "by geographic area."

In addition, the amendments would harmonize the disclosure requirements that apply to foreign private issuers with the disclosure requirements that apply to domestic issuers with respect to oil and gas activities. In particular, the proposal would require foreign private issuers to disclose the information required by proposed Items 1205 through 1208 of Regulation S-K regarding drilling activities, present activities, delivery commitments, wells, and acreage, which they are not required to provide currently under Appendix A to Form 20-F. These proposed disclosure items present the substantive disclosures currently called for by Items 4 through 8 of Industry Guide 2, but are not included specifically in Appendix A to Form 20-F, although much of this disclosure may be included in the more general discussions of business and property on that form.

C. Paperwork Reduction Act Burden Estimates

For purposes of the Paperwork Reduction Act, we estimate the total annual increase in the paperwork burden for all affected companies to comply with our proposed collection of information requirements to be approximately 7,472 hours of in-house company personnel time and to be approximately $1,659,000 for the services of outside professionals.[166] These estimates include the time and the cost of preparing and reviewing disclosure, filing documents, and retaining records. Our methodologies for deriving the above estimates are discussed below.

Our estimates represent the burden for all oil and gas companies that file annual reports or registration statements with the Commission. Based on filings received during the Commission's last fiscal year, we estimate that 241 oil and gas companies file annual reports and 67 oil and gas companies file registration statements. Most of the information called for by the new proposed disclosure requirements, including the optional disclosure items, is readily available to oil and gas companies and includes information that is regularly used in their internal management systems. These proposed disclosures include:

- Information on the company's development of proved undeveloped reserves;
- Technologies that the company used to establish additions to reserves estimates;

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166 For administrative convenience, the presentation of the totals related to the paperwork burden hours have been rounded to the nearest whole number and the cost totals have been rounded to the nearest thousand.

- Material changes to reserves estimates due to technology, prices, and concession conditions;
- The objectivity and qualifications of any third party primarily responsible for preparing or auditing the reserves estimates, if the company represents that it has enlisted a third party to conduct a reserves audit;
- The qualifications and measures taken to assure the independence and objectivity of any employee primarily responsible for preparing or auditing the reserves estimates;
- The report of a third party preparer or reserves auditor, if one is used;
- Disclosure of reserves by geographic area; and
- Optional disclosure of probable and possible reserves and a sensitivity analysis.

We estimate that, on average, companies will incur a burden of 35 hours to prepare these disclosures in an annual report or registration statement.

The proposed amendments would not require, or request, companies to disclose probable and possible reserves. Rather, the proposed rules only would remove the current prohibition on companies from disclosing this information in their filings with the Commission. As we have noted, many companies already disclose this information on their Web sites. Similarly, commenters on the Concept Release noted that many companies already use such estimates in their business decisions. Our rules also do not dictate how companies generate estimates for probable and possible reserves. Thus, we have not included an estimate of the burden and cost of preparing probable and possible reserves estimates in this PRA analysis, but we have included the burden and cost of disclosing such information.

The proposed amendments would apply several disclosure items to foreign private issuers that previously did not apply to them. As noted above, many of these disclosure items, such as drilling activities, wells and acreage, would require the issuer to provide more specificity about its business and property. Foreign private issuers that do not currently provide such specificity would incur an added burden to present such disclosures in their filings. We estimate that this burden would be 20 hours per foreign private issuer.

The proposed amendments would include reserves from non-traditional sources (e.g., bitumen and oil shale) as oil and gas reserves. Such reserves currently are required to be disclosed as reserves related to mining operations. Although there are differences in the way such reserves may be calculated, such as different levels of certainty, the processes involved in estimating such reserves do not differ significantly. We believe that there would be no change in the relative burden for estimating these reserves under the oil and gas rules, as opposed to the mining rules.

Consistent with current Office of Management and Budget estimates and recent Commission rulemakings, we estimate that 25% of the burden of preparation of registration statements on Forms S-1, S-4, F-1, F-4, 10, and 20-F is carried by the company internally and that 75% of the burden is carried by outside professionals retained by the issuer at an average cost of $400 per hour.[167] We estimate that 75% of the

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[167] In connection with other recent rulemakings, we have had discussions with several private law firms to estimate an hourly rate of $400 as the average cost of outside professionals that assist issuers in preparing disclosures and conducting registered offerings.

burden of preparation of annual reports on Form 10-K or Form 20-F is carried by the company internally and that 25% of the burden is carried by outside professionals retained by the company at an average cost of $400 per hour. The portion of the burden carried by outside professionals is reflected as a cost, while the portion of the burden carried by the company internally is reflected in hours. The following tables summarize the changes to the PRA estimates:

Table 1: Calculation of Incremental Paperwork Reduction Act Burden Estimates for Exchange Act Periodic Reports

Form	Annual Responses	Incremental Hours/Form	Incremental Burden	75% Issuer	25% Professional	$400 Professional Cost
	(A)	(B)	(C)=(A)*(B)	(D)=(C)*0.75	(E)=(C)*0.25	(F)=(E)*$300
10-K[168]	206	35	7,210	5,408	1,803	721,000
20-F	35	55	1,925	1,444	481	192,500
Total	241		9,135	6,851	2,284	913,500

Table 2: Calculation of Incremental Paperwork Reduction Act Burden Estimates for Securities Act Registration Statements and Exchange Act Registration Statements

Form	Annual Responses	Incremental Hours/Form	Incremental Burden	25% Issuer	75% Professional	$400 Professional Cost
	(A)	(B)	(C)=(A)*(B)	(D)=(C)*0.25	(E)=(C)*0.75	(F)=(E)*$300
10	5	35	175	44	131	52,500
20-F	2	55	110	28	83	33,000
S-1	38	35	1,330	333	998	399,000
S-4	17	35	595	149	446	178,500
F-1	2	55	110	28	83	33,000
F-4	3	55	165	41	124	49,500
Total	67		2,485	621	1864	745,500

D. Request for Comment

We request comment in order to evaluate the accuracy of our estimate of the burden of the collections of information. Any member of the public may direct to us any comments concerning the accuracy of these burden estimates. Persons who desire to submit comments on the collection of information requirements should direct their

168 The burden estimates for Form 10-K assume that the proposed requirements are satisfied by either including information directly in the annual reports or incorporating the information by reference from the Rule 14a-3(b) annual report to security holders.

comments to the OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington DC 20503, and should send a copy of the comments to Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090, with reference to File No. S7-15-08. Requests for materials submitted to the OMB by us with regard to this collection of information should be in writing, refer to File No. S7-15-08, and be submitted to the Securities and Exchange Commission, Records Management Branch, 100 F Street NE, Washington, DC 20549-1110. Because OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, your comments are best assured of having their full effect if OMB receives them within 30 days of publication.

XI. Cost-Benefit Analysis

A. Background

We are proposing revisions to the oil and gas reserves disclosure requirements of Regulation S-K and Regulation S-X under the Securities Act of 1933 and the Securities Exchange Act of 1934 and Industry Guide 2. The proposed revisions are intended to modernize and update the Commission's oil and gas disclosure requirements because modern technologies enables better estimates, and therefore more helpful disclosure to investors. The oil and gas industry has experienced significant changes since the Commission initially adopted its current rules and disclosure requirements between 1978 and 1982, including advancements in technology and changes in the types of projects in which oil and gas companies invest. The proposed revisions also are intended to provide investors with improved disclosure about an oil and gas company's business and prospects without sacrificing clarity and comparability, which provide protection and transparency to investors.

B. Description of Proposal

Currently, Industry Guide 2 specifies many of the disclosure guidelines for oil and gas companies. The Industry Guide calls for disclosure relating to reserves, production, property, and operations in addition to that which is required by Regulation S-K. Although the Industry Guide itself does not appear in Regulation S-K or in the Code of Federal Regulations, it is referenced in an instruction to Item 102 of Regulation S-K (Description of Property) and also is included in the listing of Industry Guides in Items 801 and 802 of Regulation S-K. Generally, the proposal would codify the existing disclosures of Industry Guide 2 into a new Subpart 1200 of Regulation S-K, while at the same time updating such disclosures, clarifying the level of detail required to be disclosed, and requiring disclosure in a tabular presentation. The proposed changes would accomplish the following:

- Disclosure of reserves from non-traditional sources (e.g., bitumen and oil shale) as oil and gas reserves;
- Optional disclosure of probable and possible reserves;
- Optional disclosure of oil and gas reserves' sensitivity to price;
- Disclosure of the development of proved undeveloped reserves, including those that are held for five years or more and an explanation of why they should continue to be considered proved;
- Disclosure of technologies used to establish additions to reserves estimates;

- Disclosure regarding material changes due to technology, prices, and concession conditions;
- The objectivity and qualifications of any third party primarily responsible for preparing or auditing the reserves estimates, if the company represents that it has enlisted a third party to conduct a reserves audit;
- The qualifications and measures taken to assure the independence and objectivity of any employee primarily responsible for preparing or auditing the reserves estimates;
- If a company represents that it is relying on a third party to prepare the reserves estimates or conduct a reserves audit, filing a report prepared by the third party; and
- Disclosure based on a new definition of the term "by geographic area."

The proposal also would make revisions and additions to the definitions section of Rule 4-10 of Regulation S-X. These revisions would update and extend reserves definitions to reflect changes in the oil and gas industry and new technologies. The revisions are intended to address perceived inadequacies in existing definitions while maintaining standards of clarity and comparability that provide protection and transparency to investors. In particular, the proposal would:

- Expand the definition of "oil and gas producing activities" to include the extraction of hydrocarbons from oil sands, shale, coalbeds, or other natural resources and activities undertaken with a view to such extraction;
- Add a definition of "reasonable certainty" to provide better guidance regarding the meaning of that term;

- Add a definition of "reliable technology" to permit the use of new, widely accepted technologies to establish proved reserves;
- Define probable and possible reserves estimates; and
- Add definitions to explain new terms used in the revised definitions.

In addition, the amendments would harmonize the disclosure requirements that apply to foreign private issuers with the disclosure requirements that apply to domestic issuers with respect to oil and gas activities. In particular, the proposal would require foreign private issuers to disclose the information required by proposed Items 1205 through 1208 regarding drilling activities, present activities, delivery commitments, wells, and acreage, which they are not required to provide currently under Appendix A to Form 20-F. These proposed disclosure items present the substantive disclosures currently called for by Items 4 through 8 of Industry Guide 2, but are not included specifically in Appendix A to Form 20-F, although much of this disclosure may be included in the more general discussions of business and property on that form.

C. Benefits

We expect that the proposed rules would increase transparency in disclosure by oil and gas companies by providing improved reporting standards. The proposed revisions to the definitions should align our disclosure rules with the realities of the modern oil and gas markets. For example, we believe that the inclusion of bitumen and other resources from continuous accumulations as oil and gas producing activities is consistent with company practice to treat these operations as part of, rather than separate from, their traditional oil and gas producing activities. Similarly, the proposed expansion of permissible technologies for determining certainty levels of reserves recognizes that companies now take advantage of these technological advances to make business decisions. We expect these proposals to improve disclosure by aligning the required disclosure more closely with the way companies conduct their business.

Allowing companies to disclose probable and possible reserves is designed to improve investors' understanding of a company's unproved reserves. For those companies that already disclose such reserves on their Web sites, the proposals would permit them to make such disclosures more accessible to investors. Disclosure of these categories of reserves beyond proved reserves may foster better company valuations by investors, creditors, and analysts, thus improving capital allocation and reducing investment risk. Because some of the proposed disclosure requirements are optional, the amount of increased transparency will depend on the extent to which companies elect to provide the additional disclosure afforded by the proposal. If companies elect not to provide the optional disclosure, then the benefits from increased transparency would be limited to the extent that the new rules improve the transparency of proved reserves disclosure. We expect that replacing the Industry Guide with new Regulation S-K items would provide greater certainty because the disclosure requirements would be in rules established by the Commission.

By permitting increased disclosure, the proposal provides a mechanism for oil and gas companies to seek more favorable financing terms through more disclosure and increased transparency. Investors may be able to request such additional disclosure in Commission filings during negotiations regarding bond and debt covenants. Thus, we expect that, as a result of competing factors in the marketplace, the proposal would result in increased transparency, either because companies elect to voluntarily provide increased disclosure, or because investors may discount companies that do not do so. We believe that the benefits and costs of disclosing unproved reserves ultimately will be determined by market conditions, rather than regulatory requirements.

We expect that permitting companies to disclose probable and possible reserves would increase market transparency, provide investors with more reserves information, and allow for more accurate production forecasts. By correlating deterministic criteria to comparable probabilistic thresholds for establishing a given level of certainty, the proposed rules should result in increased standardization in reporting practices which would promote comparability of reserves across companies. The proposal would define the term "reliable technology" to permit oil and gas companies to prepare their reserves estimates using new types of technology that companies are not permitted to use under the current rules. This proposed definition is designed to encompass new technologies as they are developed in the future and become widely accepted, thereby providing investors and the market with a more comprehensive understanding of a company's estimated reserves.

1. Average price

The proposal to change the price used to calculate reserves from a year-end single-day price to an historical average price over the company's most recently ended fiscal year is expected to reduce the effects of seasonality and facilitate comparability between companies. Many of the commenters to the Concept Release supported the use of an historical price, even though this approach is less useful with respect to a company's future prospects compared to a futures market price. We believe investors are concerned not only about the quantity of a company's reserves, but also about the profitability of those reserves. We recognize that some reserves will be of more value than others due to extraction and transportation costs. As a result, since our proposal would require the use of a single price to estimate reserves, the proposal also gives companies the option of providing a sensitivity analysis and reporting reserves based on additional price estimates. If companies elect to provide a sensitivity analysis, we expect this to benefit investors by allowing them to formulate better projections of company prospects that are more consistent with management's planning price and prices higher and lower that may reasonably be achieved. We expect that companies would be more likely to adopt a sensitivity analysis approach if investors and other market participants determine that this information would reduce investment risk, or if companies believe such disclosure will reduce the cost of capital formation. The proposal would result in increased price stability in determining whether reserves are economically producible. This should mitigate seasonal effects, resulting in reserves estimates that more closely reflect those used by management in planning and investment decisions. We expect this to allow for more accurate company valuations and improve projections of company prospects.

2. Probable and possible reserves

We anticipate that disclosure of probable and possible reserves, if companies elect to do so, would allow investors, creditors, and other users to better assess a company's reserves. The proposed tabular format for disclosing probable and possible reserves should reduce investor search costs by making it easier to locate reserves disclosures and facilitating comparability among oil and gas companies.

While we recognize that many companies already communicate with investors about their unproved and other reserves through alternative means, such as company Web sites or press releases, some commenters remarked that an objective comparison among companies is difficult because different companies have defined such reserves classifications differently. We believe that permitting disclosure of this information in Commission filings would provide a more consistent means of comparison. Although our proposal would make disclosure of probable and possible reserves optional, and large oil and gas producers suggested in their comment letters that such disclosure would be of limited benefit, we believe that competitive pressures within the industry might make it beneficial for large producers to disclose this information. Increased disclosure might, for example, improve credit quality and lower the cost of debt financing, or reduce the risk associated with business transactions between the company and its customers or suppliers.

3. Reserves estimate preparers and reserves auditors

We believe that investors would benefit from a greater level of assurance with respect to the reliability of reserve estimates. The proposed disclosure requirements relating to the objectivity and qualifications of any third party primarily responsible for preparing or auditing the reserves estimates, if the company represents that it has enlisted a third party to conduct a reserves audit, and the qualifications and measures taken to assure the independence and objectivity of any employee primarily responsible for preparing or auditing the reserves estimates should provide greater confidence with respect to the accuracy of reserves estimates. Unproved reserves are inherently less certain than proved reserves. Although not all companies would choose to undertake a reserves audit, because the proposal would not require such a reserves audit, third party participation in the estimation of reserves should add credibility to a company's public disclosure. The opinion of an objective, qualified person on the reserves estimates is designed to increase the reliability of these estimates and investor confidence.

4. Development of proved undeveloped reserves

The proposal would require tabular disclosure of the aging of proved undeveloped reserves. We believe that such disclosure supplements our proposed amendments that would ease the requirements for recognizing PUDs and thereby increase the amount of PUDs disclosed in filings, even though the properties representing such proved reserves have not yet been developed and therefore do not provide the company with cash flow.

5. Disclosure guidance

The proposal also provides guidance about the type of information that companies should consider disclosing in Management's Discussion and Analysis, and would allow companies to include this information with the relevant tables. Locating this discussion with the tables themselves should benefit investors by simplifying the presentation of disclosure, and providing insight into the information disclosed in the tables. Providing the additional guidance should assist companies in preparing their disclosure, improving the quality and consistency of this disclosure.

6. Updating of definitions related to oil and gas activities

The proposal also updates the definition of the term "oil and gas producing activities" as well as updating or creating new definitions for other terms related to such activities, including "proved oil and gas reserves" and "reasonable certainty." We believe that updating these definitions will help companies disclose oil and gas operations in the same way that companies manage those operations. This includes resources extracted from nontraditional sources that companies consider oil and gas activities, although our definitions have excluded them from the definition of "oil and gas producing activities." In addition, adding definitions for terms like "reasonable certainty" (which currently is in the definition of "proved oil and gas reserves," but not defined) will provide companies with added guidance and assist them in providing consistent disclosures between companies.

7. Harmonizing foreign private issuer disclosure

We believe that the proposals to harmonize foreign private issuer disclosure would help make disclosures of foreign private issuers more comparable with domestic companies. The oil and gas industry has changed significantly since the rules were adopted. Today, many companies have interests that span the globe. In addition, many of these projects are joint ventures between foreign private issuers and domestic companies. Having differing levels of disclosure for companies that may be participating in the same projects harms comparability between investment choices. The proposal to harmonize foreign private issuer disclosure is intended to promote comparability among all oil companies.

D. Costs

We expect that the proposed amendments would result in some initial and ongoing costs to oil and gas companies. Although we are proposing to add a new subpart to Regulation S-K to set forth the disclosure requirements that are unique to oil and gas companies, the proposed subpart, for the most part, codifies the substantive disclosure called for by Industry Guide 2. The proposed disclosure requirements have been updated and clarified, and require the disclosure to be presented in a tabular format. Although many companies already present this information in tabular form, for companies that do not, this proposed requirement could impose a burden on companies as they transition from a narrative to tabular disclosure format. We expect, however, that any increased preparation costs would be highest in the first year after adoption, but would decline in subsequent years as companies adjust to the new format. We think this burden is justified because tabular disclosure will increase comparability and facilitate understanding and analysis by investors..

1. Probable and possible reserves

Allowing disclosure of probable and possible reserves could create an increased risk of litigation because these categories of reserves estimates are less certain than proved reserves. Companies may choose not to disclose such reserves, in part, because of the risk of incurring litigation costs to defend their disclosures due to the increased risk and uncertainty of these categories. Disclosure of probable and possible reserves may also result in revealing competitive information because it might reveal a company's business strategy, such as the geography and nature of their exploration and discovery. For example, if geographical detail can be inferred from estimates of unproved reserves, this might reveal information about the value of a company's assets to competitors and could put the producer at a competitive disadvantage. We expect companies would incur costs in preparing the additional disclosures such as calculating and aggregating the reserve projections in a prescribed format. If probable and possible categories of reserves have different extraction cost structures, particularly with respect to time, and they are not sufficiently separated from proved reserves, this could result in increased uncertainty in an investor's assessment of a company's prospects. We believe that making these disclosures voluntary mitigates these concerns. Companies unwilling to bear the added risk can simply opt not to provide this disclosure.

2. Reserves estimate preparers and reserves auditors

If a company chooses to use a third party to prepare or audit reserve estimates, it would incur costs to hire these outside consultants. The proposed amendments would not require companies to hire such a person. If enough companies that currently do not use such consultants begin to hire them, we believe that industry wages could potentially increase due to increased demand for reserves calculating specialists unless that demand is compensated by an increase in the supply of such persons. If wages increased, then all companies, not just those employing third party consultants, would incur added costs.

Large companies may be less likely to hire third parties because they tend to have staff to make reserves estimates. However, if such large companies chose to hire third party consultants, third parties would expend significantly more effort on such projects than for smaller companies because larger companies have more properties to evaluate. Thus, we expect third party fees, and the time required to conduct such projects, would scale upwards with the quantity of company reserves.

Disclosure of unproved reserves without third party certification may present a risk with respect to smaller oil and gas producers. Because smaller companies are likely to have less in-house expertise, and less market reputation, than larger companies, this could increase the need for certification. We believe that making the third party involvement optional is similar to the current approach. Current disclosures of proved reserves do not require a third party to audit the reserves estimates, and oil and gas producers already release, as discussed above, unproved reserve information through other means. Thus, even if companies do not choose to use a third party to audit their reserves estimates, the disclosure of unproved reserves with improved standards on how such reserves should be reported, should benefit investors.

3. Average price

While the use of an historical average price to calculate reserves should enhance comparability, it would provide investors with less forward-looking information than if we were to adopt a price standard based on futures prices. Forward-looking prices based on futures, however, are not necessarily available for all products in all geographic areas and would require adjustments.

4. Consistency with IASB

Some commenters remarked that the International Accounting Standards Board is currently preparing a set of guidelines for oil and gas extractive activities, including a definition of oil and gas reserves, and recommended that the Commission align its regulations with those guidelines. We intend to monitor this initiative and work with the IASB, but our proposal may differ from the guidelines ultimately established by the International Accounting Standards Board. This could make it more difficult for investors to compare foreign and domestic companies.

5. Harmonizing foreign private issuer disclosure

The proposal to harmonize foreign private issuer disclosure regarding oil and gas activities would increase the burden on foreign private issuers. However, it is our understanding that the large foreign private issuers already voluntarily provide disclosure comparable to the level required from domestic companies. Much of the added new disclosures relate to the day-to-day business and properties of these companies, including drilling activities, number of wells and acreage. This is information that is central to the activities of oil and gas companies, and therefore is readily known to these companies. We believe that applying the proposed Subpart 1200 to these companies could prompt more detailed disclosure regarding these activities, which would cause these companies to incur some cost. The provision permitting foreign private issuers to omit disclosures if prohibited from making those disclosures by their home jurisdiction could mitigate some of these costs.

E. Request for Comments

We request comment on all aspects of the Cost-Benefit Analysis, including identification of any additional costs or benefits of, or suggested alternatives to, the proposed amendments. We also request that those submitting comments provide, to the extent possible, empirical data and other factual support for their views.

XII. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation

Securities Act Section 2(b)[169] requires us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act[170] requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2)

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169 15 U.S.C. 77b(b).

170 15 U.S.C. 78w(a)(2).

prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Section 3(f) of the Exchange Act[171] requires us, when engaging in rulemaking that requires us to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.

We expect the proposed amendments, if adopted, to increase efficiency and enhance capital formation, and thereby benefit investors, by providing the market with better information based on updated technology as well as increased information covering a broader range of reserves classifications held by a company and reserves found in non-traditional sources of oil and gas. Such increased and improved information would permit investors to better assess a company's prospects. In particular, the existing prohibitions against disclosing reserves other than proved reserves, using modern technology to determine the certainty level of reserves, and including resources from non-traditional sources can lead to incomplete disclosures about a company's actual resources and prospects. The proposals are designed to better align the disclosure requirements with the way companies make business decisions.

We believe that permitting the disclosure of probable and possible reserves will benefit smaller companies, in particular. Larger issuers tend to already have large amounts of proved reserves. The proposals would permit smaller companies, who often participate in a significant amount of exploratory activity, to better disclose their business prospects. Consequently, we anticipate that the proposal, if adopted, could lead to

171 15 U.S.C. 78c(f).

efficiencies in capital formation, as more information would be available regarding the prospects of smaller issuers.

The effects of the proposed amendments on competition are difficult to predict, but it is possible that permitting public issuers to disclose probable and possible reserves will lead to a reallocation of capital, as companies that previously could show few proved reserves would be able to disclose a broader range of its business prospects, making it easier for these issuers to raise capital and compete with companies that have large proved reserves. Although our proposal would make disclosure of probable and possible reserves optional, and large oil and gas producers suggested in their comment letters that such disclosure would be of limited benefit, we believe that competitive pressures within the industry might make it beneficial for large producers to disclose this information. Increased disclosure might, for example, improve credit quality and lower the cost of debt financing, or reduce the risk associated with business transactions between the company and its customers or suppliers.

We request comment on whether the proposals, if adopted, would promote efficiency, competition, and capital formation or have an impact or burden on competition. Commenters are requested to provide empirical data and other factual support for their views, if possible.

XIII. Initial Regulatory Flexibility Analysis

This Initial Regulatory Flexibility Act Analysis has been prepared in accordance with 5 U.S.C. 603. It relates to proposed revisions to disclosure items for oil and gas companies.

A. Reasons for, and Objectives of, the Proposed Action

The Commission adopted the current disclosure regime for oil and gas producing companies in 1978 and 1982, respectively. Since that time, there have been significant changes in the oil and gas industry and markets, including technological advances, and changes in the types of projects in which oil and gas companies invest their capital. On December 12, 2007, the Commission published a Concept Release on possible revisions to the disclosure requirements relating to oil and gas reserves.[172] Prior to our issuance of the Concept Release, many industry participants had expressed concern that our disclosure rules are no longer in alignment with current industry practices and therefore have limited usefulness to the market and investors.

Our proposed amendments to these existing forms are intended to modernize and update our reserves definitions to reflect changes in the oil and gas industry and markets and new technologies that have occurred in the decades since the current rules were adopted, including expanding the scope of permissible technologies for establishing certainty levels of reserves, reserves classifications that a company can disclose in a Commission filing, and the types of resources that can be included in a company's reserves, as well as providing information regarding the objectivity and qualifications of any third party primarily responsible for preparing or auditing the reserves estimates, if the company represents that it has enlisted a third party to conduct a reserves audit, and the qualifications and measures taken to assure the independence and objectivity of any employee primarily responsible for preparing or auditing the reserves estimates. The proposals also are intended to codify, modernize and centralize the disclosure items for

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172 See Release No. 33-8870 (Dec. 12, 2007) [72 FR 71610].

oil and gas companies into Regulation S-K. Finally, the proposals are intended to harmonize oil and gas disclosures by foreign private issuers with disclosures by domestic companies. Overall, the proposed amendments attempt to provide improved disclosure about an oil and gas company's business and prospects without sacrificing clarity and comparability, which provide protection and transparency to investors.

B. Legal Basis

We are proposing the amendments pursuant to Sections 3(b), 6, 7, 10 and 19(a) of the Securities Act and Sections 12, 13, 14(a), 15(d), and 23(a) of the Exchange Act, as amended.

C. Small Entities Subject to the Proposed Amendments

The proposals would affect small entities that are engaged in oil and gas producing activities, the securities of which are registered under Section 12 of the Exchange Act or that are required to file reports under Section 15(d) of the Exchange Act. The proposals also would affect small entities that file, or have filed, a registration statement that has not yet become effective under the Securities Act and that has not been withdrawn. Securities Act Rule 157[173] and Exchange Act Rule 0-10(a)[174] define an issuer to be a "small business" or "small organization" for purposes of the Regulatory Flexibility Act if it had total assets of $5 million or less on the last day of its most recent fiscal year. We believe that the proposals would affect small entities that are operating companies. Based on filing in 2007, we estimate that there are approximately 28 oil and gas companies that may be considered small entities.

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173 17 CFR 230.157.

174 17 CFR 240.0-10(a).

D. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed amendments to Regulation S-K would expand some existing disclosures, and eliminate others. In particular, the proposed new disclosure requirements, many of which were requested by industry participants, include the following:

- Disclosure of reserves from non-traditional sources (e.g., bitumen and shale) as oil and gas reserves;
- Optional disclosure of probable and possible reserves;
- Optional disclosure of oil and gas reserves' sensitivity to price;
- Disclosure of the development of proved undeveloped reserves, including those that are held for 5 years or more and an explanation of why they should continue to be considered proved;
- Disclosure of technologies used to establish additions to reserves estimates;
- Disclosure regarding material changes due to technology, prices, and concession conditions;
- Disclosure of the objectivity and qualifications of any third party primarily responsible for preparing or auditing the reserves estimates, if the company represents that it has enlisted a third party to conduct a reserves audit;
- Disclosure of the qualifications and measures taken to assure the independence and objectivity of any employee primarily responsible for preparing or auditing the reserves estimates;

- If a company represents that it is relying on a third party to prepare the reserves estimates or conduct a reserves audit, filing a report prepared by the third party; and
- Disclosure based on a new definition of the term "by geographic area."

There would be no mandatory retention period for the information disclosed, and the information disclosed would be made publicly available on the EDGAR filing system.

E. Duplicative, Overlapping, or Conflicting Federal Rules

We believe that there are no federal rules that conflict with or duplicate the proposed rules.

F. 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 proposals, we considered the following alternatives:

(1) Establishing different compliance or reporting requirements which take into account the resources available to smaller entities;

(2) Exempting smaller entities from coverage of the disclosure requirements, or any part thereof;

(3) The clarification, consolidation, or simplification of disclosure for small entities; and

(4) Use of performance standards rather than design standards.

With regard to Alternatives 1 and 2, we believe that separate disclosure requirements for small entities that would differ from the proposed reporting requirements, or exempting them from these disclosures, would not achieve our disclosure objectives. In particular, we believe the changes that are reflected in the proposed amendments would balance the informational needs of investors in smaller companies with the burdens imposed on such companies by the disclosure requirements. We note that a number of the proposed new disclosure items are voluntary. We believe that small entities are more likely to take advantage of these permitted disclosures, particularly regarding probable and possible reserves, than larger companies, which typically already have significant proved reserves. A wholesale exemption for small entities would thwart our intent to make uniform the application of the disclosure and other requirements that would be amended.

Regarding Alternative 3, we believe the amendments would clarify and consolidate the requirements for all public companies into Regulation S-K, which may make such requirements easier to access. This may simplify the process of preparing a company's annual report or registration statement. In addition, the proposed tabular format for making the disclosures may lead to systemization of the disclosures, making such information simpler to organize.

Regarding Alternative 4, we have used design rather than performance standards in connection with the proposals for two reasons. First, based on our past experience, we believe the proposed disclosure would be more useful to investors if there were specific informational requirements. The proposed mandated disclosures are intended to result in more focused and comprehensive disclosure. Second, the specific disclosure requirements in the proposals would promote more comparable disclosure among public companies because they would provide greater certainty as to the scope of required disclosure.

G. Solicitation of Comment

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, we request comments regarding: (i) the number of small entity issuers that may be affected by the proposed revisions; (ii) the existence or nature of the potential impact of the proposed revisions on small entity issuers discussed in the analysis; and (iii) how to quantify the impact of the proposed revisions. 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 revisions are adopted, and will be placed in the same public file as comments on the proposed amendments.

XIV. Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[175] a rule is "major" if it has resulted, or is likely to result in:

- an annual effect on the U.S. economy of $100 million or more;
- a major increase in costs or prices for consumers or individual industries; or
- significant adverse effects on competition, investment or innovation.

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175 Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

We request comment on whether our proposals would be a "major rule" for purposes of the Small Business Regulatory Enforcement Fairness Act. We solicit comment and empirical data on: (a) the potential effect on the U.S. economy on an annual basis; (b) any potential increase in costs or prices for consumers or individual industries; and (c) any potential effect on competition, investment, or innovation.

XV. Statutory Basis and Text of Proposed Amendments

We are proposing the amendments pursuant to Sections 3(b), 6, 7, 10 and 19(a) of the Securities Act and Sections 12, 13, 14(a), 15(d), and 23(a) of the Exchange Act, as amended.

TEXT OF PROPOSED AMENDMENTS

List of Subjects

17 CFR Part 210

Accountants, Accounting, Reporting and recordkeeping requirements, Securities.

17 CFR Parts 229 and 249

Reporting and recordkeeping requirements, Securities.

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

PART 210—FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for part 210 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z–2, 77z–3, 77aa(25), 77aa(26), 78c, 78j–1, 78l, 78m, 78n, 78o(d), 78q, 78u–5, 78w(a), 78ll, 78mm, 80a–8, 80a–20, 80a–29, 80a–30, 80a–31, 80a–37(a), 80b–3, 80b–11, 7202 and 7262, unless otherwise noted.

2. Amend § 210.4-10 by:

a. Redesignating the subparagraphs in paragraph (a) as follows:

Old paragraph number	New paragraph number
(a)(1)	(a)(16)
(a)(2)	(a)(24)
(a)(3)	(a)(22)
(a)(4)	(a)(25)
(a)(5)	(a)(23)
(a)(6)	(a)(34)
(a)(7)	(a)(21)
(a)(8)	(a)(15)
(a)(9)	(a)(29)
(a)(10)	(a)(13)
(a)(11)	(a)(9)
(a)(12)	(a)(32)
(a)(13)	(a)(33)
(a)(14)	(a)(1)
(a)(15)	(a)(12)
(a)(16)	(a)(7)
(a)(17)	(a)(20)

b. Adding new paragraphs (a)(2), (a)(3), (a)(4), (a)(5), (a)(6), (a)(8), (a)(10), (a)(11), (a)(14, (a)(17), (a)(18), (a)(19), (a)(26), (a)(27), (a)(28), (a)(30), and (a)(31); and

c. Revising newly redesignated paragraphs (a)(13), (a)(16), (a)(22), (a)(24), and (a)(25).

The additions and revisions read as follows:

§ 210.4-10 Financial accounting and reporting for oil and gas producing activities pursuant to the Federal securities laws and the Energy Policy and Conservation Act of 1975.

(a) <u>Definitions.</u> * * *

(1) <u>Acquisition of properties.</u> * * *

(2) Analogous formation in the immediate area. An "analogous formation in the immediate area" refers to a formation that shares the following characteristics with the formation of interest:

(i) Same geological formation;

(ii) Same environment of deposition;

(iii) Similar geological structure; and

(iv) Same drive mechanism.

Instruction to paragraph (a)(2): Reservoir properties must be no more favorable in the analog than in the formation of interest. When the geological properties change, the proposed analog formation can no longer be said to be an analogous formation in the immediate area of the formation of interest.

(3) Condensate. Condensate is a mixture of hydrocarbons that exists in the gaseous phase at original reservoir temperature and pressure, but that, when produced, is in the liquid phase at surface pressure and temperature.

(4) Continuous accumulations. Continuous accumulations are resources that are pervasive throughout large areas, have ill-defined boundaries, and typically lack or are unaffected by hydrocarbon-water contacts near the base of the accumulation. Examples include, but are not limited to, natural bitumen (oil sands), gas hydrates, and self-sourced accumulations such as coalbed methane, shale gas, and oil shale deposits. Typically, such accumulations require specialized extraction technology (e.g., removal of water from coalbed methane accumulations, large fracturing programs for shale gas, steam, or solvents to mobilize bitumen for in-situ recovery, and, in some cases, mining

methods). Moreover, the extracted oil or gas may require significant processing prior to sale (e.g., bitumen upgraders).

(5) Conventional accumulations. Conventional accumulations are discrete oil or gas resources related to localized geological structural features or stratigraphic conditions, with the accumulation typically bounded by a hydrocarbon-water contact near its base, and which are significantly affected by the tendency of lighter hydrocarbons to "float" or accumulate above heavier water.

(6) Deterministic estimate. The method of estimating reserves or resources is called deterministic when a single value for each parameter (from the geoscience, engineering, or economic data) in the reserves calculation is used in the reserves estimation procedure.

(7) Development costs. * * *

(8) Development project. A development project is the means by which petroleum resources are brought to the status of economically producible. As examples, the development of a single reservoir or field, an incremental development in a producing field, or the integrated development of a group of several fields and associated facilities with a common ownership may constitute a development project.

(9) Development well. * * *

(10) Economically producible. The term economically producible, as it relates to a resource means a resource which generates revenue that exceeds, or is reasonably expected to exceed, the costs of the operation. The value of the products that generate revenue shall be determined at the terminal point of oil and gas producing activities as defined in paragraph (a)(16) of this section.

(11) Estimated ultimate recovery (EUR). Estimated ultimate recovery is the sum of reserves remaining as of a given date and cumulative production as of that date.

(12) Exploration costs. * * *

(13) Exploratory well. A well drilled to find and produce oil or gas in an unproved area or to find a new reservoir in a field previously found to be productive of oil or gas in another reservoir. Generally, an exploratory well is any well that is not a development well, an extension well, a service well, or a stratigraphic test well as those items are defined in this section.

(14) Extension well. A well drilled to extend the limits of a proved reservoir.

(15) Field. * * *

(16) Oil and gas producing activities. (i) Oil and gas producing activities include:

(A) The search for crude oil, including condensate and natural gas liquids, or natural gas ("oil and gas") in their natural states and original locations;

(B) The acquisition of property rights or properties for the purpose of further exploration or for the purpose of removing the oil or gas from existing reservoirs on such properties;

(C) The construction, drilling, and production activities necessary to retrieve oil and gas from their natural reservoirs, including the acquisition, construction, installation, and maintenance of field gathering and storage systems, such as:

(1) Lifting the oil and gas to the surface; and

(2) Gathering, treating, and field processing (as in the case of processing gas to extract liquid hydrocarbons); and

(D) Extraction of marketable hydrocarbons, in the solid, liquid, or gaseous state, from oil sands, shale, coalbeds, or other nonrenewable natural resources which can be upgraded into natural or synthetic oil or gas, and activities undertaken with a view to such extraction.

Instruction 1 to paragraph (a)(16)(i): The oil and gas production function shall be regarded as terminating at the first point at which:

a. Oil, gas, or gas liquids are delivered to a main pipeline, a common carrier, a refinery, or a marine terminal; and

b. In the case of marketable hydrocarbons that can be upgraded into natural or synthetic oil or gas, the marketable hydrocarbons are delivered to a main pipeline, a common carrier, a refinery, a marine terminal, or a facility which upgrades such natural resources into synthetic oil or gas from the natural resources.

Instruction 2 to paragraph (a)(16)(i): For purposes of this paragraph (a)(16), the term "marketable hydrocarbons" means hydrocarbons for which there is a market for the product in the state in which the hydrocarbons are delivered.

(ii) Oil and gas producing activities do not include:

(A) Transporting, refining, processing (other than field processing of gas to extract liquid hydrocarbons), or marketing oil and gas;

(B) Activities relating to the production of natural resources other than oil, gas, or natural resources from which natural or synthetic oil and gas can be extracted; or

(C) Production of geothermal steam.

(17) Possible reserves. Possible reserves are those additional reserves that are less certain to be recovered than probable reserves.

(i) When deterministic methods are used, the total quantities ultimately recovered from a project have a low probability of exceeding proved plus probable plus possible reserves. When probabilistic methods are used, there should be at least a 10% probability that the total quantities ultimately recovered will equal or exceed the proved plus probable plus possible reserves estimates.

(ii) Possible reserves may be assigned to areas of a reservoir adjacent to probable reserves where data control and interpretations of available data are progressively less certain. Frequently, this will be in areas where geoscience and engineering data are unable to define clearly the area and vertical limits of commercial production from the reservoir by a defined project.

(iii) Possible reserves also include incremental quantities associated with a greater percentage recovery of the hydrocarbons in place than the recovery quantities assumed for probable reserves.

(iv) The proved plus probable and proved plus probable plus possible reserves estimates must be based on reasonable alternative technical and commercial interpretations within the reservoir or subject project that are clearly documented, including comparisons to results in successful similar projects.

(v) Possible reserves may be assigned where geoscience and engineering data identify directly adjacent portions of a reservoir within the same accumulation that may be separated from proved areas by faults with displacement less than formation thickness or other geological discontinuities and that have not been penetrated by a wellbore, but are interpreted to be in communication with the known (proved) reservoir. Probable or possible reserves may be assigned to areas that are structurally higher or lower than the proved area if these areas are in communication with the proved reservoir.

(vi) Pursuant to paragraph (a)(24)(iii) of this section, where direct observation has defined a highest known oil (HKO) elevation and the potential exists for an associated gas cap, proved oil reserves should be assigned in the structurally higher portions of the reservoir above the HKO only if the higher contact can be established with reasonable certainty through reliable technology. Portions of the reservoir that do not meet this reasonable certainty criterion may be assigned as probable and possible oil and/or gas based on reservoir fluid properties and pressure gradient interpretations.

(18) Probable reserves. Probable reserves are those additional reserves that are less certain to be recovered than proved reserves but which, together with proved reserves, are as likely as not to be recovered.

(i) When deterministic methods are used, it is as likely as not that actual remaining quantities recovered will exceed the sum of estimated proved plus probable reserves. When probabilistic methods are used, there should be at least a 50% probability that the actual quantities recovered will equal or exceed the proved plus probable reserves estimates.

(ii) Probable reserves may be assigned to areas of a reservoir adjacent to proved reserves where data control or interpretations of available data are less certain, even if the interpreted reservoir continuity of structure or productivity does not meet the reasonable certainty criterion.

(iii) Probable reserves estimates also include potential incremental quantities associated with a greater percentage recovery of the hydrocarbons in place than assumed for proved reserves.

(iv) See also guidelines in paragraphs (a)(17)(iv) through (a)(17)(vi) of this section.

(19) Probabilistic estimate. The method of estimation of reserves or resources is called probabilistic when the full range of values that could reasonably occur for each unknown parameter (from the geoscience, engineering, and economic data) is used to generate a full range of possible outcomes and their associated probabilities of occurrence.

(20) Production costs. * * *

(21) Proved area. * * *

(22) Proved developed oil and gas reserves. Proved developed oil and gas reserves are proved reserves that can be expected to be recovered:

(i) In projects that extract oil and gas through wells, through existing wells with existing equipment and operating methods; and

(ii) In projects that extract oil and gas in other ways, through installed extraction technology operational at the time of the reserves estimate.

(23) Proved properties. * * *

(24) Proved oil and gas reserves. Proved oil and gas reserves are those quantities of oil and gas, which, by analysis of geoscience and engineering data, can be estimated with reasonable certainty to be economically producible—from a given date forward, from known reservoirs, and under existing economic conditions, operating

methods, and government regulations—prior to the time at which contracts providing the right to operate expire, unless evidence indicates that renewal is reasonably certain, regardless of whether deterministic or probabilistic methods are used for the estimation. The project to extract the hydrocarbons must have commenced or the operator must be reasonably certain that it will commence the project within a reasonable time.

(i) The area of the reservoir considered as proved includes:

(A) The area identified by drilling and limited by fluid contacts, if any, and

(B) Adjacent undrilled portions of the reservoir that can, with reasonable certainty, be judged to be continuous with it and to contain economically producible oil or gas on the basis of available geoscience and engineering data.

(ii) In the absence of data on fluid contacts, proved quantities in a reservoir are limited by the lowest known hydrocarbons (LKH) as seen in a well penetration unless geoscience, engineering, or performance data and reliable technology establishes a lower contact with reasonable certainty.

(iii) Where direct observation from well penetrations has defined a highest known oil (HKO) elevation and the potential exists for an associated gas cap, proved oil reserves may be assigned in the structurally higher portions of the reservoir only if geoscience, engineering, or performance data and reliable technology establishes the higher contact with reasonable certainty.

(iv) Reserves which can be produced economically through application of improved recovery techniques (including, but not limited to, fluid injection) are included in the proved classification when:

(A) Successful testing by a pilot project in an area of the reservoir with properties no more favorable than in the reservoir as a whole, the operation of an installed program in the reservoir or an analogous formation in the immediate area, or other evidence using reliable technology establishes the reasonable certainty of the engineering analysis on which the project or program was based; and

(B) The project has been approved for development by all necessary parties and entities, including governmental entities.

(v) Existing economic conditions include prices and costs at which economic producibility from a reservoir is to be determined. The price shall be the average price during the 12-month period prior to the ending date of the period covered by the report, determined as an unweighted arithmetic average of the ending price for each month within such period.

(25) Proved undeveloped reserves. Proved undeveloped oil and gas reserves are reserves that are expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure is required for recompletion.

(i) Reserves on undrilled acreage shall be limited to those drilling units directly offsetting productive units that are reasonably certain of production when drilled, unless evidence using reliable technology exists that establishes reasonable certainty of economic producibility at greater distances.

(A) In a conventional accumulation, offsetting productive units must lie within an area in which economic producibility has been established by reliable technology to be reasonably certain.

(B) Proved reserves can be claimed in a conventional or continuous accumulation in a given area in which engineering, geoscience, and economic data, including actual drilling statistics in the area, and reliable technology show that, with reasonable certainty, economic producibility exists beyond immediately offsetting drilling units.

(ii) Undrilled locations can be classified as having proved undeveloped reserves only if a development plan has been adopted indicating that they are scheduled to be drilled within five years, unless unusual circumstances justify a longer time.

(iii) Under no circumstances shall estimates for proved undeveloped reserves be attributable to any acreage for which an application of fluid injection or other improved recovery technique is contemplated, unless such techniques have been proved effective by actual projects in the area and in the same reservoir or an analogous reservoir in the same geologic formation in the immediate area or by other evidence using reliable technology establishing reasonable certainty.

(26) Reasonable certainty. Reasonable certainty means "much more likely to be achieved than not." When deterministic methods are used, as changes due to increased availability of geoscience (geological, geophysical, and geochemical), engineering, and economic data are made to estimated ultimate recovery (EUR) with time, reasonably certain EUR is much more likely to increase than to either decrease or remain constant. When probabilistic methods are used, reasonable certainty means that there is at least a 90% probability that the quantities actually recovered will equal or exceed the stated volume.

(27) Reliable technology. Reliable technology is technology (including computational methods) that, when applied using high quality geoscience and engineering data, is widely accepted within the oil and gas industry, has been field tested and has demonstrated consistency and repeatability in the formation being evaluated or in an analogous formation. Expressed in probabilistic terms, reliable technology has been proved empirically to lead to correct conclusions in 90% or more of its applications.

(28) Reserves. Reserves are estimated remaining quantities of oil and gas and related substances anticipated to be recoverable, as of a given date, by application of development projects to known accumulations based on: analysis of geoscience and engineering data; the use of technology appropriate to establish the degree of certainty of the reserves; the legal right to produce; installed means of delivering the oil, gas, or related substances to markets, or the permits, financing, and the appropriate level of certainty (reasonable certainty, as likely as not, or possible but not likely) to do so; and economic producibility at current prices and costs. The volumes of reserves shall be determined on the basis of their volumes at the terminal point of oil and gas producing activities as defined in paragraph (a)(16) of this section. Reserves are classified as proved, probable, and possible according to the degree of uncertainty associated with the estimates.

Note to paragraph (a)(28): Reserves should not be assigned to adjacent reservoirs isolated by major, potentially sealing, faults until those reservoirs are penetrated and evaluated as economically producible. Reserves should not be assigned to areas that are clearly separated from a known accumulation by a non-productive reservoir (i.e., absence of reservoir, structurally low reservoir, or negative test results). Such areas may contain prospective resources (i.e., potentially recoverable resources from undiscovered accumulations).

(29) Reservoir. * * *

(30) Resources. Resources are quantities of oil and gas estimated to exist in naturally occurring accumulations. A portion of the resources may be estimated to be recoverable, and another portion may be considered to be unrecoverable. Resources include both discovered and undiscovered accumulations.

(31) Sedimentary basin. A sedimentary basin is a low area in the crust of the earth in which sediments have accumulated. Frequently, sedimentary basins that contain oil and gas reserves contain a number of discrete oil and gas reservoirs.

(32) Service well. * * *

(33) Stratigraphic test well. * * *

(34) Unproved properties. * * *

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PART 229—STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975—REGULATION S-K

3. The authority citation for part 229 continues to read in part as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z–2, 77z–3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u–5, 78w, 78ll, 78mm, 80a–8, 80a–9, 80a–20, 80a–29, 80a–30, 80a–31(c), 80a–37, 80a–38(a), 80a–39, 80b–11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

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4. Amend § 229.102 by revising Instructions 3, 4, 5 and 8 to read as follows.

§ 229.102 (Item 102) Description of property.

* * * * *

Instructions to Item 102: * * *

3. In the case of an extractive enterprise, not involved in oil and gas producing activities, material information shall be given as to production, reserves, locations, development, and the nature of the registrant's interest. If individual properties are of major significance to an industry segment:

* * * * *

4. A registrant engaged in oil and gas producing activities shall provide the information required by Subpart 1200 of Regulation S-K.

5. In the case of extractive reserves other than oil and gas reserves, estimates other than proven or probable reserves (and any estimated values of such reserves) shall not be disclosed in any document publicly filed with the Commission, unless such information is required to be disclosed in the document by foreign or state law; provided, however, that where such estimates previously have been provided to a person (or any of its affiliates) that is offering to acquire, merge, or consolidate with the registrant, or otherwise to acquire the registrant's securities, such estimates may be included in documents relating to such acquisition.

* * * * *

8. The attention of certain issuers engaged in oil and gas producing activities is directed to the information called for in Guide 4 (referred to in §229.801(d)).

* * * * *

5. Amend § 229.801 by removing and reserving paragraph (b) and removing the authority citation following the section.

6. Amend § 229.802 by removing and reserving paragraph (b) and removing the authority citation following the section.

7. Add an undesignated center heading and § 229.1201 through § 229.1209 to read as follows:

Subpart 229.1200—Disclosure by Registrants Engaged in Oil and Gas Producing Activities

Sec.

Subpart 229.1200—Disclosure by Registrants Engaged in Oil and Gas Producing Activities

§ 229.1201 (Item 1201) General instructions to oil and gas industry-specific disclosures.

(a) If oil and gas producing activities are material to the registrant's or its subsidiaries' business operations or financial position, the disclosure specified in this

Subpart 1200 should be included under appropriate captions (with cross references, where applicable, to related information disclosed in financial statements). However, limited partnerships and joint ventures that conduct, operate, manage, or report upon oil and gas drilling or income programs, that acquire properties either for drilling and production, or for production of oil, gas, or geothermal steam or water, need not include such disclosure.

(b) To the extent that Items 1202 through 1208 call for disclosures in tabular format, as specified in the particular Item, a registrant may modify such format for ease of presentation, to add information or to combine two or more required tables.

(c) The definitions in Rule 4–10(a) of Regulation S-X [17 CFR 210] shall apply for purposes of this Subpart 229.1200.

(d) For purposes of this Subpart 229.1200, the term "by geographic area" means, to the extent allowed by law:

(1) By continent;

(2) By country totals for each country that contains 15% or more of the registrant's global oil reserves or gas reserves; and

(3) By sedimentary basin or field totals for each sedimentary basin or field that contains 10% or more of the registrant's global oil reserves or gas reserves.

§ 229.1202 (Item 1202) Disclosure of reserves.

(a) Summary of conventional oil and gas reserves at fiscal year end. (1) Provide the information specified in paragraph (a)(2) of this Item in tabular format as provided below:

Summary of Oil and Gas Reserves in Conventional Accumulations as of Fiscal-Year End Based on Average Fiscal-Year Prices

	Reserves	
	Oil	Natural Gas
Reserves category	(mbbls)	(mmcf)
PROVED		
Developed		
Continent A		
Continent B		
15% Country A		
15% Country B		
10% Field A in Country B		
Other Fields in Country B		
Other Countries in Continent B		
Undeveloped		
Continent A		
Continent B		
15% Country A		
15% Country B		
10% Field A in Country B		
Other Fields in Country B		
Other Countries in Continent B		
TOTAL PROVED		
PROBABLE		
POSSIBLE		

(2) Disclose, in the aggregate and by geographic area, reserves from conventional accumulations estimated using prices and costs under existing economic conditions, for each product type, in the following categories:

(i) Proved developed reserves;

(ii) Proved undeveloped reserves;

(iii) Total proved reserves;

(iv) Probable reserves (optional); and

(v) Possible reserves (optional).

Instruction 1 to paragraph (a)(2): Disclose updated reserves tables as of the close of each fiscal year.

Instruction 2 to paragraph (a)(2): The registrant is permitted, but not required, to disclose probable or possible reserves pursuant to paragraphs (a)(2)(iv) and (a)(2)(v).

Instruction 3 to paragraph (a)(2): If the registrant discloses amounts of a product in barrels of oil equivalent, disclose the basis for such equivalency.

(3) Reported total reserves shall be simple arithmetic sums of all estimates for individual properties or fields within each reserves category. When probabilistic methods are used, reserves should not be aggregated probabilistically beyond the field or property level; instead, they should also be aggregated by simple arithmetic summation.

(4) If the registrant has not previously disclosed reserves estimates in a filing with the Commission, the registrant shall disclose the technologies used to establish the appropriate level of certainty for reserves estimates from material properties included in the total reserves disclosed. The particular properties do not need to be identified.

(5) If the registrant chooses to disclose probable or possible reserves, discuss the relative risks related to such reserves estimates.

(6) Preparation of reserves estimates or reserves audit. Disclose the following information regarding the technical person primarily responsible for preparing the reserves estimates and, if the registrant represents that a third party conducted a reserves audit, regarding the technical person primarily responsible for conducting such reserves audit:

(i) If the person is an employee of the registrant:

(A) The fact that an employee of the registrant had primary responsibility for preparing the reserves estimate (but the employee does not have to be identified); and

(B) Measures taken to assure the independence and objectivity of the estimate;

(ii) If the person is not an employee of the registrant:

(A) The identity of the person;

(B) The nature and amount of all work that the person has performed for the registrant during the past three fiscal years, other than preparing the reserves estimate or conducting the reserves audit, as well as all compensation and fees (in any form) paid to that person for all such services;

(C) Whether the person has any other interests in the company or other conflict of interests;

(iii) Whether the person:

(A) Has a minimum of three years of practical experience in petroleum engineering or petroleum production geology, with at least one full year of this experience being in the estimation and evaluation of reserves if the person was primarily responsible for preparing the reserves estimates;

(B) Has a minimum of ten years of practical experience in petroleum engineering or petroleum production geology, with at least five years of this experience being in the estimation and evaluation of reserves and the conducting of reserves audits if that person conducted a reserves audit of the registrant's reserves estimates;

(C) Has received, and is maintaining in good standing, a registered or certified professional engineer's license or a registered or certified professional geologist's license, or the equivalent thereof, from an appropriate governmental authority or a recognized self-regulating professional organization; and

(D) Has a bachelor's or advanced degree in petroleum engineering, geology, or other discipline of engineering or physical science, and if so, the specific degree earned by that person; and

(iv) Any memberships, in good standing, of the person with a self-regulatory organization of engineers, geologists, other geoscientists, or other professionals whose professional practice includes reserves evaluations or reserves audits, that:

(A) Admits members primarily on the basis of their educational qualifications;

(B) Requires its members to comply with the professional standards of competence and ethics prescribed by the organization that are relevant to the estimation, evaluation, review, or audit of reserves data; and

(C) Has disciplinary powers, including the power to suspend or expel a member; and

(v) To the extent the person does not have all of the qualifications listed in paragraphs (a)(6)(iii) and (iv) of this Item, the reasons why the registrant believes that the person is sufficiently qualified to be primarily responsible for the technical aspects of the reserves estimation or audit, as applicable, and any risks associated with reserves estimates not prepared or audited by persons with such qualifications.

<u>Instruction to Item 1202(a)(6):</u> For purposes of this Item, the identified "person" may be an individual or a business entity. To the extent that the person is a business entity, any disclosure regarding the qualifications listed in paragraphs (a)(6)(iii) and (iv)

of this Item of that person will relate to the individual that is primarily responsible for the technical aspects of the reserves estimation or audit, as applicable.

(7) Third party preparer reports. If the registrant represents that its reserves estimates, or any estimated valuation thereof, are based on estimates prepared by a third party, the registrant shall file a report of the third party as an exhibit to the relevant registration statement or report. The report must include the following disclosure:

(i) The purpose for which the report was prepared and for whom it was prepared;

(ii) The effective date of the report and the date on which the report was completed;

(iii) The proportion of the company's total reserves covered by the report and the geographic area in which the covered reserves are located;

(iv) The assumptions, data, methods, and procedures used to estimate reserves quantities, including the percentage of the registrant's total reserves reviewed in connection with the preparation of the report, and a statement that such assumptions, data, methods, and procedures are appropriate for the purpose served by the report;

(v) A discussion of primary economic assumptions;

(vi) A discussion of the possible effects of regulation on the ability of the registrant to recover the estimated reserves;

(vii) A discussion regarding the inherent risks and uncertainties of reserves estimates;

(viii) A statement that the third party has used all methods and procedures as it considered necessary under the circumstances to prepare the report; and

(ix) The signature of the third party.

(8) Third party reserves audit reports. If the registrant represents that a third party conducted a reserves audit of the registrant's reserves estimates, or any estimated valuation thereof, the registrant shall file a report of the third party as an exhibit to the relevant registration statement or report. The report must include the following disclosure:

(i) The purpose for which the report is being prepared and for whom it is prepared;

(ii) The effective date of the report and the date on which the report was completed;

(iii) The proportion of the company's total reserves covered by the report and the geographic area in which the covered reserves are located;

(iv) The assumptions, data, methods, and procedures used to conduct the reserves audit, including the percentage of the registrant's total reserves reviewed in connection with the preparation of the report, and a statement that such assumptions, data, methods, and procedures are appropriate for the purpose served by the report;

(v) A discussion of primary economic assumptions;

(vi) A discussion of the possible effects of regulation on the ability of the registrant to recover the estimated reserves;

(vii) A discussion regarding the inherent risks and uncertainties of reserves estimates;

(viii) A statement that the third party has used all methods and procedures as it considered necessary under the circumstances to prepare the report;

(ix) A brief summary of the third party's conclusions with respect to the reserves estimates; and

(x) The signature of the third party.

(9) For purposes of this Item 1202, the term "reserves audit" means the process of reviewing certain of the pertinent facts interpreted and assumptions made that have resulted in an estimate of reserves prepared by others and the rendering of an opinion about the appropriateness of the methodologies employed, the adequacy and quality of the data relied upon, the depth and thoroughness of the reserves estimation process, the classification of reserves appropriate to the relevant definitions used, and the reasonableness of the estimated reserves quantities. In order to disclose that a "reserves audit" has been conducted, the report resulting from this review must represent an examination of at least 80% of the portion of the registrant's reserves covered by the reserves audit.

(b) <u>Summary of oil and gas reserves from continuous accumulations.</u> (1) Provide the information specified in paragraph (b)(2) of this Item in tabular format as provided below:

Summary of Oil and Gas Reserves from Continuous Accumulations as of Fiscal-Year End Based on Average Fiscal-Year Prices

	Reserves		
	Product A	**Product B**	**Product C**
Reserves category	(measure)	(measure)	(measure)
PROVED			
Developed			
Country A			
Country B			
10% Field A in Country B			
Other Fields in Country B			
Undeveloped			
Country A			

Country B			
10% Field A in Country B			
Other Fields in Country B			
TOTAL PROVED			
PROBABLE			
POSSIBLE			

(2) Disclose, in the aggregate and by geographic area, reserves from continuous accumulations (including, but not limited to, bitumen and shale oil, shale gas, and coalbed methane) estimated using prices and costs under existing economic conditions, for each product type applicable to the registrant, in the following categories:

(i) Proved developed reserves;

(ii) Proved undeveloped reserves;

(iii) Total proved reserves;

(iv) Probable reserves (optional); and

(v) Possible reserves (optional).

Instruction 1 to paragraph (b)(2): Disclose updated reserves tables as of the close of each fiscal year.

Instruction 2 to paragraph (b)(2): The registrant is permitted, but not required, to disclose probable or possible reserves pursuant to paragraphs (b)(2)(iv) and (b)(2)(v) of this Item.

Instruction 3 to paragraph (b)(2): If the registrant discloses amounts of a product in barrels of oil equivalent, disclose the basis for such equivalency.

(3) Provide the disclosures required by paragraphs (a)(3) through (a)(9) of this Item, as they apply to continuous accumulations.

(c) Reserves sensitivity analysis (optional). (1) The registrant may, but is not required, to provide the information specified in paragraph (c)(2) of this Item in tabular format as provided below:

Sensitivity of Reserves to Prices
By Principal Product Type and Price Scenario

Price Case	Proved Reserves			Probable Reserves			Possible Reserves		
	Oil	Gas	Product A	Oil	Gas	Product A	Oil	Gas	Product A
	mbbls	mmcf	measure	mbbls	mmcf	measure	mbbls	mmcf	measure
Scenario 1									
Scenario 2									

(2) The registrant may, but is not required to, disclose, in the aggregate, an estimate of reserves estimated for each product type based on different price and cost criteria, such as a range of prices and costs that may reasonably be achieved, including standardized futures prices or management's own forecasts.

(3) If the registrant provides disclosure under this paragraph (c) of this Item, disclose the price and cost schedules and assumptions on which the values disclosed under paragraphs (c)(2)(i) through (c)(2)(iv) of this Item are based.

Instruction to Item 1202: Estimates of oil or gas resources other than reserves, and any estimated values of such resources, shall not be disclosed in any document publicly filed with the Commission, unless such information is required to be disclosed in the document by foreign or state law; provided, however, that where such estimates previously have been provided to a person (or any of its affiliates) that is offering to acquire, merge, or consolidate with the registrant or otherwise to acquire the registrant's securities, such estimate may be included in documents related to such acquisition.

§ 229.1203 (Item 1203) **Proved undeveloped reserves.**

(a) Provide the information specified in paragraph (b) of this Item in tabular format as provided below:

Conversion of Proved Undeveloped Reserves

Fiscal Year	Proved Undeveloped Reserves Converted to Proved Developed Reserves			Investment in Conversion of Proved Undeveloped Reserves to Proved Developed Reserves, $
	Oil	Gas	Product A	
	(mbbls)	(mmcf)	(measure)	
Fiscal Year – 4				
Fiscal Year – 3				
Fiscal Year – 2				
Fiscal Year – 1				
Fiscal Year				

(b) For the last five fiscal years, disclose, by product type, proved reserves estimated using current prices and costs in the following categories:

(i) Proved undeveloped reserves converted to proved developed reserves during the year; and

(ii) Investments in the conversion of proved undeveloped reserves to proved developed reserves during the year.

(c) Disclose, by product type, any proved undeveloped reserves which have remained undeveloped for five years or more. Explain the reason for the lack of development.

(d) Disclose the registrant's plans to develop proved undeveloped reserves and to further develop proved oil and gas reserves.

(e) Discuss any material changes to proved undeveloped reserves.

§ 229.1204 (Item 1204) Oil and gas production.

(a) Provide the information specified in paragraph (b) of this Item in tabular format as provided below:

Oil and Gas Production, Sales Prices, and Production Costs

Location	Oil			Gas			Product A		
	Production (mbbls)	Sales Price ($US/bbl)	Production Cost ($US/boe)	Production (mmcf)	Sales Price ($US/mcf)	Production Cost ($US/mcfe)	Production (measure)	Sales Price ($US measure)	Production Cost ($US/ measure)
Geographic Area A									
Fiscal Year – 2									
Fiscal Year – 1									
Fiscal Year									
Geographic Area B									
Geographic Area C									

(b) Disclose, by geographic area, for the last three years:

(i) Net oil and gas production;

(ii) Average oil and gas sales prices, net of any effects as a result of hedging transactions; and

(iii) Average production costs (lifting costs, not including severance taxes) per unit of production.

(c) For purposes of this Item 1204, the term "net production" includes only production that the registrant owns and production attributable to the registrant's interest in projects less royalties and production due to others. In special situations (e.g., foreign operations), the registrant may provide net production before royalties if more appropriate. If the registrant provides "net before royalty" production figures, it must note the change from usage of "net production."

§ 229.1205 (Item 1205) Drilling and other exploratory and development activities.

(a) Provide the information specified in paragraph (b) of this Item in tabular format as provided below:

Drilling Activities
[Geographic area]

	Exploratory Wells		Development Wells		Extension Wells	
	Gross	Net	Gross	Net	Gross	Net
Oil						
Fiscal Year						
Fiscal Year -1						
Fiscal Year -2						
Natural Gas						
Fiscal Year						
Fiscal Year -1						
Fiscal Year -2						
Product A						
Fiscal Year						
Fiscal Year -1						
Fiscal Year -2						
Suspended						
Fiscal Year						
Fiscal Year -1						
Fiscal Year -2						
Dry						
Fiscal Year						
Fiscal Year -1						
Fiscal Year -2						
Total						

(b) Disclose, by geographic area, for each of the last three years, the following information:

(i) The number of gross and net productive, suspended, and dry exploratory wells drilled;

(ii) The number of gross and net productive, suspended, and dry development wells drilled; and

(iii) The number of gross and net productive, suspended, and dry extension wells drilled.

(c) Definitions. For purposes of this Item, the following terms shall be defined as indicated below.

(i) A dry well is an exploratory, development, or extension well that proves to be incapable of producing either oil or gas in sufficient quantities to justify completion as an oil or gas well.

(ii) A productive well is an exploratory, development, or extension well that is not a dry well.

(iii) A suspended well is a well that has neither been declared dry nor completed for use in field operations.

(iv) Completion refers to installation of permanent equipment for production of oil or gas, or, in the case of a dry well, to reporting to the appropriate authority that the well has been abandoned.

(v) The number of wells drilled refers to the number of wells completed at any time during the fiscal year, regardless of when drilling was initiated.

(d) Disclose, by geographic area, for each of the last three years, any other exploratory or development activities conducted, including implementation of mining methods for purposes of oil and gas producing activities.

§ 229.1206 (Item 1206) Present activities.

(a) Disclose, by geographical area, the registrant's present activities, such as the number of wells in the process of being drilled (including wells temporarily suspended), waterfloods in process of being installed, pressure maintenance operations, and any other related activities of material importance.

(b) Provide the description of present activities as of a date at the end of the most recent fiscal year or as close to the date that the registrant files the document as reasonably possible.

(c) Include only those wells in the process of being drilled at the "as of" date and express them in terms of both gross and net wells.

(d) Do not include wells that the registrant plans to drill, but has not commenced drilling unless there are factors that make such information material.

§ 229.1207 (Item 1207) Delivery commitments.

(a) If the registrant is committed to provide a fixed and determinable quantity of oil or gas in the near future under existing contracts or agreements, disclose material information concerning the estimated availability of oil and gas from any principal sources, including the following:

(1) The principal sources of oil and gas that the registrant will rely upon and the total amounts that the registrant expects to receive from each principal source and from all sources combined;

(2) The total quantities of oil and gas that are subject to delivery commitments; and

(3) The steps that the registrant has taken to ensure that available reserves and supplies are sufficient to meet such commitments for the next one to three years.

(b) Disclose the information required by this Item:

(1) In a form understandable to investors; and

(2) Based upon the facts and circumstances of the particular situation, including, but not limited to:

(i) Disclosure by geographic area;

(ii) Significant supplies dedicated or contracted to the registrant;

(iii) Any significant reserves or supplies subject to priorities or curtailments which may affect quantities delivered to certain classes of customers, such as customers receiving services under low priority and interruptible contracts;

(iv) Any priority allocations or price limitations imposed by Federal or State regulatory agencies, as well as other factors beyond the registrant's control that may affect the registrant's ability to meet its contractual obligations (the registrant need not provide detailed discussions of price regulation);

(v) Any other factors beyond the registrant's control, such as other parties having control over drilling new wells, competition for the acquisition of reserves and supplies, and the availability of foreign reserves and supplies, which may affect the registrant's ability to acquire additional reserves and supplies or to maintain or increase the availability of reserves and supplies; and

(vi) Any impact on the registrant's earnings and financing needs resulting from its inability to meet short-term or long-term contractual obligations. (See Items 303 and 1209 of Regulation S-K.)

(c) If the registrant has been unable to meet any significant delivery commitments in the last three years, describe the circumstances concerning such events and their impact on the registrant.

(d) For purposes of this Item, available reserves are estimates of the amounts of oil and gas which the registrant can produce from current proved developed reserves using presently installed equipment under existing economic and operating conditions and an estimate of amounts that others can deliver to the registrant under long-term contracts or agreements on a per-day, per-month, or per-year basis.

§ 229.1208 (Item 1208) Oil and gas properties, wells, operations, and acreage.

(a) Identify and describe generally the registrant's material properties, plants, facilities, and installations:

(1) Identify the geographic area in which they are located;

(2) Indicate whether they are located onshore or offshore; and

(3) Describe any statutory or other mandatory relinquishments, surrenders, back-ins, or changes in ownership.

(b) Provide the information specified in paragraph (c) of this Item in tabular format as provided below:

Wells

Location	Producing Wells	
	Gross	Net
Geographic Area A		
Oil Wells		
Natural Gas Wells		
Product A Wells		
Total		
Geographic Area B		
Oil Wells		
Natural Gas Wells		
Product A Wells		
Total		

(c) For oil wells and gas wells in both conventional and continuous accumulations and for other wells for products from continuous accumulations, disclose separately the number of the registrant's producing wells, expressed in terms of both gross wells and net wells, by geographic area.

(d) To the extent the registrant is extracting hydrocarbons through means other than wells, provide a discussion of such operations.

(e) Provide the information specified in paragraph (f) of this Item in tabular format as provided below:

Acreage

	Developed Acres		Undeveloped Acres	
	Gross	Net	Gross	Net
Geographic Area A				
Geographic Area B				
Geographic Area C				
Total				

(f) Disclose, by geographic area, the registrant's total gross and net developed acres (i.e., acres spaced or assignable to productive wells) and undeveloped acres, including leases and concessions.

(g) For unproved properties disclose:

(1) The existence, nature (including any bonding requirements), timing, and cost (specified or estimated) of any work commitments; and

(2) By geographic area, the net area of unproved property for which the registrant expects its rights to explore, develop, and exploit to expire within one year.

(h) Disclose areas of acreage concentration, and, if material, the minimum remaining terms of leases and concessions.

(i) Definitions. For purposes of this Item, the following terms shall be defined as indicated:

(1) A gross well or acre is a well or acre in which the registrant owns a working interest. The number of gross wells is the total number of wells in which the registrant owns a working interest. Count one or more completions in the same bore hole as one well. In a footnote, disclose the number of wells with multiple completions. If one of the multiple completions in a well is an oil completion, classify the well as an oil well.

(2) A net well or acre is deemed to exist when the sum of fractional ownership working interests in gross wells or acres equals one. The number of net wells or acres is the sum of the fractional working interests owned in gross wells or acres expressed as whole numbers and fractions of whole numbers.

(3) Productive wells include producing wells and wells mechanically capable of production.

(4) Undeveloped acreage encompasses those leased acres on which wells have not been drilled or completed to a point that would permit the production of economic quantities of oil or gas regardless of whether such acreage contains proved reserves. Do not confuse undeveloped acreage with undrilled acreage held by production under the terms of the lease.

§ 229.1209 (Item 1209) Discussion and analysis of changes, trends, and uncertainties for registrants engaged in oil and gas activities.

(a) Provide, either as part of Management's Discussion and Analysis of Financial Condition and Results of Operations or in a separate section, a discussion of:

(1) Material changes in proved reserves and, if disclosed, probable and possible reserves, and the sources to which such changes are attributable, including changes made due to:

(i) Changes in prices;

(ii) Technical revisions; and

(iii) Changes in the status of any concessions held (such as terminations, renewals, or changes in provisions);

(2) Technologies used to establish the appropriate level of certainty for any material additions to, or increases in, reserves estimates; and

(3) Known trends, demands, commitments, uncertainties, and events that have had, or are reasonably likely to have, a material effect on the company with respect to matters including, but not limited to, the following:

(i) Prices and costs;

(ii) Performance of currently producing wells, including water production from such wells and the need to use enhanced recovery techniques to maintain production from such wells;

(iii) Performance of any mining-type activities for the production of hydrocarbons;

(iv) The registrant's recent ability to convert:

(A) Proved undeveloped reserves to proved developed reserves;

(B) Probable reserves to proved reserves, if disclosed; and

(C) Possible reserves to probable or proved reserves, if disclosed;

(v) Anticipated capital expenditures directed toward conversion of:

(A) Proved undeveloped reserves to proved developed reserves;

(B) Probable reserves to proved reserves, if disclosed; and

(C) Possible reserves to probable or proved reserves, if disclosed;

(vi) Anticipated exploratory activities, well drilling, and production;

(vii) The minimum remaining terms of leases and concessions;

(viii) Material changes to any line item in the tables described in §§ 229.1202 through 229.1208; and

(ix) Potential effects of different forms of rights to resources, such as production sharing contracts, on operations.

(b) To the extent that such discussion or analysis of material changes, known trends, or uncertainties is directly relevant to a particular disclosure required by §§ 229.1202 through 229.1208, the registrant may include such discussion or analysis in response to the relevant section, with appropriate cross-references, rather than including such discussion or analysis in its general response to § 229.303 (Management's Discussion and Analysis of Financial Condition and Results of Operations).

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

8. The authority citation for part 249 continues to read in part as follows:

Authority: 15 U.S.C. 78a et seq., 7202, 7233, 7241, 7262, 7264, and 7265; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

9. Amend Form 20-F (referenced in §249.220f) by:

a. Revising "Instruction to Item 4" and the introductory text and paragraph (b) of "Instructions to Item 4.D"; and

b. Removing paragraph (c) of "Instructions to Item 4.D" and "Appendix A to Item 4.D—Oil and Gas."

The additions and revisions read as follows:

[Note: The text of Form 20-F does not, and this amendment thereto will not, appear in the Code of Federal Regulations.]

FORM 20-F

* * * * *

Item 4. Information on the Company

* * * * *

Instructions to Item 4:

1. Furnish the information specified in any industry guide listed in Part 9 of Regulation S-K (§229.802 of this chapter) that applies to you.

2. If oil and gas operations are material to your or your subsidiaries' business operations or financial position, provide the information specified in Subpart 1200 of Regulation S-K (§229.1200 et seq. of this chapter). If the required information is not disclosed because a foreign government restricts the disclosure of estimated reserves for properties under its governmental authority, or amounts under long-term supply, purchase, or similar agreements, the registrant shall disclose the country, cite the law or regulation which restricts such disclosure, and indicate that the reported reserves estimates or amounts do not include figures for the named country.

* * * * *

Instruction to Item 4.D: In the case of an extractive enterprise, other than an oil and gas producing activity:

* * * * *

(b) In documents that you file publicly with the Commission, do not disclose estimates of reserves unless the reserves are proved or probable and do not give estimated values of those reserves, unless foreign law requires you to disclose the information. If these types of estimates have already been provided to any person that is offering to acquire you, however, you may include the estimates in documents relating to the acquisition.

* * * * *

By the Commission.

Florence E. Harmon

Florence E. Harmon
Acting Secretary

June 26, 2008

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 58035 / June 26, 2008

In the Matters of **Bear Wagner Specialists LLC** **Admin. Proc. File No. 3-11445** **Fleet Specialist, Inc.** **Admin. Proc. File No. 3-11446** **LaBranche & Co. LLC** **Admin. Proc. File No. 3-11447** **Spear, Leeds & Kellogg Specialists LLC** **Admin. Proc. File No. 3-11448** **Van der Moolen Specialists USA, LLC** **Admin. Proc. File No. 3-11449** **Performance Specialist Group LLC** **Admin. Proc. File No. 3-11558** **SIG Specialists, Inc.** **Admin. Proc. File No. 3-11559** **Respondents.**	**ORDER APPROVING A DISTRIBUTION, AUTHORIZING DISBURSEMENT OF FUNDS, MODIFYING PRIOR ORDER, AND MODIFYING DISTRIBUTION PLAN**

I.

FACTS

1. In March and July 2004, the Commission entered into settlements with the seven specialist firms operating on the New York Stock Exchange. The Commission's orders (Securities Exchange Act Release Nos. 49498 – 49502 and Nos. 50075 – 50076) (the "Settlement Orders") provided, among other things, for payment of disgorgement and civil penalties totaling, in the aggregate, over $247 million. The Settlement Orders further provided that the disgorgement and civil penalties were to be placed in seven Fair Funds (the "Distribution Funds") to be distributed pursuant to a distribution plan (the "Plan") drawn up by a fund administrator. Heffler, Radetich & Saitta L.L.P. ("Heffler") was appointed the fund administrator in October 2004.

2. On May 17, 2006, the Commission issued an order (the "May 2006 Order") approving Heffler's Plan. Pursuant to the Plan, Heffler must identify the customers who were injured as a result of the previously identified violative trades, calculate each injured customer's

Document 41 of 48

distribution amount – which is the sum of the disgorgement amount, and the prejudgment and post-judgment interest thereon – and make distributions to the injured customers. The distributions are to be made on a rolling basis. The May 2006 Order and the Plan were modified by a Commission order dated June 15, 2007, which extended the initial termination date of the Distribution Funds from December 31, 2006 to June 30, 2008.

3. Pursuant to previous Commission orders, Heffler has thus far made four distributions under the Plan, totaling, in the aggregate, over $120 million.

a. The initial distribution was made on July 19, 2006, pursuant to a Commission Order dated July 5, 2006. This initial distribution involved a total disbursement of $52,732,921.43, which was comprised of $42,082,144.95 in disgorgement, $6,101,253.76 in prejudgment interest, and $4,549,522.72 in post-judgment interest.

b. On November 30, 2006, Heffler made a second rolling distribution under the Plan, pursuant to a Commission Order dated November 24, 2006. This second distribution involved a total disbursement of $42,765,263.59, which was comprised of $33,548,991.43 in disgorgement, $4,942,721.04 in prejudgment interest, and $4,273,551.12 in post-judgment interest.

c. On June 19, 2007, Heffler made a third rolling distribution under the Plan, pursuant to a Commission Order dated June 15, 2007. This third distribution involved a total disbursement of $14,305,053.02, which was comprised of $10,923,205.08 in disgorgement, $1,606,357.24 in prejudgment interest, and $1,775,490.70 in post-judgment interest.

d. On December 19, 2007, Heffler made a fourth rolling distribution under the Plan, pursuant to a Commission Order dated December 12, 2007. This fourth distribution involved a total disbursement of $10,733,490.40, which was comprised of $7,935,062.94 in disgorgement, $1,267,325.27 in prejudgment interest, and $1,531,102.19 in post-judgment interest.

4. Heffler has notified the staff that it is now prepared to make a fifth distribution in this matter. Section III of the Plan provides that the Commission must approve all distributions to injured customers.

5. In accordance with the Plan, Heffler has submitted, for Commission approval, a report dated June 9, 2008 (the "Distribution Report"), identifying the injured customers who will receive a distribution check, and their distribution amount, with respect to the fifth rolling distribution in this matter. This fifth distribution involves a total disbursement of $2,885,895.39, comprised of $2,069,722.41 in disgorgement, $354,784.94 in prejudgment interest, and $461,388.04 in post-judgment interest. The Plan calls for post-judgment interest on each transaction to be calculated starting from the day following the entry of the Settlement Orders and ending on the date of distribution. For purposes of calculating the post-judgment interest in this distribution, Heffler has selected June 30, 2008, as the date of distribution.

6. Heffler has also submitted a schedule of estimated printing and mailing costs (the "Distribution Costs") that will be incurred in connection with this fifth distribution, and has

requested that the Commission authorize a member of the Enforcement staff at or above the level of Associate Regional Director at the Commission's New York Regional Office (the "SEC Representative") to approve the advance payment of such costs. The Distribution Costs are estimated at $6,450. Citizens Bank of Pennsylvania ("Citizens Bank"), the escrow agent and disbursing agent in this matter, has also requested that the Commission authorize the SEC Representative to approve the payment of estimated banking fees (the "Bank Fees") as they relate to the fifth distribution when they are incurred. Citizens Bank had previously provided the staff with an estimate of Bank Fees amounting to $38,220 for services in connection with processing the first 500,000 checks issued in the distributions.

7. In the Plan, as previously modified by the Commission's June 15, 2007 Order, Heffler proposed June 30, 2008, as the termination date of the Distribution Funds, with the proviso that "such date may be subsequently amended in light of Heffler's recommendation for periodic distributions, which is based on future responses received from Clearing Members and Nominees." The Plan provides that Heffler will continue to work with the clearing member firms and nominees to identify the injured customers, and when Heffler determines that "efforts to identify the Injured Customers have been exhausted," it will submit a final report to the Commission recommending that the Distribution Funds be terminated.

8. Heffler has notified the staff that while Heffler's efforts to identify injured customers are nearing exhaustion, Heffler continues to receive responses from clearing member firms and nominees identifying injured customers. As such, Heffler may need to make an additional distribution in the near future. In addition, pursuant to the Plan, injured customers receiving a check as part of the fifth distribution will have 180 days from the date of issuance, or until December 30, 2008, to negotiate the same. Finally, Heffler has informed the staff that Heffler will require a certain amount of time to finalize and close out the Distribution Funds after all the payments, including payments associated with any future distribution, have been made. Accordingly, Heffler has requested that the Commission further modify the May 2006 Order and the Plan to extend Heffler's proposed date of termination of the Distribution Funds to June 30, 2009, or such other date as ordered by the Commission.

II.

In view of the foregoing, it is ORDERED that:

1. The fifth rolling distribution, and the corresponding disbursement, of $2,885,895.39 in accordance with the Distribution Report submitted by Heffler, are hereby approved and authorized.

2. The SEC Representative is hereby authorized to approve the advance payment of the Distribution Costs, and authorized to approve the payment of the Bank Fees as they are incurred in connection with this fifth distribution. Heffler and Citizens Bank shall provide adequate supporting documentation for the Distribution Costs and the Bank Fees, respectively, to the SEC Representative. Any disbursements from the Fair Funds with respect to Distribution Costs and Bank Fees shall be made only upon the written authorization of the SEC

Representative to Citizens Bank followed by a verbal confirmation from the SEC Representative of such written authorization.

3. The May 2006 Order and the Plan are hereby further modified to extend Heffler's proposed date of termination of the Distribution Funds to June 30, 2009, or such other date as may be further ordered by the Commission.

By the Commission.

Florence E. Harmon
Acting Secretary

J. Lynn Taylor

By: J. Lynn Taylor
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 240

[Release No. 34-58047; File No. S7-16-08]

RIN 3235-AK15

Exemption of Certain Foreign Brokers or Dealers

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("Commission" or "SEC") is proposing to amend a rule under the Securities Exchange Act of 1934 ("Exchange Act"), which provides conditional exemptions from broker-dealer registration for foreign entities engaged in certain activities involving certain U.S. investors. To reflect increasing internationalization in securities markets and advancements in technology and communication services, the proposed amendments would update and expand the scope of certain exemptions for foreign entities, consistent with the Commission's mission to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation.

DATES: Comments should be received on or before [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 S7-16-08 on the subject line; or

Document 42 of 48

- Use the Federal eRulemaking Portal (http://www.regulations.gov/). Follow the instructions for submitting comments.

Paper comments:

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

All submissions should refer to File Number S7-16-08. 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. We 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 FUTHER INFORMATION CONTACT: Erik R. Sirri, Director, Marlon Quintanilla Paz, Senior Counsel to the Director, Brian A. Bussey, Assistant Chief Counsel, Matthew A. Daigler, Special Counsel, or Max Welsh, Attorney, Office of the Chief Counsel, Division of Trading and Markets, at (202) 551-5500, at the Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6628.

SUPPLEMENTARY INFORMATION: The Commission is requesting public comment on the proposed amendments to Rule 15a-6 [17 CFR 240.15a-6] under the Exchange Act.

TABLE OF CONTENTS

I. Introduction and Background

Section 15(a) of the Exchange Act generally provides that, absent an exception or exemption, a broker or dealer that uses the mails or any means of interstate commerce to effect transactions in, or to induce or attempt to induce the purchase or sale of, any security must register with the Commission.[1] The Commission uses a territorial approach in applying the broker-dealer registration requirements to the international operations of broker-dealers.[2] Under this approach, broker-dealers located outside the United States that induce or attempt to induce securities transactions with persons in the United States are required to register with the Commission, unless an exemption applies.[3] Entities that conduct such activities entirely outside the United States do not have to register. Because this territorial approach applies on an entity level, not a branch level, if a foreign broker-dealer establishes a branch in the United States,

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1 See 15 U.S.C. 78o(a)(1). Section 3(a)(4) of the Exchange Act generally defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others," but provides 11 exceptions for certain bank securities activities. Section 3(a)(5) of the Exchange Act generally defines a "dealer" as "any person engaged in the business of buying and selling securities for his own account," but includes exceptions for certain bank activities. 15 U.S.C. 78c(a)(4). Exchange Act Section 3(a)(6) defines a "bank" as a bank or savings association that is directly supervised and examined by state or federal banking authorities (with certain additional requirements for banks and savings associations that are not chartered by a federal authority or a member of the Federal Reserve System). 15 U.S.C. 78c(a)(6). Accordingly, foreign banks that act as brokers or dealers within the jurisdiction of the United States are subject to U.S. broker-dealer registration requirements. See Exchange Act Release No. 27017 (Jul. 11, 1989), 54 FR 30013, 30015 n.16 (Jul. 18, 1989) ("1989 Adopting Release"); and Exchange Act Release No. 25801 (Jun. 14, 1988), 53 FR 23645 at n.1 (Jun. 23, 1988) ("1988 Proposing Release"). To the extent, however, that a foreign bank establishes a branch or agency in the United States that is supervised and examined by a federal or state banking authority and otherwise meets the requirements of Section 3(a)(6), the Commission considers that branch or agency to be a "bank" for purposes of the exceptions from the "broker" and "dealer" definitions. See 1989 Adopting Release, 54 FR at 30015 n.16.

2 See 1989 Adopting Release, 54 FR at 30016.

3 See id.

broker-dealer registration requirements would extend to the entire foreign broker-dealer entity.[4] The registration requirements do not apply, however, to a foreign broker-dealer with an affiliate, such as a subsidiary, operating in the United States.[5] Only the U.S. affiliate must register and only the U.S. affiliate may engage in securities transactions and perform related functions on behalf of U.S. investors.[6] The territorial approach also requires registration of foreign broker-dealers operating outside the United States that effect, induce or attempt to induce securities transactions for any person inside the United States, other than a foreign person temporarily within the United States.[7]

In response to numerous inquiries seeking no-action relief and interpretive advice regarding whether certain international securities activities required U.S. broker-dealer registration, the Commission issued a release on June 14, 1988, to clarify the registration requirements for foreign-based broker-dealers, foreign affiliates of U.S. broker-dealers, and other foreign financial institutions.[8] The release also proposed Rule 15a-6, which provided conditional exemptions from registration under Section 15(b) of the Exchange Act for foreign broker-dealers that induce or attempt to induce the purchase or sale of any security by certain U.S. institutional investors, if the foreign broker-dealer satisfied certain conditions. The Commission adopted Rule 15a-6 on July 11, 1989, and it became effective August 15, 1989.[9]

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4 See id. at 30017.

5 See id.

6 See id.

7 See id. For contacts by foreign broker-dealers with U.S. citizens domiciled abroad, the Commission generally does not require registration. Paragraph (a)(4)(v) of Rule 15a-6 specifically addresses this situation.

8 See 1988 Proposing Release.

9 17 CFR 240.15a-6. See 1989 Adopting Release.

While the rule has provided a useful framework for certain U.S. investors to access foreign broker-dealers for almost two decades, ever increasing market globalization suggests that it is time to revisit that framework to consider whether it could be made more workable, consistent with the Commission's mission to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation.

As discussed below, the amendments we propose today would generally expand the category of U.S. investors that foreign broker-dealers may contact for the purpose of providing research reports and soliciting securities transactions. The proposed amendments would also reduce the role U.S. registered broker-dealers must play in intermediating transactions effected by foreign broker-dealers on behalf of certain U.S. investors. Proposed new safeguards are intended to ensure that the expanded exemptions would remain consistent with the Commission's statutory mandate.

II. The Regulatory Framework under Rule 15a-6

As discussed below, Rule 15a-6 provides conditional exemptions from broker-dealer registration for foreign broker-dealers that engage in certain activities involving certain U.S. investors. Paragraph (b)(3) of the rule defines a "foreign broker-dealer" as "any non-U.S. resident person . . . that is not an office or branch of, or a natural person associated with, a registered broker-dealer, whose securities activities, if conducted in the United States, would be described by the definition of 'broker' or 'dealer' in Section 3(a)(4) or 3(a)(5) of the Act."[10] Among the activities that foreign broker-dealers may engage in under the rule are: (i) "nondirect" contacts by foreign broker-dealers with U.S. investors through execution of unsolicited securities transactions and the provision of research reports to certain U.S. institutional investors and (ii)

[10] 17 CFR 240.15a-6(b)(3).

"direct" contacts, involving the execution of transactions through a registered broker-dealer intermediary with or for certain U.S. institutional investors, and without this intermediary with or for certain entities such as registered broker-dealers and banks acting in a broker or dealer capacity.[11]

A. Unsolicited Trades

As we explained in adopting Rule 15a-6, a broker-dealer that solicits a transaction with a U.S. investor must be registered with the Commission.[12] Because the Commission determined that, as a policy matter, registration is not necessary if a U.S. investor initiated a transaction with a foreign broker-dealer entirely by his or her own accord, paragraph (a)(1) of Rule 15a-6[13] provides an exemption for a foreign-broker dealer that effects unsolicited securities transactions with U.S. persons.[14] As the Commission expressed in adopting Rule 15a-6, solicitation is construed broadly as "any affirmative effort by a broker or dealer intended to induce transactional business for the broker-dealer or its affiliates."[15] For example, the Commission views telephone calls to U.S. investors, advertising circulated or broadcast in the United States and holding investment seminars in the United States, regardless of whether the seminars were hosted by a registered broker-dealer, as forms of solicitation.[16] Solicitation also includes

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11 See 1989 Adopting Release, 54 FR at 30013.

12 See id. at 30017.

13 17 CFR 240.15a-6(a)(1).

14 See 1989 Adopting Release, 54 FR at 30017.

15 See id.

16 See id. at 30017-18.

recommending the purchase or sale of securities to customers or prospective customers for the purpose of generating transactions.[17]

The exemption in paragraph (a)(1) is intended to allow a foreign broker-dealer to effect transactions with U.S. investors when the foreign broker-dealer does not make any affirmative effort to induce transactional activity with the U.S. investor. Because of the breadth of the meaning of solicitation in the broker-dealer registration context, this exemption typically would not be a viable basis for a foreign broker-dealer to conduct an ongoing business, which would likely involve some form of solicitation, in the United States.[18]

B. Provision of Research Reports

The provision of research to investors also may constitute solicitation by a broker or dealer that would require broker-dealer registration.[19] Broker-dealers often provide research to customers with the expectation that the customer eventually will trade through the broker-dealer.[20] Paragraph (a)(2) of Rule 15a-6[21] provides an exemption from U.S. broker-dealer

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17 See id.

18 See id.; see also Exchange Act Release No. 39779, "Interpretation Re: Use of Internet Web Sites To Offer Securities, Solicit Securities Transactions, or Advertise Investment Services Offshore" (Mar. 23, 1998), 63 FR 14806, 14813 (Mar. 27, 1998) (stating that "[f]oreign broker-dealers that have Internet Web sites and that intend to rely on Rule 15a-6's 'unsolicited' exemption should ensure that the 'unsolicited' customer's transactions are not in fact solicited, either directly or indirectly, through customers accessing their Web sites").

19 See 1989 Adopting Release, 54 FR at 30021-22.

20 See id. ("Broker-dealers often provide research to customers on a non-fee basis, with the expectation that the customer eventually will trade through the broker-dealer. They may provide research to acquaint potential customers with their existence, to maintain customer goodwill, or to inform customers of their knowledge of specific companies or markets, so that these customers will be encouraged to use their execution services for that company or those markets. In each instance, the basic purpose of providing the non-fee research is to generate transactional business for the broker-dealer. In the Commission's view, the deliberate transmission of information, opinions, or

registration for foreign broker-dealers that provide research reports to certain institutional investors under conditions that are designed to permit the flow of research without allowing foreign broker-dealers to do more to solicit transactions with U.S investors.[22]

In particular, the rule exempts from U.S. broker-dealer registration a foreign broker-dealer that provides research to certain U.S. institutional investors if (i) the research reports do not recommend that the investor use the foreign broker-dealer to effect trades in any security, (ii) the foreign broker-dealer does not initiate follow up contacts or otherwise induce or attempt to induce investors to effect transactions in any security, (iii) transactions with the foreign broker-dealer in securities covered by the research reports are effected through a registered broker-dealer according to the provisions of paragraph (a)(3) of the rule, described below, and (iv) the provision of research is not pursuant to an understanding that the foreign broker-dealer will receive commission income from transactions effected by U.S. investors.[23]

The exemption in paragraph (a)(2) of Rule 15a-6 is available only with respect to research reports that are furnished to "major U.S. institutional investors." Paragraph (b)(4) of the rule defines a "major U.S. institutional investor" as (i) a U.S. institutional investor[24] that has, or has under management, total assets in excess of $100 million (which may include the assets of any family of investment companies of which it is a part); or (ii) an investment adviser registered

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recommendations to investors in the United States, whether directed at individuals or groups, could result in the conclusion that the foreign broker-dealer has solicited those investors.").

21 17 CFR 240.15a-6(a)(2).

22 See 17 CFR 240.15a-6(a)(2).

23 See id.

24 See Part II.C., infra, for discussion of the definition of "U.S. institutional investor."

with the Commission under Section 203 of the Investment Advisers Act of 1940 that has total assets under management in excess of $100 million.[25]

C. Solicited Trades

As we discussed in adopting Rule 15a-6, although many foreign broker-dealers have established registered broker-dealer affiliates to deal with U.S. investors and trade in U.S. securities, they may prefer to deal with institutional investors in the United States from their overseas trading desks, where their dealer operations and principal sources of current information on foreign market conditions and foreign securities are based.[26] For similar reasons, many U.S. institutions want direct contact with overseas traders. Except for limited instances of unsolicited transactions, such contact would require the foreign broker-dealer to register with the Commission.

Paragraph (a)(3) of Rule 15a-6[27] provides an exemption for foreign broker-dealers that induce or attempt to induce securities transactions by certain institutional investors, if a U.S. registered broker-dealer intermediates certain aspects of the transactions by carrying out specified functions. In particular, the U.S. registered broker-dealer is required to effect all aspects of the transaction (other than negotiation of the terms).[28] It must issue all required

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25 See 17 CFR 240.15a-6(b)(4); cf. Letter from Richard R. Lindsey, Director, Division of Market Regulation, to Mr. Giovanni P. Prezioso, Cleary Gottlieb, Steen & Hamilton (Apr. 9, 1997) ("1997 Staff Letter").

26 See 1989 Adopting Release, 54 FR at 30024.

27 17 CFR 240.15a-6(a)(3).

28 17 CFR 240.15a-6(a)(3)(iii)(A). In adopting Rule 15a-6, the Commission recognized that rules of foreign securities exchanges and over-the-counter markets may require the foreign broker-dealer, as a member or market maker, to perform the actual physical execution of transactions in foreign securities listed on those exchanges or traded in those markets. See 1989 Adopting Release, 54 FR at 30029 n.185. For this reason, the Commission stated that, while it does not believe that it is appropriate to allow the U.S.

confirmations[29] and account statements to the U.S institutional investor or major U.S. institutional investor. As the Commission explained, these documents are significant points of contact between the investor and the broker-dealer, and they provide important information for investors.[30] Also, as between the foreign broker-dealer and the U.S. registered broker-dealer, the latter is required to extend or arrange for the extension of any credit to these investors in connection with the purchase of securities.[31] In addition, the U.S. registered broker-dealer is responsible for maintaining required books and records relating to the transactions conducted under paragraph (a)(3) of the rule, including those required by Rules 17a-3 and 17a-4,[32] which facilitates Commission supervision and investigation of these transactions.[33] Of course, the U.S. registered broker-dealer also must maintain sufficient net capital in compliance with Exchange Act Rule 15c3-1,[34] and receive, deliver and safeguard funds and securities in connection with the

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registered broker-dealer to delegate the performance of its duties under the rule to the foreign broker-dealer, it would permit such delegation in the case of physically executing foreign securities trades in foreign markets or on foreign exchanges. See 1989 Adopting Release, 54 FR at 30025; cf. 1997 Staff Letter. As a result, the treatment of U.S. securities and foreign securities under paragraph (a)(3) of the rule differs. Specifically, with foreign securities the foreign broker-dealer may not only negotiate the terms, but also execute the transactions in the circumstances specified in the Adopting Release. See 1989 Adopting Release, 54 FR at 30029 n.185; cf. NASD Rule 6620(g)(2) (trade reporting of transactions in foreign equity securities not required when the transaction is executed on and reported to a foreign securities exchange or over the counter in a foreign country and reported to the foreign regulator). With respect to U.S. securities, however, the U.S. broker-dealer is required to execute the transactions and to comply with the provisions of the federal securities laws, the rules thereunder and SRO rules applicable to the execution of transactions.

29 See Rule 10b-10, 17 CFR 240.10b-10. See 17 CFR 240.15a-6(a)(3)(iii)(A)(2).

30 See 1989 Adopting Release, 54 FR at 30029.

31 17 CFR 240.15a-6(a)(3)(iii)(A)(3).

32 17 CFR 240.17a-3 and 17a-4. See 17 CFR 240.15a-6(a)(3)(iii)(A)(4).

33 See 1989 Adopting Release, 54 FR at 30029.

34 17 CFR 240.15c3-1. See 17 CFR 240.15a-6(a)(3)(iii)(A)(5).

transactions in compliance with Exchange Act Rule 15c3-3.[35] Furthermore, the U.S. registered broker-dealer must take responsibility for certain key sales activities, including "chaperoning" the contacts of foreign associated persons with certain U.S. institutional investors.[36]

In adopting Rule 15a-6, the Commission pointed out that the U.S. registered broker-dealer's intermediation is intended to help protect U.S. investors and securities markets.[37] For example, the U.S. registered broker-dealer has an obligation, as it has for all customer accounts, to review any Rule 15a-6(a)(3) account for indications of potential problems.[38]

This exemption in Rule 15a-6(a)(3) applies to transactions with major U.S. institutional investors, described above, as well as "U.S. institutional investors." The rule defines a "U.S. institutional investor" as (i) an investment company registered with the Commission under Section 8 of the Investment Company Act of 1940; or (ii) a bank, savings and loan association, insurance company, business development company, small business investment company, or employee benefit plan defined in Rule 501(a)(1) of Regulation D under the Securities Act of 1933 ("Securities Act"); a private business development company defined in Rule 501(a)(2); an organization described in Section 501(c)(3) of the Internal Revenue Code, as defined in Rule 501(a)(3); or a trust defined in Rule 501(a)(7).[39]

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35 17 CFR 240.15c3-3. See 17 CFR 240.15a-6(a)(3)(iii)(A)(6); cf. 1997 Staff Letter.

36 See 17 CFR 240.15a-6(a)(3)(ii)(A) and (a)(3)(iii)(B); cf. 1997 Staff Letter.

37 See 1989 Adopting Release, 54 FR at 30025.

38 See id. While the rule does not require the U.S. registered broker-dealer to implement procedures to obtain positive assurance that the foreign broker-dealer is operating in accordance with U.S. requirements, the U.S. registered broker-dealer, in effecting trades arranged by the foreign broker-dealer, has a responsibility to review these trades for indications of possible violations of the federal securities laws. Id.

39 See 17 CFR 240.15a-6(b)(7).

D. Counterparties and Specific Customers

Paragraph (a)(4) of Rule 15a-6[40] provides an exemption for foreign broker-dealers that effect transactions in securities with or for, or induce or attempt to induce the purchase or sale of securities by, five categories of persons: (1) registered broker-dealers (acting either as principal or for the account of others) or banks acting pursuant to an exception or exemption from the definition of "broker" or "dealer" in Sections 3(a)(4)(B), 3(a)(4)(E), or 3(a)(5)(C) of the Exchange Act or the rules thereunder;[41] (2) certain international organizations and their agencies, affiliates and pension funds;[42] (3) foreign persons temporarily present in the United States with whom the foreign broker-dealer had a pre-existing relationship; (4) any agency or branch of a U.S. person permanently abroad; and (5) U.S. citizens resident outside the United States, as long as the transactions occur outside the United States and the foreign broker-dealer does not target solicitations at identifiable groups of U.S. citizens resident abroad.

III. Proposed Amendments to Rule 15a-6

The pace of internationalization in securities markets around the world has continued to accelerate since we adopted Rule 15a-6 in 1989. Advancements in technology and communication services have provided greater access to global securities markets for all types of

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40 17 CFR 240.15a-6(a)(4).

41 While the exemption allows foreign broker-dealers to effect transactions with or for certain banks or registered broker-dealers, it does not allow direct contact by foreign broker-dealers with the U.S. customers of the registered broker-dealers or banks. See 1989 Adopting Release, 54 FR at 30013 n.202.

42 The organizations are the African Development Bank, the Asian Development Bank, the Inter-American Development Bank, the International Bank for Reconstruction and Development, the International Monetary Fund, the United Nations. See 17 CFR 240.15a-6(a)(4)(ii).

investors.[43] U.S. investors are seeking to take advantage of this increased access by seeking more direct contact with those expert in foreign markets and foreign securities. In addition, discussions over the years with industry representatives regarding Rule 15a-6 have suggested areas where the rule could be revised to achieve its objectives more effectively without jeopardizing investor protections.[44]

In response to these developments and suggestions, the Commission is proposing to amend Rule 15a-6 to remove barriers to access while maintaining key investor protections. In general, and as discussed more fully in Part III.G. below, the proposed amendments would expand and streamline the conditions under which a foreign broker-dealer could operate without triggering the registration requirements of Section 15(a)(1) or 15B(a)(1) of the Exchange Act and the reporting and other requirements of the Exchange Act (other than Sections 15(b)(4) and 15(b)(6)), and the rules and regulations thereunder, that apply specifically to a broker-dealer that is not registered with the Commission solely by virtue of its status as a broker or dealer, while maintaining a regulatory structure designed to protect investors and the public interest.[45]

A. Extension of Rule 15a-6 to Qualified Investors

The proposed rule would expand the category of U.S. investors with which a foreign broker-dealer[46] could interact under Rule 15a-6(a)(2) and would expand, with a few exceptions, the category of U.S. investors with which a foreign broker-dealer could interact under Rule 15a-6(a)(3) by replacing the categories of "major U.S. institutional investor" and "U.S. institutional

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43 See, e.g., Spotlight On: Roundtable Discussions Regarding Mutual Recognition (Jun. 12, 2007) (available at: http://www.sec.gov/spotlight/mutualrecognition.htm).

44 See, e.g., id.

45 See Part III.G., infra, regarding the scope of the exemption.

46 The definition of "foreign broker or dealer" in the proposed rule would be the same as in the current rule, except as described below. See proposed Rule 15a-6(b)(2).

investor" with the category of "qualified investor," as defined in Section 3(a)(54) of the Exchange Act.[47] In adopting the definitions of "U.S. institutional investor" and "major U.S. institutional investor," the Commission expressed the view that institutions with the major U.S. institutional investor "level of assets are more likely to have the skills and experience to assess independently the integrity and competence of the foreign broker-dealers providing [foreign market] access."[48] As discussed below, we believe that advancements in communications and other technology have made it increasingly likely that a broader range of persons would have these skills and experience at a lower asset level.

The proposed rule would give the term "qualified investor" the same meaning as set forth in Section 3(a)(54) of the Exchange Act.[49] The qualified investor standard is well known to the financial community. Section 3(a)(54)(A) defines a "qualified investor" as:

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47 The proposed rule would also eliminate the definition of "family of investment companies," which is currently used in the definition of "major U.S institutional investor," because it would no longer be needed. See 17 CFR 240.15a-6(b)(1), (4) and (7).

48 1989 Adopting Release, 54 FR at 30027. In proposing the definition of "U.S. institutional investor," the Commission stated that "[t]he proposed asset limitation in the rule is based on the assumption that direct U.S. oversight of the competence and conduct of foreign sales personnel may be of less significance where they are soliciting only U.S. institutional investors with high levels of assets. The $100 million asset level . . . is designed to increase the likelihood that the institution or its investment advisers have prior experience in foreign markets that provides insight into the reliability and reputation of various foreign broker-dealers." 1988 Proposing Release, 53 FR 23654.

49 15 U.S.C. 78c(54). The definition of "qualified investor" was added to the Exchange Act by the Gramm-Leach-Bliley-Act of 1999 (Pub. L. No. 106-102, 113 Stat. 1338 (1999)) and has application to several of the bank exceptions from broker-dealer registration, including: (1) the broker exception for identified banking products when the product is an equity swap agreement (Section 206(a)(6) of Pub. L. No. 106-102, 15 U.S.C. 78c note, as incorporated into Exchange Act Section 3(a)(4)(B)(ix), 15 U.S.C. 78c(a)(4)(B)(ix)); (2) the dealer exception for identified banking products when the product is an equity swap agreement (Section 206(a)(6) of Pub. L. No. 106-102, 15 U.S.C. 78c note, as incorporated into Exchange Act Section 3(a)(5)(C)(iv), 15 U.S.C. 78c(a)(5)(C)(iv)); and (3) the dealer exception for asset-backed securities (Exchange Act Section 3(a)(5)(C)(iii),

(i) any investment company registered with the Commission under Section 8 of the Investment Company Act of 1940 ("Investment Company Act");

(ii) any issuer eligible for an exclusion from the definition of investment company pursuant to Section 3(c)(7) of the Investment Company Act;

(iii) any bank (as defined in Section 3(a)(6) of the Exchange Act), savings association (as defined in Section 3(b) of the Federal Deposit Insurance Act), broker, dealer, insurance company (as defined in Section 2(a)(13) of the Securities Act), or business development company (as defined in Section 2(a)(48) of the Investment Company Act);

(iv) any small business investment company licensed by the United States Small Business Administration under Section 301 (c) or (d) of the Small Business Investment Act of 1958;

(v) any State sponsored employee benefit plan, or any other employee benefit plan, within the meaning of the Employee Retirement Income Security Act of 1974, other than an individual retirement account, if the investment decisions are made by a plan fiduciary, as defined in Section 3(21) of that Act, which is either a bank, savings and loan association, insurance company, or registered investment adviser;

(vi) any trust whose purchases of securities are directed by a person described in clauses (i) through (v) above;

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15 U.S.C. 78c(a)(5)(C)(iii)). These exceptions permit banks to sell certain securities to qualified investors without registering as broker-dealers with the Commission.

(vii) any market intermediary exempt under Section 3(c)(2) of the Investment Company Act;

(viii) any associated person of a broker or dealer other than a natural person;

(ix) any foreign bank (as defined in Section 1(b)(7) of the International Banking Act of 1978);[50]

(x) the government of any foreign country;[51]

(xi) any corporation, company, or partnership that owns and invests on a discretionary basis not less than $25,000,000 in investments;

(xii) any natural person who owns and invests on a discretionary basis not less than $25,000,000 in investments;

(xiii) any government or political subdivision, agency, or instrumentality of a government that owns and invests on a discretionary basis not less than $50,000,000 in investments; or

(xiv) any multinational or supranational entity or any agency or instrumentality thereof.

The Commission proposes to use the definition of "qualified investor" in section 3(a)(54) of the Exchange Act for several reasons primarily related to the sophistication and likely experience with foreign securities and foreign markets of the investors included in the definition. For example, the entities described in paragraphs (i) through (ix) of Section 3(a)(54)(A) of the

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50 The definition of qualified investor includes any foreign bank. Unlike foreign governments (see note 51, infra), foreign banks may establish a permanent presence in the United States, such as a branch, that would not qualify under Exchange Act Section 3(a)(6) as a bank. See note 1, supra. Foreign broker-dealers need to rely on Rule 15a-6 to effect transactions with such entities.

51 Of course, foreign broker-dealers currently do not need to rely on Rule 15a-6 to effect transactions with foreign governments because foreign governments are neither located in the United States nor U.S. persons resident abroad.

Exchange Act, without limitation based on ownership or investment, are all engaged primarily in financial activities, including the business of investing. The persons in paragraphs (xi), (xii) and (xiii) of Section 3(a)(54)(A) are not primarily engaged in investing and may have limited investment experience. Thus, Congress established ownership and investment thresholds for those latter persons as indicators of investment experience and sophistication.[52] The Commission believes that Congress' standard for investors with significant investment experience and sophistication to deal with banks that are not registered as broker-dealers should ensure that these investors would possess sufficient experience with financial matters to be able to enter into securities transactions with foreign broker-dealers under the proposed exemption. Thus, the Commission believes that it would be appropriate and consistent with the protection of investors to extend the relief in proposed Rules 15a-6(a)(2) and (a)(3) to a corporation, company, partnership that, or a natural person who, owns and invests on a discretionary basis not less than $25,000,000 in investments, and to a government or political subdivision, agency or instrumentality of a government that owns and invests on a discretionary basis not less than $50,000,000 in investments.

The primary distinction between a major U.S. institutional investor and a qualified investor is the threshold value of assets or investments owned or invested and the inclusion of natural persons. As a result, under the proposed rule, the threshold would decline from institutional investors that own or control greater than $100 million in total assets to, among

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52 See 15 U.S.C 6801 et seq., Pub. L. No. 106-102, 113 Stat. 1338 (1999). Congress did not include an ownership or investment threshold for multinational or supranational entities, or any agencies or instrumentalities thereof, presumably regarding such entities as possessing sufficient financial sophistication, net worth and knowledge and experience in financial matters to be considered a qualified investor. Exchange Act Release No. 47364 (Feb. 13, 2003), 68 FR 8686, 8693 (Feb. 24, 2003).

others, all investment companies registered with the Commission under Section 8 of the Investment Company Act and corporations, companies, or partnerships that own or invest on a discretionary basis $25 million or more in investments. In addition, under the proposed rule, natural persons who own or invest on a discretionary basis not less than $25,000,000 in investments would be included. In adopting Rule 15a-6, we explained that the $100 million asset level was designed "to increase the likelihood that [the investor has] prior experience in foreign markets that provides insight into the reliability and reputation of various foreign broker-dealers."[53] While we believe this is still the right focus, increased access to information about foreign securities markets due to advancements in communication technology suggest that a broader spectrum of investors are likely to have this type of sophistication.

We believe that the proposed use of the definition of qualified investor would more accurately encompass persons that have prior experience in foreign markets and an appropriate level of investment experience and sophistication overall. In certain instances, it would exclude persons that are currently included in the definition of U.S. institutional investor or major U.S. institutional investor. In each such instance, the proposed use of the definition of qualified investor would require greater investment experience of the entity than the current definition.

For example, with respect to employee benefit plans, the definition of qualified investor includes plans in which investment decisions are made by certain plan fiduciaries. The definition of U.S. institutional investor does not require a fiduciary to make investment decisions and encompasses plans with $5 million or more in assets. While there is no asset requirement in the employee benefit plan section in the definition of qualified investor, the Commission believes that proposing to require investment decisions to be made by plan fiduciaries as a qualification

53 See 1989 Adopting Release, 54 FR at 30027.

for the definition would help ensure a higher level of investing experience and sophistication than a $5 million asset threshold. Similarly, while a qualified investor applies to trusts whose purchases are directed by certain entities, the definition of "U.S. institutional investor" does not impose that limitation, but instead applies to certain trusts with $5 million or more in assets. Also, while the proposed definition (like the existing definition) would encompass business development companies as defined in Section 2(a)(48) of the Investment Company Act, the definition of "U.S. institutional investor" extends to private business development companies defined in Section 202(a)(22) of the Investment Advisers Act of 1940. The definition of "U.S. institutional investor," unlike the definition of "qualified investor," further applies to certain organizations described in Section 503(c) of the Internal Revenue Code with assets of $5 million or more. Proposing to require the higher level of investing experience and sophistication would be appropriate in light of the expanded activities in which foreign broker-dealers would be permitted to engage under the proposed rule, as well as the reduced role that would be played by the U.S. registered broker-dealer.

The Commission requests comment on the proposed use of the definition of "qualified investor" generally and, more specifically, whether allowing foreign broker-dealers to induce or attempt to induce transactions with the persons included in the proposed definition is appropriate. Are the ownership and investment thresholds applicable to certain persons included in the proposed use of the definition of "qualified investor" appropriate? Does the definition encompass investors that likely would have an appropriate level of investing or business experience in foreign markets? If not, why not? Should the definition be tailored to include only investors that have a demonstrated pattern of appropriate transactional activity with U.S. registered or foreign broker-dealers in foreign securities? If so, how?

The Commission also requests comment on whether the proposed use of the definition of "qualified investor" should include additional minimum asset levels for any of the persons included in Exchange Act Section 3(a)(54). For example, should the proposed rule use a new definition that includes a requirement that a small business investment company own and invest a certain amount of investments? Should it include any of the omitted categories of persons from the definition of "U.S. institutional investor"? Are there any categories of investors included in the proposed use of the definition of qualified investor that should be excluded, such as market intermediaries exempt under Section 3(c)(2) of the Investment Company Act?

In addition, the Commission requests comment on whether the proposed use of the definition of "qualified investor" should include natural persons who own or invest on a discretionary basis at least $25,000,000 in investments. If not, should the Commission adopt a different threshold level of investments or ownership? What criteria, if any, should apply to help ensure that a natural person would have sufficient investment experience and sophistication specifically in foreign securities? Are there additional safeguards for natural persons that would be appropriate to include in the rule, such as increasing the involvement of U.S. registered broker-dealers in transactions solicited by foreign broker-dealers? For example, foreign broker-dealers could be required to make suitability determinations before sales to natural persons under the exemption. If additional safeguards applied to transactions with natural persons who own or invest on a discretionary basis at least $25,000,000 in investments, would foreign broker-dealers choose to comply with those safeguards or choose not to do business directly with natural persons under such a rule? Finally, should any of the dollar thresholds in the proposed use of the definition of qualified investor be adjusted for inflation? If so, what mechanism should be used to make such adjustments?

B. Unsolicited Trades

As we noted in adopting Rule 15a-6, although the requirements of Section 15(a) under the Exchange Act do not distinguish between solicited and unsolicited transactions, the Commission does not believe, as a policy matter, that registration is necessary if U.S. investors have sought out foreign broker-dealers outside the United States and initiated transactions in foreign securities markets entirely of their own accord.[54] In that event, U.S. investors would have taken the initiative to trade outside the United States with foreign broker-dealers that are not conducting activities within this country and the U.S. investors would have little reason to expect these foreign broker-dealers to be subject to U.S. broker-dealer requirements.[55] Therefore, the Commission is not proposing to amend paragraph (a)(1) of the current rule, other than to add the title "Unsolicited Trades." Notably, in order to rely on this exemption, foreign broker-dealers need to determine whether each transaction effected in reliance on it has been solicited under the proposed rule.

Because the Commission construes solicitation broadly and relatively few transactions qualify for the unsolicited exemption,[56] the Commission is proposing to provide further interpretive guidance related to solicitation under the proposed rule with respect to quotation systems. In adopting the current rule, we noted that access to foreign market makers' quotations is of considerable interest to registered broker-dealers and institutional investors that seek timely information on foreign market conditions.[57] The Commission also stated that it generally would not consider a solicitation to have occurred for purposes of Rule 15a-6 if there were a U.S.

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[54] <u>See</u> 1989 Adopting Release, 54 FR at 30017.

[55] <u>See</u> <u>id.</u>

[56] <u>See</u> <u>id.</u> at 30021.

[57] <u>See</u> <u>id.</u> at 30017.

distribution of foreign broker-dealers' quotations by third-party systems, such as systems operated by foreign marketplaces or by private vendors, that distributed these quotations primarily in foreign countries.[58] The Commission's position applies only to third-party systems that do not allow securities transactions to be executed between the foreign broker-dealer and persons in the United States through the systems.[59] The Commission noted that it would have reservations about certain specialized quotation systems, which might constitute a more powerful inducement to effect trades because of the nature of the proposed transactions.[60] With respect to direct dissemination of a foreign market maker's quotations to U.S. investors, such as through a private quote system controlled by a foreign broker-dealer (as distinct from a third-party system), the Commission noted in adopting the current rule that such conduct would not be appropriate without registration, because the dissemination of these quotations would be a direct, exclusive inducement to trade with that foreign broker-dealer.[61]

Since the time the current rule was adopted, third-party quotation systems have become increasingly global in scope such that the distinction between systems that distribute quotations

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58 See id.

59 See id.

60 See id. at n.66. For example, the Commission stated that a foreign broker-dealer whose quotations were displayed in a system that disseminated quotes only for large block trades might well be deemed to have engaged in solicitation requiring broker-dealer registration, as opposed to a foreign broker-dealer whose quotes were displayed in a system that disseminated the quotes of numerous foreign dealers or market makers in the same security. See id.

61 See id. at 30019. In making the statement that the conduct would not be appropriate "without registration," the Commission did not intend to preclude a foreign broker-dealer from directly inducing U.S. investors to trade with the foreign broker-dealer via such a quotation system where the U.S. investor subscribes to the quotation system through a U.S. broker-dealer, the U.S. broker-dealer has continuing access to the quotation system, the foreign broker-dealer's other contacts with the U.S. investor are permissible under the current rule and any resulting transactions are intermediated in accordance with the requirements of Rule 15a-6(a)(3).

primarily in the United States and those that distribute quotations primarily in foreign countries is no longer a meaningful or workable distinction because most third-party quotation systems no longer serve a primary location.[62] As a result, under the Commission's proposed interpretation, the Commission's previous guidance on U.S. distribution of foreign broker-dealers' quotations by third-party systems no longer would be limited to third-party systems that distributed their quotations primarily in foreign countries under the proposed rule. In other words, under the proposed interpretation, U.S. distribution of foreign broker-dealers' quotations by a third-party system (which did not allow securities transaction to be executed between the foreign broker-dealer and persons in the U.S. through the system) would not be viewed as a form of solicitation, in the absence of other contacts with U.S. investors initiated by the third-party system or the foreign broker-dealer.

The Commission seeks comment regarding whether retaining the proposed Unsolicited Trades exemption in paragraph (a)(1) is appropriate. Are any modifications to this exemption necessary to reflect increasing internationalization in securities markets and advancements in technology and communication services since the exemption was adopted in 1989? Commenters are invited to provide information on the specific circumstances in which foreign broker-dealers use the exemption in paragraph (a)(1) of the current rule and particularly on the frequency of its use. The Commission also seeks comment on its proposed interpretation with respect to third-party quotation systems under the proposed rule. Are there other interpretive issues relating to third-party quotation systems, or proprietary quotation systems, that the Commission should address? Is guidance needed under the Commission's interpretation of solicitation for other

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62 <u>Cf.</u> 1997 Staff Letter.

entities, such as third-party or proprietary systems that provide indications of interest, for purposes of the proposed amendments of Rule 15a-6?

Because one of the requirements for being an alternative trading system under Regulation ATS[63] is to be registered as a broker-dealer under Section 15(b) of the Exchange Act, a foreign broker-dealer relying on an exemption in proposed Rule 15a-6 would not be eligible to rely on the exemption in Regulation ATS. The Commission solicits comment on whether it should consider amending Regulation ATS to allow a foreign broker-dealer relying on an exemption in proposed Rule 15a-6 to operate an alternative trading system in the United States so long as it otherwise complies with the terms of Regulation ATS.

C. Provision of Research Reports

The provision of research to investors also may constitute solicitation by a broker-dealer, in part because broker-dealers often provide research to customers on a non-fee basis, with the expectation that the customers eventually will trade through the broker-dealer.[64] As we noted in adopting Rule 15a-6, the Commission does not wish to restrict the ability of U.S. investors to obtain foreign research reports in the United States if adequate regulatory safeguards are present.[65] Therefore, the Commission would retain the current exemption for the provision of research reports in paragraph (a)(2) of the current rule. However, for the reasons discussed above,[66] the Commission is proposing to expand the class of investors to which the foreign broker-dealer could provide research reports directly from major U.S. institutional investors to qualified investors. As proposed, paragraph (a)(2) would permit a foreign broker-dealer, subject

63 See 17 CFR 242.300 et seq.

64 See 1989 Adopting Release, 54 FR at 30021.

65 See id.

66 See Part III.A., supra.

to the conditions discussed below, to furnish research reports to qualified investors and effect transactions in the securities discussed in the research reports with or for those qualified investors.

Paragraph (a)(2) of the proposed rule would retain the conditions in current Rule 15a-6(a)(2), modified solely to reflect the proposed expansion of the class of investors to qualified investors. Specifically, proposed paragraph (a)(2) would be available, provided that: (1) the research reports do not recommend the use of the foreign broker-dealer to effect trades in any security; (2) the foreign broker-dealer does not initiate contact with the qualified investors to follow up on the research reports and does not otherwise induce or attempt to induce the purchase or sale of any security by the qualified investors; (3) if the foreign broker-dealer has a relationship with a registered broker-dealer that satisfies the requirements of paragraph (a)(3) of the proposed rule, any transactions with the foreign broker-dealer in securities discussed in the research reports are effected pursuant to the provisions of paragraph (a)(3); and (4) the foreign broker-dealer does not provide research to U.S. persons pursuant to any express or implied understanding that those U.S. persons will direct commission income to the foreign broker-dealer. We understand from discussions with industry representatives that these conditions have been workable for both foreign broker-dealers and U.S. registered broker-dealers and we have no knowledge of investor protection concerns having been raised with regard to foreign broker-dealers that operate in compliance with the current exemption. Accordingly, we do not propose to amend them.

If these conditions are met, the Commission proposes to allow the foreign broker-dealer to effect transactions in the securities discussed in a research report at the request of a qualified investor. The Commission believes that, under the proposed conditions, the direct distribution of research to qualified investors would be consistent with the free flow of information across national boundaries without raising substantial investor protection concerns.[67]

The Commission seeks comment on the proposed "Research Reports" exemption in paragraph (a)(2). Should any of the conditions of the current exemption be changed to address the proposed expansion of the class of institutional investors to which research reports may be distributed directly, or to reflect increasing internationalization in securities markets and advancements in technology and communication services since the exemption was adopted in 1989? If so, how? Similarly, should any of the conditions of the current exemption be changed to more closely align with the proposed modifications to the requirements of paragraph (a)(3) discussed below in Part III.D.? If so, how? Commenters are invited to provide information on the specific circumstances in which foreign broker-dealers use the exemption in paragraph (a)(2) of the current rule and on the frequency of its use.

D. Solicited Trades

The proposed rule would significantly revise the conditions under which a foreign broker-dealer could induce or attempt to induce the purchase or sale of a security by certain U.S. investors under paragraph (a)(3) of Rule 15a-6. Overall, and as discussed more fully below, the proposed rule would reduce and streamline the obligations of the U.S. registered broker-dealer in connection with these transactions and, in certain situations, permit a foreign broker-dealer to provide full-service brokerage by effecting securities transactions on behalf of qualified investors and maintaining custody of qualified investor funds and securities relating to any resulting transactions.

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[67] See 1989 Adopting Release, 54 FR at 30021.

1. Customer Relationship

The proposed rule would require a foreign broker-dealer that induces or attempts to induce the purchase or sale of any security by a qualified investor to engage a U.S. registered broker-dealer under one of two exemptive approaches, to which we will refer as Exemption (A)(1) and Exemption (A)(2), corresponding to paragraphs (a)(3)(iii)(A)(1) and (A)(2) of the proposed rule.[68] As explained below, under both proposed exemptions, the U.S. registered broker-dealer would have fewer obligations than under paragraph (a)(3) of the current rule and the foreign broker-dealer would correspondingly be permitted to play a greater role in effecting any resulting transactions. Both proposed exemptions would allow qualified investors the more direct contact they seek with those expert in foreign markets and foreign securities, without certain barriers such as the chaperoning requirements that may be unnecessary in light of other protections and investor sophistication. Nevertheless, as explained below, both proposed exemptions would retain important measures of investor protection that the Commission believes would, among other things, address the potential risks to qualified investors related to contacts with foreign associated persons with a disciplinary history and ensure that the books and records related to transactions for U.S. investors are available to the Commission.

There are two primary differences between the two proposed exemptive approaches. First, Exemption (A)(1) could only be used by foreign broker-dealers that conduct a "foreign business,"[69] while Exemption (A)(2) could be used by all foreign broker-dealers. Second, the foreign broker-dealer would be permitted to custody funds and securities of qualified investors in

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68 See proposed Rule 15a-6(a)(3)(iii)(A).

69 See Part III.D.1.a.ii., infra, for discussion of "foreign business."

connection with resulting transactions under Exemption (A)(1), but not under Exemption (A)(2). These distinctions are discussed in the following paragraphs.

a. Exemption (A)(1)

i. Role of the U.S. Registered Broker-Dealer

For transactions effected by a foreign broker-dealer pursuant to proposed Exemption (A)(1),[70] a U.S. registered broker-dealer would be required to maintain copies of all books and records, including confirmations and statements issued by the foreign broker-dealer to the qualified investor, relating to any such transactions.[71] As discussed below, the proposed rule would allow such books and records to be maintained by the U.S. registered broker-dealer in the form, manner and for the periods prescribed by the foreign securities authority (as defined in Section 3(a)(50) of the Exchange Act)[72] regulating the foreign broker-dealer.[73] The proposed rule would give the term "foreign securities authority" the same meaning as set forth in Section 3(a)(50) of the Exchange Act,[74] which defines "foreign securities authority" to mean "any foreign government, or any governmental body or regulatory organization empowered by a foreign government to administer or enforce its laws as they relate to securities matters."

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70 As mentioned above and discussed more fully below, only foreign broker-dealers that conduct a "foreign business" would be eligible to effect transactions on behalf of qualified investors pursuant to Exemption (A)(1).

71 See proposed Rule 15a-6(a)(3)(iii)(A)(1). Of course, this would not prevent the U.S. registered broker-dealer from performing other aspects of the transaction.

72 15 U.S.C. 78c(a)(50).

73 See proposed Rule 15a-6(a)(3)(iii)(A)(1). Of course, this would not change any books and recordkeeping obligations a U.S. registered broker-dealer may have under Exchange Act Rules 17a-3 and 17a-4 (17 CFR 240.17a-3 and 17a-4).

74 15 U.S.C. 78c(a)(50).

Because proposed Exemption (A)(1) would allow a foreign broker-dealer to effect transactions for qualified investors and custody their funds and assets, the foreign broker-dealer would generate books and records relating to the transactions. Proposed Exemption (A)(1) would allow the U.S. registered broker-dealer to maintain such books and records with the foreign broker-dealer, provided that the U.S. registered broker-dealer makes a reasonable determination that copies of any or all of such books and records could be furnished promptly to the Commission and promptly provides any such books and records to the Commission, upon request.[75] In making such a determination, the U.S. registered broker-dealer would need to consider, among other things, the existence of any legal limitations in the foreign jurisdiction that might limit the ability of the foreign broker-dealer to disclose information relating to transactions conducted pursuant to proposed Exemption (A)(1) to the U.S. registered broker-dealer. Proposing to require U.S. registered broker-dealers to make a reasonable determination that the books and records could be furnished promptly to the Commission is designed to ensure that the ability of the Commission to obtain copies of the books and records would not be diminished. It should also significantly reduce the U.S. registered broker-dealer's cost of recordkeeping with respect to transactions effected pursuant to this exemption. Thus, the Commission believes that allowing U.S. registered broker-dealers to maintain books and records with a foreign broker-dealer would appropriately support the Commission's interest in the protection of investors – by being designed to ensure that the books and records related to transactions for U.S. investors are

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75 See Exchange Act Release No. 44992 (Oct. 26, 2001), 66 FR 55818, 55825 & n.72 (Nov. 2, 2001) ("Generally, requests for records which are readily available at the office (either on-site or electronically) should be filled on the day the request is made. If a request is unusually large or complex, then the firm should discuss with the regulator a mutually agreeable time-frame for production. . . . Valid reasons for delays in producing the requested records do not include the need to send the records to the firm's compliance office for review prior to providing the records.").

available to the Commission – while avoiding the burden that might be placed on U.S. registered broker-dealers under the exemption by requiring the books and records to be maintained in the form, manner and for the periods prescribed by Rules 17a-3 and 17a-4 under the Exchange Act,[76] as if the U.S. registered broker-dealer had effected the transactions under proposed Exemption (A)(1).

Unlike under the current rule, under Exemption (A)(1), the intermediating U.S. registered broker-dealer would not be required to effect all aspects of the transaction.[77] Thus, with respect to transactions effected pursuant to Exemption (A)(1), the intermediating U.S. registered broker-dealer would no longer be required to comply with the provisions of the federal securities laws, the rules thereunder and SRO rules applicable to a broker-dealer effecting a transaction in securities, unless it were otherwise involved in effecting the transaction.[78] However, if a foreign broker-dealer effects a transaction pursuant to Exemption (A)(1) on a U.S. national securities exchange, through a U.S. alternative trading system, or with a market maker or an over-the-counter dealer in the United States, as is common with respect to U.S. securities, a U.S. registered broker-dealer would be involved in effecting the transaction and would be required to comply with the provisions of the federal securities laws, the rules thereunder and SRO rules applicable to such activity. In other words, such provisions would apply with respect to all transactions in U.S. securities under Exemption (A)(1) other than certain over-the-counter

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76 See 17 CFR 240.17a-3 and 17a-4.

77 See 17 CFR 240.15a-6(a)(3)(iii)(A) (requiring the U.S. registered broker-dealer to effect all aspects of a transaction other than negotiation of its terms) and proposed Rule 15a-6(a)(3)(iii)(A)(1); see also note 28, supra, for a discussion of the differing treatment of U.S. and foreign securities under current Rule 15a-6(a)(3)(iii)(A)(1).

78 See note 28, supra, for a discussion of the differing treatment of U.S. and foreign securities under current Rule 15a-6(a)(3)(iii)(A)(1).

transactions that a foreign broker-dealer does not effect by or through a U.S. registered broker-dealer.

The intermediating U.S. registered broker-dealer also would no longer be required to extend or arrange for the extension of credit, issue confirmations and account statements, comply with Rule 15c3-1 with respect to the transactions, or receive, deliver and safeguard funds and securities in connection with the transactions in compliance with Rule 15c3-3.[79] In addition, the intermediating U.S. registered broker-dealer would no longer be required to maintain accounts for the customers of foreign broker-dealers relying on Exemption (A)(1),[80] or comply with the requirements applicable to broker-dealers that maintain such accounts. As a result, among other requirements, the U.S. registered broker-dealer may not have obligations under Exchange Act Rule 17a-8[81] with respect to customers of foreign broker-dealers relying on Exemption (A)(1). Rule 17a-8 requires a U.S. registered broker-dealer to comply with the reporting, recordkeeping and record retention requirements in regulations implemented under the Bank Secrecy Act.[82] As discussed above, current Rule 15a-6 permits an unregistered foreign broker-dealer to effect transactions directly with U.S. persons on an unsolicited basis,[83] and to solicit certain U.S. institutional investors by means of research reports and effect transactions in securities discussed

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79 See 17 CFR 240.15a-6(a)(3)(iii)(A)(1), (2), (3), (4) and (5) and the discussion in Part II.C., supra.

80 See text accompanying note 38, supra.

81 17 CFR 240.17a-8.

82 Currency and Foreign Transactions Reporting Act of 1970 (commonly referred to as the Bank Secrecy Act). See 31 U.S.C. 5311 et seq., 12 U.S.C. 1829b and 12 U.S.C. 1951-1959. The Secretary of the U.S. Department of Treasury has delegated responsibility for the administration of the Bank Secrecy Act to the Director of the Financial Crimes Enforcement Network ("FinCEN"), a bureau of the U.S. Department of Treasury. See Treasury Order 180-01 (Sep. 26, 2002).

83 See Part II.A., supra.

in such reports, subject to certain conditions,[84] in either case without intermediation by a U.S. registered broker-dealer subject to Rule 17a-8. Would permitting a foreign broker-dealer to effect securities transactions on a solicited basis with certain U.S. persons under proposed Exemption (A)(1) present any concerns with respect to Rule 17a-8 or anti-money laundering obligations under the Bank Secrecy Act? How should these concerns, if any, be addressed? For example, are there specific circumstances in which the Commission should consider imposing additional obligations on the U.S. registered broker-dealer or the foreign broker-dealer under proposed Exemption (A)(1) or alternatively prohibiting the use of Exemption (A)(1)?

The Commission requests comment generally on the proposed requirements in Exemption (A)(1) of the proposed rule. In particular, the Commission requests comment on whether the Commission should require the U.S. registered broker-dealer to comply with any requirements with respect to transactions under Exemption (A)(1) other than the proposed requirement to maintain books and records relating to the transactions. Should the requirements differ based on whether the securities are U.S. securities or foreign securities? If so, why and how? The Commission also requests comment on whether the Commission should require the U.S. registered broker-dealer to maintain books and records relating to the transactions in the form, manner and for the periods prescribed by Rules 17a-3 and 17a-4 under the Exchange Act as if the U.S. registered broker-dealer had effected the transactions under Exemption (A)(1). In addition, the Commission requests comment on whether the Commission should permit the U.S. registered broker-dealers to maintain copies of books and records resulting from transactions under paragraph Exemption (A)(1) with the foreign broker-dealer. Should it depend on the adequacy of the books and recordkeeping requirements to which the foreign broker-dealer is

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84 See Part II.B., supra.

subject? Should the Commission provide more guidance on or should the proposed rule provide parameters for what would constitute a reasonable determination? In lieu of the proposed requirement of a reasonable determination by the U.S. registered broker-dealer under Exemption (A)(1), should the Commission condition the exemption on the foreign broker-dealer filing a written undertaking with the Commission to furnish the books and records to the U.S. registered broker-dealer or the Commission upon request?

Furthermore, the Commission requests comment on whether the requirement under Exemption (A)(1) that the U.S. registered broker-dealer make a reasonable determination that books and records relating to any resulting transactions could be furnished promptly to the Commission upon request, and promptly provide such books and records to the Commission upon request, is the appropriate standard given the potential time-zone differences and the fact that such records may be maintained in paper form. If not, what is the appropriate standard and why?

ii. Role of the Foreign Broker-Dealer

The proposed rule would limit the availability of Exemption (A)(1) to foreign broker-dealers that are regulated for conducting securities activities (such as effecting transactions in securities), including the specific activities in which the foreign broker-dealer engages with the qualified investor, in a foreign country by a foreign securities authority.[85] This requirement is designed to ensure that only foreign entities that are legitimately in the business of conducting securities activities (such as effecting transactions in securities), and that are regulated in the conduct of those activities, could rely on Exemption (A)(1).

85 See proposed Rule 15a-6(b)(2)(i).

Both Exemption (A)(1) and Exemption (A)(2) would require the foreign broker-dealer to disclose to the qualified investor that it is regulated by a foreign securities authority and not by the Commission. Unlike under Exemption (A)(2), for the reasons discussed below,[86] the foreign broker-dealer operating under proposed Exemption (A)(1) would also be required to disclose that U.S. segregation requirements (e.g., the requirement that customer funds and assets be segregated from the broker-dealer's own proprietary funds and assets), U.S. bankruptcy protections (e.g., preference to creditors in bankruptcy) and protections under the Securities Investor Protection Act ("SIPA")[87] will not apply to any funds and securities of the qualified investor held by the foreign broker-dealer.[88]

These disclosure requirements are intended to help to put qualified investors on notice that foreign broker-dealers operating pursuant to Exemption (A)(1) of the proposed rule would not be subject to the same regulatory requirements as U.S. registered broker-dealers. This notice would be important because the proposed rule would eliminate the current chaperoning requirements, as described below, and allow a foreign broker-dealer to effect transactions on behalf of qualified investors and custody qualified investor funds and securities relating to any resulting transactions with more limited participation in the transactions by a U.S. registered broker-dealer. This should be sufficient notice given the level of sophistication of the investors with which the foreign broker-dealer would be engaging in transactions under Exemption (A)(1).

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86 See Part III.D.b.ii., infra.

87 15 U.S.C. 78aaa et seq. The SIPA created the Securities Investor Protection Corporation ("SIPC"), a nonprofit, private membership corporation to which most registered brokers and dealers are required to belong, and established a fund administered by SIPC designed to protect the customers of brokers or dealers subject to the Act from loss in case of financial failure of the member.

88 See proposed Rule 15a-6(a)(3)(i)(D)(1) and (2).

Specifically, proposing to require disclosure that the foreign broker-dealer is regulated by a foreign securities authority and not the Commission should alert qualified investors that the foreign broker-dealer would not be subject to the full scope of the Commission's broker-dealer regulatory framework. Proposing to require disclosure that U.S. segregation requirements, U.S. bankruptcy protection and protections under the SIPA would not apply to the funds and securities of the qualified investor held by the foreign broker-dealer should alert the qualified investor that its funds and assets would not receive the same protections that they would under U.S. law.

Exemption (A)(_1_) would only be available to foreign broker-dealers that conduct a "foreign business."[89] As explained below, the proposed rule would define "foreign business" to mean the business of a foreign broker-dealer with qualified investors and foreign resident clients[90] where at least 85% of the aggregate value of the securities purchased or sold in transactions conducted pursuant to both paragraphs (a)(3) and (a)(4)(vi) of the proposed rule by the foreign broker-dealer, calculated on a rolling two-year basis, is derived from transactions in foreign securities, as defined below.[91] In general, the Commission believes that making Exemption (A)(_1_) available only to a foreign broker-dealer conducting a foreign business would provide U.S. investors increased access to foreign securities and markets without creating opportunities for regulatory arbitrage vis-à-vis U.S. securities markets because the foreign broker-dealer's business in U.S. securities would be limited.

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89 See proposed Rule 15a-6(b)(2)(ii).

90 See Part III.E., infra.

91 See proposed Rule 15a-6(b)(3).

The proposed definition of foreign securities would include both debt and equity securities of foreign private issuers and debt securities of issuers organized or incorporated in the United States but where the distribution is wholly outside the United States in compliance with Regulation S, as well as certain securities issued by foreign governments. The proposed definition is not restricted to certain types of securities, rather, to the extent that qualified investors are interested in purchasing foreign securities, the Commission believes that they should be able to access a broad range of foreign securities. The proposed rule would define "foreign securities" to mean:

(i) an equity security (as defined in 17 CFR 230.405) of a foreign private issuer (as defined in 17 CFR 230.405);[92]

(ii) a debt security (as defined in 17 CFR 230.902) of a foreign private issuer (as defined in 17 CFR 230.405);

(iii) a debt security (as defined in 17 CFR 230.902) issued by an issuer organized or incorporated in the United States in connection with a distribution conducted solely outside the United States pursuant to Regulation S (17 CFR 230.903 et seq.);[93]

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92 17 CFR 230.405 defines "foreign private issuer" to mean any foreign issuer other than a foreign government, except issuers that meet the following conditions: (1) more than 50 percent of the outstanding voting securities of such issuer directly or indirectly owned of record by residents of the United States; (2) the majority of the executive officers or directors are U.S. citizens or residents; (3) more than 50 percent of the assets of the issuer are located in the United States; or (4) the business of the issuer is administered principally in the United States. The rule sets forth guidelines for determining the percentage of outstanding voting securities owned of record by residents of the United States.

93 Thus, debt securities of an issuer organized or incorporated under the laws of the United States would not qualify as "foreign securities" if they were offered and sold as part of a global offering involving both an offer and sale of the securities in the United States and

(iv) a security that is a note, bond, debenture or evidence of indebtedness issued or guaranteed by a foreign government (as defined in 17 CFR 230.405) that is eligible to be registered with the Commission under Schedule B of the Securities Act; and

(v) a derivative instrument on a security described in subparagraph (i), (ii), (iii), or (iv) of this paragraph.[94]

The proposed rule would require the foreign broker-dealer to compute the absolute value of all transactions pursuant to both paragraphs (a)(3) and (a)(4)(vi) of the proposed rule (i.e., without netting the transactions) each year to determine the aggregate amount for the previous two years. For example, a foreign broker-dealer that sold 100 shares of Security A at $10.00 per share and bought 100 shares of Security A at $10.00 per share pursuant to paragraphs (a)(3) and (a)(4)(vi) of the proposed rule would have an aggregate value of securities bought and sold of $2000.00 (or (100 x $10.00) + (100 x $10.00)).

We note that the definition of foreign security would include, among other things, derivative instruments on debt and equity securities of foreign private issuers. Given that the proposed rule would provide an exemption for foreign broker-dealers that effect transactions in securities, the proposed definition of "foreign securities" would not include derivative instruments that are not themselves securities. Thus, foreign broker-dealers would not need to include the value of swap agreements that meet the definition of "swap agreement" in Section 206A of the Gramm-Leach-Bliley Act ("GLBA") in the foreign business test calculation because

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a contemporaneous distribution outside the United States. This would be consistent with the purpose of the foreign business test, as discussed below.

94 See proposed Rule 15a-6(b)(5).

they are excluded from the definition of security.[95] In the case of other derivative instruments that are securities, the valuation would depend on the product. For example, the value of options on a security or group or index of securities bought or sold would be the premium paid by the buyer, not the value of the underlying security or securities. Similarly, the value of a security future would be the price times the number of securities to be delivered at the time the transaction is entered into.

Foreign broker-dealers should be able to use this valuation information to calculate the total, combined value of the securities purchased or sold in transactions conducted pursuant to both paragraphs (a)(3) and (a)(4)(vi) of the proposed rule to determine the percentage of foreign securities bought from, or sold to, U.S. investors.

The calculation of the composition of the foreign broker-dealer's business on a rolling, two-year basis would mean that, after the first year the foreign broker-dealer relies on the exemption, the foreign broker-dealer would calculate the aggregate value of securities purchased and sold for the prior two years to determine whether it has complied with the foreign business test to be eligible for proposed Exemption (A)(1). This proposed requirement would allow for short-term fluctuations that otherwise could cause a foreign broker-dealer to be out of compliance with the exemption on isolated occasions. A foreign broker-dealer would have the

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95 The GLBA defines "swap agreement," in part, as an agreement between eligible contract participants (as defined in Section 1a(12) of the Commodity Exchange Act), the material terms of which (other than price and quantity) are subject to individual negotiation. Swap agreements may be based on a wide range of financial and economic interests. Section 206B of the GLBA defines "security-based swap agreement" as a swap agreement of which "a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein." Section 3A of the Exchange Act excludes from the definition of security both security-based swap agreements and "non-security-based swap agreements." The Commission retains, however, antifraud authority (including authority over insider trading) over security-based swap agreements. See, e.g., Section 10(b) of the Exchange Act.

flexibility to elect to use a calendar year or the firm's fiscal year for purposes of complying with the foreign business test. In addition, to provide foreign broker-dealers sufficient time to obtain and verify the relevant aggregate value data, the proposed rule would allow foreign broker-dealers to rely on the calculation made for the prior year for the first 60 days of a new year.[96] Hence, a foreign broker-dealer that had a foreign business over years 1 and 2 would be deemed to have a foreign business for the first 60 days of year 4, regardless of the result of the calculation for year 3. We believe that 60 days would be an appropriate "grace period" because it would give a foreign broker-dealer time to make the necessary calculation and to cease relying on Exemption (A)(1) if the calculation revealed that it was no longer conducting a foreign business.

Making Exemption (A)(1) available only to a foreign broker-dealer conducting a foreign business would provide U.S. investors increased access to foreign securities and foreign markets without creating opportunities for regulatory arbitrage vis-à-vis U.S. securities markets because the foreign broker-dealer's business in U.S. securities would be limited. We believe this is particularly important because, under Exemption (A)(1), for the first time, a foreign broker-dealer would be able to provide full-service brokerage services (including maintaining custody of funds and securities from resulting transactions) to certain U.S. investors.

We are proposing an 85% percent threshold for determining whether a foreign broker-dealer conducts a foreign business because we understand from industry representatives that foreign broker-dealers currently effect transactions pursuant to paragraph (a)(3) of Rule 15a-6 primarily in foreign securities and only do a small percentage of business in U.S. securities (less than 10%, by most estimates). The Commission has not been given any indication that foreign

96 See proposed Rule 15a-6(b)(3).

broker-dealers would seek to use an expanded exemption to increase their business in U.S. securities. The 85% threshold should accommodate existing business models and allow foreign broker-dealers to continue to do a limited amount of business in U.S. securities, whether as an accommodation to their clients or as part of program trading (i.e., any trading strategy involving the related purchase or sale of a group of stocks as part of a coordinated trading strategy, which could include U.S. securities), without causing those foreign broker-dealers to lose the benefit of the exemption. Any lower threshold could allow a foreign broker-dealer to conduct significant business in U.S. securities with certain U.S. investors without being subject to the full scope of the Commission's broker-dealer regulatory framework. This, in turn, could hinder the ability of the Commission to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation,[97] as well as affect the competitive positions of U.S. registered broker-dealers and foreign broker-dealers.[98]

The Commission seeks comment on proposed Exemption (A)(1) generally. We invite comment on the proposed limitation of foreign broker-dealers to those that are regulated for conducting securities activities by a foreign securities authority and that conduct a foreign business. The Commission also seeks comment on whether the proposed disclosures provide appropriate notice to qualified investors that foreign broker-dealers would not be subject to the same regulatory requirements as U.S. registered broker-dealers. Would notice be sufficient? Are there are other disclosures that should be required, in particular if the foreign jurisdiction does not require the segregation of qualified investor funds and assets or provide for bankruptcy protection for those funds and assets? Should the foreign broker-dealer be required to identify

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97 See Exchange Act Section 2, 15 U.S.C. 78b.

98 See Exchange Act Section 3(f); see also Part VI.C., infra.

the foreign securities authority or authorities regulating the foreign broker-dealer? Should disclosure of the applicable dispute resolution system be required? In addition, the Commission requests comment regarding the proposed required form of these disclosures. Should the proposed disclosures be eliminated or modified in any way? If so, how and why?

The Commission solicits comment on the proposed definition of foreign broker-dealer. Should the proposed rule require a foreign broker-dealer to be regulated for conducting securities activities, including the specific activities in which the foreign broker or dealer engages with the qualified investor, in a foreign country by a foreign securities authority? What if foreign securities authorities do not apply their regulations to the activities of their broker-dealers outside their country or with non-residents? The Commission also seeks comment on the proposed definition of foreign securities.[99] Are there any other types of securities that should be included within the definition? Should any types of securities be excluded? Will reference to the equity and debt securities of a "foreign private issuer," as that term is defined in 17 CFR 230.405, affect the interest of foreign issuers to cross-list on both foreign and U.S. exchanges? If so, how? Furthermore, will reference to the equity and debt securities of a "foreign private issuer," as that term is defined in 17 CFR 230.405, affect listings of American Depositary Receipts issued by depositaries against the deposit of the securities of foreign issuers on U.S. exchanges? If so, how?

The Commission seeks comment on the proposed definition of "foreign business."[100] Would the proposed test be workable? Would it be relatively easy for foreign broker-dealers to make the foreign business test calculation? Should the proposed test apply separately to debt and

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99 See proposed Rule 15a-6(b)(5).

100 See proposed Rule 15a-6(b)(3).

equity securities? Should the proposed test exclude U.S. government securities from the percentage of business in U.S. securities for purposes of computing the threshold? Is the proposed method of valuing options and security futures appropriate? Should we provide examples of how to value other types of derivative instruments?

The Commission requests comment on whether the proposed 85% threshold would be sufficient to enable foreign broker-dealers to effect transactions in U.S. securities as an accommodation and engage in program trading with qualified investors. Would compliance with the threshold be easily determinable? Should it be raised or lowered to better protect against regulatory arbitrage or to achieve its stated purposes? Commenters suggesting a different threshold or a different method for determining compliance with the threshold should explain why the Commission should choose that threshold or method. Instead of requiring foreign broker-dealers to conduct a "foreign business," should Exemption (A)(1) of the proposed rule instead permit foreign broker-dealers to effect transactions in foreign securities and U.S. government securities, with a limited exemption for the purchase of U.S. securities by qualified persons as part of a program trade, provided that the purchase or sale of foreign securities predominates?

b. Exemption (A)(2)

Proposed Exemption (A)(2) is designed to be used by foreign broker-dealers that would like to solicit transactions from qualified investors that have accounts, and custody their funds and securities, with U.S. registered broker-dealers. Because we expect that qualified investors would likely select a foreign broker-dealer for its knowledge of local markets and/or its ability to execute trades in particular markets, as they would under Exemption (A)(1), but the foreign broker-dealer would not be acting as custodian of the funds and securities of the qualified investor (i.e., not acting as a full-service broker), we do not believe it would be necessary for Exemption (A)(2) to include certain of the requirements proposed to be included in Exemption (A)(1), particularly the proposed requirement that the foreign broker-dealer conduct a foreign business, as described above.

i. Role of the U.S. Registered Broker-Dealer

Under Exemption (A)(2), the U.S. registered broker-dealer would be responsible for maintaining books and records, including copies of all confirmations issued by the foreign broker-dealer to the qualified investor, relating to any transactions effected under this exemption.[101] This requirement is designed to ensure that the Commission would have access to books and records relating to resulting transactions, as well as copies of confirmations issued by the foreign broker-dealer to the qualified investor. Because the U.S. registered broker-dealer would carry the account of the qualified investor under Exemption (A)(2), we understand from discussions with industry representatives that it would be consistent with current business practices for the U.S. registered broker-dealer to maintain the books and records for transactions effected under this exemption.

Proposed Exemption (A)(2) would also require the U.S. registered broker-dealer to receive, deliver and safeguard funds and securities in connection with the transactions on behalf of the qualified investor in compliance with Rule 15c3-3 under the Exchange Act.[102] As explained below, Exemption (A)(2) is designed to permit qualified investors that have an account

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101 See proposed Rule 15a-6(a)(3)(iii)(A)(2)(i).

102 17 CFR 240.15c3-3. See proposed Rule 15a-6(a)(3)(iii)(A)(2)(ii). Securities received and safeguarded under Exemption (A)(2) would be securities carried for the account of a customer under Rule 15c3-3(a)(2). 17 CFR 240.15c3-3(a)(2).

with a U.S. registered broker-dealer to have access to foreign broker-dealers regardless of the types of securities that are involved.[103]

Unlike under the current rule, under Exemption (A)(2), the intermediating U.S. registered broker-dealer would not be required to effect the transaction.[104] Thus, with respect to transactions effected pursuant to Exemption (A)(2), the intermediating U.S. registered broker-dealer would no longer be required to comply with the provisions of the federal securities laws, the rules thereunder and SRO rules applicable to a broker-dealer effecting a transaction in securities, unless it were otherwise involved in effecting the transaction.[105] However, if a foreign broker-dealer effects a transaction pursuant to Exemption (A)(2) on a U.S. national securities exchange, through a U.S. alternative trading system, or with a market maker or an over-the-counter dealer in the United States, as is common with respect to U.S. securities, a U.S. registered broker-dealer would be involved in effecting the transaction and would be required to comply with the provisions of the federal securities laws, the rules thereunder and SRO rules applicable to such activity. In other words, such provisions would apply with respect to all transactions in U.S. securities under Exemption (A)(2) other than certain over-the-counter

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103 Under Exemption (A)(2), the foreign broker-dealer would be permitted to clear and settle the transactions on behalf of the U.S. registered broker-dealer. The Commission believes that this is appropriate for transactions effected under Exemption (A)(2) for investors that possess the sophistication of qualified investors, particularly given that the exemption would require a U.S. registered broker-dealer to maintain books and records and receive, deliver and safeguard funds and securities in connection with the transactions.

104 See 17 CFR 240.15a-6(a)(3)(iii)(A) (requiring the U.S. registered broker-dealer to effect all aspects of a transaction other than negotiation of its terms) and proposed Rule 15a-6(a)(3)(iii)(A)(2); see also note 28, supra, for a discussion of the differing treatment of U.S. and foreign securities under current Rule 15a-6(a)(3)(iii)(A)(1).

105 See note 28, supra, for a discussion of the differing treatment of U.S. and foreign securities under current Rule 15a-6(a)(3)(iii)(A)(1).

transactions that a foreign broker-dealer does not effect by or through a U.S. registered broker-dealer.

ii. Role of the Foreign Broker-Dealer

A foreign broker-dealer relying on Exemption (A)(2) would not be permitted to maintain custody of qualified investor funds and securities relating to any resulting transactions. Because of this limitation, Exemption (A)(2) would be available to all foreign broker-dealers and not just those that conduct a foreign business. Because entities that meet the definition of foreign broker-dealer under the proposed rule could not operate full-service brokerage under this exception, we believe that there is less risk of regulatory arbitrage.

Like Exemption (A)(1), Exemption (A)(2) would only be available to foreign broker-dealers that are regulated for conducting securities activities, including the specific activities in which the foreign broker-dealer engages with the qualified investor, in a foreign country by a foreign securities authority.[106] This requirement is designed to ensure that only foreign entities that are legitimately in the business of conducting securities activities (such as effecting transactions in securities), and that are regulated in the conduct of those activities, could rely on Exemption (A)(2). In addition, the foreign broker-dealer relying on Exemption (A)(2) would be required to disclose to the qualified investor that the foreign broker-dealer is regulated by a foreign securities authority and not by the Commission. Unlike under Exemption (A)(1), however, the foreign broker-dealer relying on Exemption (A)(2) would not be required to provide disclosures to the qualified investor regarding segregation requirements, bankruptcy protections and protections under SIPA. The Commission does not believe these disclosures would be necessary given that, under proposed Exemption (A)(2), the U.S. registered broker-

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106 See proposed Rule 15a-6(b)(2)(i).

dealer would be maintaining custody of funds and securities of qualified investors in connection with the resulting transactions.

As noted above, we expect that Exemption (A)(2) would be used by qualified investors that would like to access foreign broker-dealers but nonetheless would like to have an account, and maintain custody of their funds and securities, with a U.S. registered broker-dealer. Because a foreign broker-dealer would be selected for its knowledge of local markets and/or its ability to execute trades in particular markets, but would not be acting as custodian of the funds and securities of the qualified investor (i.e., not acting as a full-service broker), we do not believe it would be necessary for proposed Exemption (A)(2) to include certain of the requirements contained in proposed Exemption (A)(1), particularly the requirement that the foreign broker-dealer conduct a foreign business, as described above.

The Commission requests comment on proposed Exemption (A)(2) generally. How would this exemption likely be used and by whom? Should proposed Exemption (A)(2) be available when the U.S. registered broker-dealer does not maintain custody of the qualified investor's funds and securities (e.g., when a U.S. or foreign affiliate of the U.S. registered broker-dealer custodies the funds and securities otherwise than pursuant to Rule 15c3-3 under the Exchange Act)?[107]

The Commission also seeks comment on whether the proposed rule should require the U.S. registered broker-dealer to comply with any requirements with respect to transactions under Exemption (A)(2) other than the proposed requirement to maintain books and records and maintain custody of qualified investors' funds and securities relating to the transactions. Should

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[107] 17 CFR 240.15c3-3.

the requirements differ based on whether the securities are U.S. securities or foreign securities? If so, why?

In addition, the Commission seeks comment on whether the proposed disclosures would provide appropriate notice to qualified investors that foreign broker-dealers would not be subject to the same regulatory requirements as U.S. registered broker-dealers. Would notice be sufficient? Are there are other disclosures that should be required? In particular, should the foreign broker-dealer be required to identify the foreign securities authority or authorities regulating the foreign broker-dealer? Should disclosure of the applicable dispute resolution system be required? In addition, the Commission requests comment regarding the proposed required form of these disclosures. Should the proposed disclosures be eliminated or modified in any way? If so, how and why?

In general, the Commission seeks comment on whether proposed Exemption (A)(1) and Exemption (A)(2) alternatives would provide a meaningful choice for qualified investors wishing to access foreign broker-dealers. What would be the advantages and disadvantages of using each alternative?

2. Sales Activities

Both proposed Exemption (A)(1) and proposed Exemption (A)(2) would eliminate the requirements in current Rule 15a-6(a)(3) for foreign associated persons[108] to be accompanied by an associated person of a U.S. registered broker-dealer during in-person visits with U.S. investors. The proposed rule also would eliminate the current requirement for an associated

108 The proposed rule would retain the definition of "foreign associated person" that is in paragraph (b)(2) of the current Rule 15a-6, but would substitute "qualified investor" for "U.S. institutional investor or major U.S. institutional investor" in the definition. See proposed Rule 15a-6(b)(1).

person of a U.S. registered broker-dealer to participate in communications between foreign associated persons and U.S. investors, whether oral or electronic.

From discussions with industry representatives, the staff understands that the current chaperoning requirements have been criticized as impractical and that they have been viewed as imposing unnecessary operational and compliance burdens particularly for communications with broker-dealers in time zones outside those of the United States. The current rule allows some unchaperoned contacts, in part due to the existence of other provisions of the rule that require review of "the background of, foreign personnel who will contact U.S. institutional investors."[109] The proposed amendments would retain the requirement that the background of foreign personnel be reviewed, albeit by the foreign broker-dealer,[110] but would expand the ability of foreign broker-dealers to have unchaperoned contacts. Specifically, the proposed rule would not limit a foreign broker-dealer's ability to have unchaperoned communications, both oral and electronic, with qualified investors, as part of a transaction pursuant to either exemption in paragraph (a)(3) of the proposed rule. In addition, the proposed rule would provide that a foreign associated person may conduct unchaperoned visits to qualified investors within the United States, provided that transactions in any securities discussed during visits by the foreign associated person with qualified investors are effected pursuant to either exemption in paragraph (a)(3) of the proposed rule because these transactions would be viewed as being solicited.[111] The Commission believes that increasing the ability of foreign broker-dealers to have unchaperoned contacts should provide greater flexibility for both investors and industry participants in

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109 See 1988 Proposing Release, 53 FR at 23653.

110 See Proposed Rule 15a-6(a)(3)(i)(B) and (C).

111 See proposed Rule 15a-6(a)(3)(ii).

conducting communications and that eliminating the requirement to have a U.S. registered broker-dealer present for such communications should not result in any significant loss of safeguards for qualified investors because of the sophistication and experience standards in the definition of qualified investor and the proposed disclosure requirements in Exemption (A)(1) and Exemption (A)(2).

As noted above, the proposed rule would allow a foreign broker-dealer to have unchaperoned visits within the United States. Whether a foreign associated person's stay in the United States would qualify as a "visit" for purposes of the proposed rule would be a facts and circumstances determination based on factors including, but not limited to, the purpose, length and frequency of any stays. The Commission proposes to interpret a "visit" as one or more trips to the United States over a calendar year that do not last more than 180 days in the aggregate. The purpose of this proposed limitation regarding visits is to prevent foreign broker-dealers from essentially having a permanent sales force in the United States, which may result in foreign broker-dealers essentially conducting a U.S. based business, similar to U.S. registered broker-dealers, without appropriate regulatory oversight of these foreign broker-dealers. We preliminarily believe that 180 days strikes the proper balance between facilitating legitimate foreign broker-dealer activity in the United States, such as investment banking, and the potential competitive issues with U.S. registered broker-dealers and investor protection concerns.

The Commission requests comment on its proposed interpretation of what would constitute a visit. Should the Commission provide a bright-line definition of what constitutes a "visit" or is a more flexible approach appropriate? Is it appropriate to interpret "visit" as a specific number of days in a calendar year that a foreign broker-dealer could be in the United States? If so, is 180 days a calendar year appropriate? Or would a lower number such as 120, 90, 60, or 30 days a calendar year be more appropriate? We also solicit comment on the factors for determining what qualifies as a "visit," described above. In addition, the Commission requests comment on eliminating the chaperoning requirements of the current rule. Are unchaperoned contacts between foreign broker-dealers and their associated persons and qualified investors appropriate?

3. Establishment of Qualification Standards

Foreign broker-dealers intending to rely on proposed Rule 15a-6(a)(3) would need to meet certain qualification requirements.[112] As under the current rule, the foreign broker-dealer would be required to provide the Commission, upon request or pursuant to agreement between the Commission or the United States and any foreign securities authority, information or documents related to the foreign broker-dealer's activities in inducing or attempting to induce securities transactions by qualified investors.[113] This information would permit the Commission to monitor and follow up on transactional activity conducted under Rule 15a-6, as necessary and appropriate.

The proposed rule also would require the foreign broker-dealer to determine that its associated persons that effect transactions with qualified investors are not subject to a statutory disqualification under Section 3(a)(39) of the Exchange Act.[114] This would be a change from the current rule, which requires the U.S. registered broker-dealer intermediating the transaction to make this determination.[115] Specifically, current Rule 15a-6(a)(3)(ii)(B) requires a U.S. registered broker-dealer to determine that the foreign associated persons of a foreign broker-

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112 See proposed Rule 15a-6(a)(3)(i).

113 See proposed Rule 15a-6(a)(3)(i)(A) and 17 CFR 240.15a-6(a)(3)(i)(B).

114 See proposed Rule 15a-6(a)(3)(i)(B).

115 See 17 CFR 240.15a-6(a)(3)(ii)(B).

dealer effecting transactions with U.S. institutional investors or major U.S. institutional investors are not subject to a statutory disqualification specified in Section 3(a)(39) of the Exchange Act, or certain substantially equivalent foreign disciplinary actions. Because of subsequent legislation, the proposed rule would no longer separately describe the foreign equivalents of statutory disqualification.[116] The Commission believes shifting the responsibility for making the statutory disqualification determination would be appropriate because the foreign broker-dealer is in possession of the relevant information regarding its foreign associated persons. Thus, we believe, as a practical matter, foreign broker-dealers are already making this determination so that U.S. registered broker-dealers can comply with their obligations under the existing rule. As discussed below, the proposed rule would require the U.S. registered broker-dealer to obtain a representation from the foreign broker-dealer that it has made this determination.

Under the current rule, a U.S. registered broker-dealer must obtain, with respect to each foreign associated person, information specified in Rule 17a-3(a)(12) under the Exchange Act[117] that relates to activities under paragraph (a)(3).[118] The proposed rule would require the foreign broker-dealer to maintain this information in its files and make it available upon request by the U.S. registered broker-dealer or the Commission.[119] This information would include the foreign

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116. At the time the Commission adopted Rule 15a-6, the definition of "statutory disqualification" in Section 3(a)(39) did not include expulsions, suspensions or other orders under foreign statutes or foreign equivalents of U.S. regulatory authorities. The International Securities Enforcement Cooperation Act of 1990 amended Section 3(a)(39) to include certain foreign conduct and disciplinary action in the definition of "statutory disqualification," including each type of conduct or disciplinary action described in paragraphs (a)(3)(ii)(B)(1)(i) - (v), (a)(3)(ii)(B)(2) and (a)(3)(ii)(B)(3) of Rule 15a-6. See Pub. L. No. 101-550, 104 Stat. 2714 (1990).

117. 17 CFR 240.17a-3(a)(12).

118. See 17 CFR 240.15a-6(a)(3)(iii)(C).

119. See proposed Rule 15a-6(a)(3)(i)(C).

associated person's name; address; social security number or foreign equivalent; the starting date of employment or other association with the foreign broker-dealer; date of birth; a complete, consecutive statement of all the foreign associated person's business connections for at least the preceding ten years, including whether the employment was part-time or full-time; a record of any denial of membership or registration, and of any disciplinary action taken, or sanction imposed, upon the foreign associated person by any agency, or by any securities exchange or securities association, including any finding that the foreign associated person was a cause of any disciplinary action or had violated any law; a record of any denial, suspension, expulsion or revocation of membership or registration of any foreign broker-dealer with which the foreign associated person was associated in any capacity when such action was taken; a record of any permanent or temporary injunction entered against the foreign associated person or any foreign broker-dealer with which the foreign associated person was associated in any capacity at the time such injunction was entered; a record of any arrest or indictment for any felony or foreign equivalent, or any misdemeanor or foreign equivalent pertaining to securities, commodities, banking, insurance or real estate (including, but not limited to, acting or being associated with a foreign broker-dealer), fraud, false statements or omissions, wrongful taking of property or bribery, forgery, counterfeiting or extortion, and the disposition of the foregoing; and a record of any other name or names by which the foreign associated person has been known or which the foreign associated person has used.[120]

[120] 17 CFR 240.17a-3(a)(12).

The proposed rule would provide that the information kept by the foreign broker-dealer as specified in Rule 17a-3(a)(12)(i)(D)[121] must include documentation of sanctions imposed by foreign securities authorities, foreign exchanges, or foreign associations, including without limitation those described in Section 3(a)(39) of the Exchange Act.[122] The Commission believes shifting the responsibility would be appropriate because the foreign broker-dealer is in possession of the relevant information regarding its foreign associated persons. Thus, we believe, as a practical matter, foreign broker-dealers are already making this determination so that U.S. registered broker-dealers can comply with their obligations under the existing rule. As discussed below, the proposed rule would require the U.S. registered broker-dealer to obtain a representation from the foreign broker-dealer that it is maintaining the required information.

Consistent with the current rule, proposed Rule 15a-6(a)(3) would require the U.S. registered broker-dealer to obtain from the foreign broker-dealer and each foreign associated person written consent to service of process for any civil action brought by or proceeding before the Commission or a self-regulatory organization (as defined in Section 3(a)(26) of the Exchange Act).[123] The U.S. registered broker-dealer would also be responsible for obtaining from the foreign broker-dealer a representation that the foreign broker-dealer has determined that any

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121 17 CFR 240.17a-3(a)(12)(i)(D) (requiring a broker-dealer to make and keep current a record of any denial of membership or registration, and of any disciplinary action taken, or sanction imposed, upon the associated person by any federal or state agency, or by any national securities exchange or national securities association, including any finding that the associated person was a cause of any disciplinary action or had violated any law).

122 See proposed Rule 15a-6(a)(3)(i)(C).

123 See proposed Rule 15a-6(a)(3)(iii)(B) and 17 CFR 240.15a-6(a)(3)(iii)(C). As in the current rule, the consent would be required to provide that process may be served on them by service on the registered broker-dealer in the manner set forth on the registered broker's or dealer's current Form BD. This would put individuals on notice of the manner in which process would be served.

foreign associated person of the foreign broker-dealer effecting transactions with the qualified investor is not subject to a statutory disqualification specified in section 3(a)(39) of the Act, as required by paragraph (a)(3)(i)(B) of the proposed rule and discussed above.[124]

In addition, the U.S. registered broker-dealer would be responsible for obtaining from the foreign broker-dealer a representation that it has in its files, and the foreign broker-dealer would make available upon request by the U.S. registered broker-dealer or the Commission, the types of information specified in Rule 17a-3(a)(12) under the Act, as required by paragraph (a)(3)(i)(C) of the proposed rule and discussed above.[125] Finally, the proposed rule would require the U.S. registered broker-dealer to maintain records of these written consents and representations and, as in the current rule, make these records available to the Commission upon request.[126] These proposed requirements are important because they are designed to ensure that the Commission would be able to obtain information regarding foreign associated persons if it were necessary in the context of an investigation into alleged misconduct by a foreign broker-dealer or persons associated with the foreign broker-dealer. The Commission believes that allowing U.S. registered broker-dealers to rely upon the determinations and representations of foreign broker-dealers discussed above is a balanced approach that should address the risks to

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124 See proposed Rule 15a-6(a)(3)(iii)(C).

125 See id.

126 See proposed Rule 15a-6(a)(3)(i)(D). The provisions of proposed Rules 15a-6(a)(3)(iii)(B) and (D) are similar to paragraphs (a)(3)(iii)(D) and (E) of the current rule, although the proposed rule would eliminate the requirement under current Rule 15a-6(a)(3)(iii)(E) that the registered broker-dealer maintain a written record of all records in connection with trading activities of the qualified investor involving the foreign broker-dealer. This requirement is subsumed in other sections of the proposed rule. See proposed Rule 15a-6(a)(3)(iii)(A) - (D).

qualified investors related to, among other things, contacts with foreign associated persons with a disciplinary history.

The Commission seeks comment on the qualification standards that would apply to foreign broker-dealers and U.S. registered broker-dealers under the proposed rule. Commenters are invited to discuss whether reliance by a U.S. registered broker-dealer upon the determinations and representations of a foreign broker-dealer appropriately addresses the potential risks to qualified investors related to, among other things, contacts with foreign associated persons with a disciplinary history. Should any of the responsibilities for making the statutory disqualification determinations or obtaining consents be shifted? Should the proposed rule require that the foreign broker-dealer (or the U.S. registered broker-dealer) determine whether the foreign associated persons are subject to statutory disqualifications?

E. Counterparties and Specific Customers

As in the current rule, proposed Rule 15a-6(a)(4) would provide exemptions for foreign broker-dealers that effect transactions in securities with or for, or induce or attempt to induce the purchase or sale of any security, by certain persons, including registered broker-dealers, certain international banks and bank organizations, certain foreign persons temporarily present in the United States and certain U.S. persons or groups of U.S. persons abroad. We understand from discussions with industry that these exemptions have been workable for both foreign broker-dealers and the U.S. entities and we have no knowledge of investor protection concerns being raised. Accordingly, we do not propose to amend them.

We do, however, propose to provide an additional exemption for transactions with U.S. resident fiduciaries of accounts for "foreign resident clients" because it is our understanding that foreign resident clients would not assume that the broker-dealer through which a U.S. resident fiduciary is effecting transactions is regulated by the Commission.[127] The proposed rule would define "foreign resident client" to mean "(i) any entity not organized or incorporated under the laws of the United States and not engaged in a trade or business in the United States for federal income tax purposes; (ii) any natural person not a resident for federal income tax purposes; and (iii) any entity not organized or incorporated under the laws of the United States, 85% or more of whose outstanding voting securities are beneficially owned by persons in subparagraphs (i) and (ii) of this paragraph."[128] Discussions with industry have indicated that these are the types of entities that would likely use the proposed exemption. We selected the 85% threshold to capture foreign entities that are predominantly foreign-owned, while accommodating a small amount of U.S. ownership.[129]

For purposes of both the broker-dealer registration provisions of the Exchange Act and the proposed exemption provided by Rule 15a-6(a)(4)(vi), a U.S. resident fiduciary is considered to be a U.S. person, regardless of the residence of the owners of the underlying accounts.

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127 Cf. Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, to Giovanni P. Prezioso, Cleary Gottlieb, Steen & Hamilton (Jan. 30, 1996).

128 See proposed Rule 15a-6(b)(4).

129 The Commission considers a person to be a control person if he or she directly or indirectly has the power to vote 25 percent or more of the voting securities or interests of an entity. See, e.g., 17 CFR 240.12b-2. The concept of control, which is found in all the statutes administered by the Commission, varies to some degree between statutes. Although the Exchange Act does not define "control," Rule 12b-2 under the Exchange Act defines "control" as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." This definition has been found to apply to all Exchange Act control determinations. In re Commonwealth Oil / Tesoro Petroleum Securities Litigation, 484 F. Supp. 253, 268 (W.D. Tex. 1979) (the right to vote 25 percent or more of the voting securities or is entitled to 25 percent or more of the profits is presumed to control that company). The 85 percent threshold in proposed paragraph (b)(4)(iii) is designed to ensure that entities with U.S. control persons would not meet the proposed definition of "foreign resident client."

Accordingly, absent an exemption, a foreign broker-dealer that induces or attempts to induce a securities transaction with a U.S. resident fiduciary would be required either to register with the Commission or effect transactions in accordance with Rule 15a-6(a)(3). We understand, however, that foreign resident clients of a U.S. resident fiduciary reasonably may not expect the U.S. broker-dealer regulatory requirements to apply to their transactions in foreign securities, in large part simply because the transactions are in foreign securities.

Accordingly, the proposed rule would permit a foreign broker-dealer to effect transactions in, or induce or attempt to induce the purchase or sale of, securities, with or for any U.S. person, other than a registered broker-dealer or a bank acting pursuant to an exception or exemption from the definition of "broker" or "dealer,"[130] that acts in a fiduciary capacity for an account of a foreign resident client. Consistent with our understanding of the expectations of foreign resident clients of a U.S. resident fiduciary, this proposed exemption would be available only to a foreign broker-dealer that conducts a foreign business.[131] As indicated above, this exemption would recognize that foreign resident clients would not expect that the broker-dealer through which a U.S. resident fiduciary is effecting transactions is regulated by the Commission. Moreover, under the proposed rule, the foreign broker-dealer would be required to obtain a written representation from the U.S. fiduciary that the account is managed in a fiduciary capacity

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130 See Sections 3(a)(4)(B), 3(a)(4)(E) and 3(a)(5)(C) of the Exchange Act. Foreign broker-dealers that want to effect transactions for registered broker-dealers or banks acting pursuant to certain exceptions or exemptions from the definition of "broker" or "dealer" can do so under the exemption in paragraph (a)(4)(i) of Rule 15a-6. See 17 CFR 240.15a-6(a)(4)(i).

131 See proposed Rule 15a-6(b)(2)(ii).

for a foreign resident client.[132] This requirement is designed to ensure that the U.S. fiduciary is actually managing accounts for foreign resident clients.

The Commission seeks comment generally on the exemptions in paragraph (a)(4) of the proposed rule for transactions with certain U.S. entities. Are there entities or other categories of entities that should be included? The Commission particularly seeks comment on the proposed exemption for transactions with U.S. fiduciaries of accounts for foreign resident clients. Is the requirement that a foreign broker-dealer conduct a foreign business necessary or appropriate? Should the rule apply to U.S. fiduciaries for accounts other than those of foreign resident clients? The Commission requests comment on the definition of "foreign resident client," in general, and the 85 foreign ownership threshold for entities not organized or incorporated under the laws of the United States, in particular. Should it be raised or lowered to better protect against regulatory arbitrage or to achieve its stated purposes? Commenters suggesting a different threshold or a different method for determining compliance with the threshold should explain why they would choose that threshold or method.

F. Familiarization with Foreign Options Exchanges

Over the years, foreign options exchanges have inquired regarding the permissibility of limited activities designed to familiarize U.S. entities that have had prior actual experience with traded options in U.S. options markets, such as U.S. registered broker-dealers and certain U.S. institutional investors, with the existence and operations of, and options on foreign securities traded on, such foreign options exchanges. These exchanges have limited the activities conducted by their representatives, who may be located in a foreign office or in a representative office in the United States, and by their foreign broker-dealer members.

[132] See proposed Rule 15a-6(a)(4)(vi)(B).

1. Exchange Act Section 15(a)

Because the activities by a representative of a foreign options exchange may constitute solicitation,[133] they raise potential registration concerns for foreign broker-dealer participants on the exchanges under Section 15(a).[134] This is in part because the activities are undertaken with the expectation that one or more U.S. registered broker-dealers or U.S. institutional investors will engage in foreign options transactions executed through the exchange, and thus trade through one or more foreign broker-dealer members of the exchange. Similarly, the activities of a foreign broker-dealer member of a foreign options exchange may constitute solicitation under the Commission's broad interpretation of solicitation.

The Commission recognizes the role of these activities in making certain U.S. investors aware of foreign options markets and the options on foreign securities traded on those markets. Accordingly, the Commission is proposing a new exemption to provide legal certainty for the foreign broker-dealer members and these foreign options exchanges. Paragraph (a)(5) of proposed Rule 15a-6 would allow a foreign broker-dealer that is a member of a foreign options exchange to effect transactions in options on foreign securities listed on that exchange for a qualified investor that has not otherwise been solicited by the foreign broker-dealer.[135] Under this exemption, a foreign broker-dealer, a foreign options exchange and representatives of the

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133 For a discussion of the Commission's broad interpretation of solicitation, see Parts II.A. and III.B., supra.

134 The fact that the activities are conducted by the exchanges through their representatives does not necessarily eliminate the registration concerns of the participants on those exchanges. See Exchange Act Section 20(b), 17 U.S.C. 78t(b) ("It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this title or any rule or regulation thereunder through or by means of any other person").

135 See proposed Rule 15a-6(a)(5).

foreign options exchange could conduct certain activities or communicate with a qualified investor in a manner that might otherwise be considered a form of solicitation, as described below.[136] Transactions effected by or through the foreign broker-dealer with or for qualified investors that result from these activities or communications would not require registration or compliance with proposed Rule 15a-6(a)(3). However, while these activities would not necessarily constitute a form of solicitation, the Commission anticipates that given the broad interpretation of solicitation, it would be difficult, if not impractical, to conduct repeated transactions with the same qualified investor without the foreign broker-dealer engaging in some form of communication that would constitute solicitation. Therefore, the Commission anticipates that most transactions with qualified investors resulting from these activities or communications would need to be completed pursuant to proposed Rules 15a-6(a)(3).

Paragraph (a)(5)(i) of proposed Rule 15a-6 would set forth the limited activities in which a representative of a foreign options exchange located in a foreign office or a representative office in the United States may engage vis-à-vis qualified investors. The proposed rule would allow the representative of a foreign options exchange to communicate with persons that he or she reasonably believes are qualified investors regarding the foreign options exchange, the options on foreign securities traded on the foreign options exchange, and, if applicable, the foreign options exchange's "OTC options processing service," as defined below.[137] Such communications could include programs and seminars in the United States.

Proposed Rule 15a-6(b)(6) would define an "OTC options processing service" as "a mechanism for submitting an options contract on a foreign security that has been negotiated and

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136 See proposed Rules 15a-6(a)(5)(i) - (iii).

137 See proposed Rule 15a-6(a)(5)(i)(A).

completed in an over-the-counter transaction to a foreign options exchange so that the foreign options exchange may replace that contract with an equivalent standardized options contract that is listed on the foreign options exchange and that has the same terms and conditions as the over-the-counter options." By utilizing an OTC options processing service, qualified investors would be able to take advantage of the flexible nature of the OTC options market, while realizing certain efficiencies and benefits available in an exchange-traded market. In particular, qualified investors would have greater opportunities to close out options positions. In a typical OTC options transaction, a party must either negotiate with its counterparty to close out the trade or enter into an offsetting transaction to reduce its risk. In addition, OTC options processing services would provide a means for qualified investors to reduce other risks that arise in trading in the OTC options market, including credit risks, liquidity risks, legal risks and operational risks. By using an OTC options processing service, qualified investors would be able to access the benefits available in the OTC options market while taking advantage of the benefits and decreased risks available in the exchange-traded market.

The proposed rule would also permit a representative of a foreign options exchange to provide persons that the representative of the foreign options exchange reasonably believes are qualified investors with a disclosure document that provides an overview of the foreign options exchange and the options on foreign securities traded on that exchange, including the differences from standardized options in the U.S. options market and special factors relevant to transactions by U.S. entities in options on the foreign options exchange.[138] In addition, a representative of a foreign options exchange could make available to persons that the representative of the foreign options exchange reasonably believes are qualified investors, solely upon the request of the

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138 See proposed Rule 15a-6(a)(5)(i)(B).

investor, a list of participants on the foreign options exchange permitted to take orders from the public and any U.S. registered broker-dealer affiliates of such participants.[139] Moreover, paragraph (5)(iii) would allow the foreign exchange to make available to qualified investors, through the foreign broker-dealer, the exchange's OTC options processing service.[140]

In proposing to limit these activities, the proposed rule is designed to ensure that a foreign options exchange and its representatives do not engage in solicitation on behalf of a particular foreign broker-dealer or limited group of particular foreign broker-dealers.

Paragraph (a)(5)(ii) of the proposed rule would set forth the activities in which a foreign broker-dealer could engage in connection with transactions effected on a foreign options exchange of which it is a member. A foreign broker-dealer would be permitted to make available to qualified investors the foreign options exchange's OTC options processing service.[141] A foreign broker-dealer would also be permitted to provide qualified investors, in response to an otherwise unsolicited inquiry concerning foreign options traded on the foreign options exchange, with a disclosure document that provides an overview of the foreign options exchange and the options on foreign securities traded on that exchange, including the differences from standardized options in the U.S. domestic options market and special factors relevant to transactions by U.S. entities in options on that exchange.[142]

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139 See proposed Rule 15a-6(a)(5)(i)(C).

140 See proposed Rule 15a-6(a)(5)(iii).

141 See proposed Rule 15a-6(a)(5)(ii)(A).

142 See proposed Rule 15a-6(a)(5)(ii)(B). Exchange Act Rule 9b-1 requires an options market to file with the Commission an options disclosure document containing the information specified in Rule 19b-1(c). "Options markets" are defined in Rule 19b-1 to include foreign securities exchanges. See Exchange Act Rule 19b-1(a)(1), 17 CFR 240.19b-1(a)(1). The Commission would not view the provision of the options disclosure document, which contains, among other things, a summary of the instruments traded and

2. Exchange Act Sections 5 and 6

Section 5 of the Exchange Act makes it "unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange with or subject to the jurisdiction of the United States to effect any transaction in a security, or to report any such transaction," unless such exchange is registered under Section 6 of the Exchange Act or exempt from such registration.[143] As described above, paragraph (a)(5) of proposed Rule 15a-6 would establish the limited activities and communications in which a representative of a foreign options exchange located in a foreign office or a representative office in the United States may engage vis-à-vis qualified investors,[144] and in which a foreign broker-dealer may engage in connection with transactions effected on a foreign options exchange in which it is a member.[145] In addition, a foreign exchange could make available to qualified investors, through a foreign broker-dealer, the exchange's OTC options processing service.[146]

The Commission is proposing to provide interpretive guidance that a foreign exchange would not be required to register as a national securities exchange under Section 6 of the Exchange Act or be exempt from such registration if the foreign exchange, its representatives, or its foreign broker-dealer members engaged in the limited activities and communications described in proposed paragraph (a)(5) of Rule 15a-6. The Commission's proposed

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the mechanics of trading on that market, as a "research report" under proposed Rule 15a-6(a)(2). See Parts II.B. and III.C., supra.

143 15 U.S.C. 78e.

144 See proposed Rule 15a-6(a)(5)(i).

145 See proposed Rule 15a-6(a)(5)(ii).

146 See proposed Rule 15a-6(a)(5)(iii).

interpretation is based on its preliminary view that, although a foreign exchange's OTC options processing service may be a facility of an exchange,[147] the OTC options processing service would not effect any transaction in a security or report any such transaction.[148] Accordingly, such activity would not trigger the registration requirements of Section 6 of the Exchange Act.[149]

The Commission seeks comment on its proposed interpretation that a foreign exchange would not be required to register as a national securities exchange under Section 6 of the Exchange Act if the foreign exchange, its representatives, or its foreign broker-dealer members engage in the limited activities and communications described in paragraph (a)(5) of proposed Rule 15a-6. Are any additional conditions necessary or are there other interpretive issues relating to the circumstances under which a foreign exchange would be required to register under Section 6 of the Exchange Act, or otherwise obtain an exemption from such registration requirements, that the Commission should address?

3. Exchange Act Section 17A

Under proposed Rule 15a-6(a)(5), qualified investors would not become direct members of, or participants in, the foreign options exchange or any associated foreign clearing organization. Further, the foreign options exchange would not trade nor would the foreign clearing organization clear and settle options on U.S. securities for a foreign broker-dealer

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147 See Section 3(a)(2) of the Exchange Act, 15 U.S.C. 78c(a)(2) (defining "facility" of an exchange).

148 See note 143 and accompanying text, supra (discussing Section 5 of the Exchange Act, which prohibits a broker, dealer, or exchange from using a facility of an exchange to effect a transaction in a security, or to report any such transaction, unless such exchange is registered under Section 6 of the Exchange Act).

149 See Section 3(a)(1) of the Exchange Act, 15 U.S.C. 78c (defining "exchange") and Rule 3b-16 under the Exchange Act, 17 CFR 240-3b-16 (further elaborating on the definition of "exchange" contained in the Exchange Act).

member or participant relying on proposed paragraph (a)(5) for the transaction. The foreign broker-dealer member or participant would execute transactions in options on foreign securities, or submit an options contract on foreign securities, and the foreign clearing organization would clear and settle these transactions for its foreign broker-dealer participants in the same manner as any other transaction executed on the foreign options exchange.

Section 17A(b)(1) of the Exchange Act prohibits any clearing agency from directly or indirectly making "use of the mails or any means or instrumentality of interstate commerce to perform the functions of a clearing agency with respect to any security (other than an exempted security)," unless it is registered with the Commission.[150] The Commission may conditionally or unconditionally exempt any clearing agency if the Commission finds that such exemption is consistent with the public interest, the protection of investors and the purposes of Section 17A.[151]

Previously, the Commission has required foreign clearing organizations to obtain an exemption from clearing agency registration only when the foreign clearing organization provides clearance and settlement services for U.S. securities directly to U.S. entities. For example, the Commission granted Euroclear and Clearstream (formerly Cedel Bank) exemptions from clearing agency registration in order that they could provide clearance and settlement services for U.S. government securities to their U.S. participants.[152] Because only the foreign broker-dealer would have direct access to the foreign clearing organization to clear and settle

150 15 U.S.C. 78q-1(b)(1).

151 Id.

152 See Exchange Act Release Nos. 43775 (Dec. 28, 2000), 66 FR 819 (order exempting Euroclear Bank from clearing agency registration) and 39643 (Feb. 18, 1998), 63 FR 8232 (order exempting Euroclear Bank's predecessor, Morgan Guaranty Trust Company, as operator of the Euroclear system, from clearing agency registration) and Exchange Act Release No. 38328 (Feb. 24, 1997), 62 FR 9225 (order exempting Clearstream Bank, formerly Cedel Bank, from clearing agency registration).

foreign securities transactions under proposed Rule 15a-6(a)(5), the Commission does not believe that relief under Section 17A of the Exchange Act would be necessary. The Commission solicits comment on whether any interpretive guidance is needed under Section 17A with respect to activities under proposed Rule 15a-6(a)(5). If so, what?

4. Securities Act

Foreign option transactions that are effected through the facilities of a foreign exchange will generally involve the offer and sale of a security by an issuer of the security.[153] As a result, unless the foreign options were registered under the Securities Act, foreign option transactions involving U.S. persons would be required to come within an exemption from registration. To the extent that the activities undertaken by foreign options exchanges in the United States can be deemed to constitute offers of foreign options under the Securities Act, such activities must also be undertaken in a fashion that is consistent with the requirements of the applicable exemption.[154]

5. Request for Comment

The Commission seeks comment on the proposed exemption in paragraph (a)(5) for transactions effected by a foreign broker-dealer on a foreign options exchanges of which it is a member. Should the Commission require a foreign broker-dealer or a representative of a foreign options exchange to determine that the persons with whom the representative communicates or otherwise provides information under proposed paragraphs (a)(5)(i)(A) - (C) are, in fact, qualified investors? Should the exemption be limited to unsolicited transactions? As a practical

153 With exchange traded options, the clearing house is the issuer of the option security. See Securities Act Release No. 8171 (Dec. 23, 2002), 68 FR 188, 188 (Jan. 2, 2003).

154 For example, to the extent that reliance is based on Securities Act Section 4(2), the activities of the foreign options exchange must not constitute a public offering of the securities.

matter, because of the broad interpretation of solicitation, would foreign broker-dealers effecting transactions with qualified investors that have been approached by the representatives of a foreign options exchange effect these transactions in reliance on proposed paragraph (a)(3) of Rule 15(a)(6)? If not, should the proposed exemption permit foreign broker-dealers to engage in additional limited solicitation activities, such as the types of contacts that would be expected in an ongoing customer relationship? In general, should foreign representatives of foreign options exchanges or foreign options exchanges be permitted to engage in any other activities under the proposed rule? If so, what? Given the purpose of the exemption to allow familiarization activities for foreign options exchanges, are there other types of markets for which it would be appropriate to permit familiarization activities? If so, which markets and what should the permissible range of activities be? Should they be broader or narrower than the permissible range of activities for foreign options exchanges? If so, why? Commenters are requested to explain their views.

G. Scope of the Proposed Exemption

When we adopted Rule 15a-6 in 1989, the Commission had authority, under Section 15(a)(2) of the Exchange Act, only to conditionally or unconditionally exempt from the broker-dealer registration requirements of Section 15(a)(1) any broker-dealer or class of broker-dealers, by rule or order, as it deems consistent with the public interest and the protection of investors.[155] However, many of the statutory and regulatory provisions under the Exchange Act actually are

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[155] See 15 U.S.C. 78o(a)(2); see also Section 15B(a)(4) of the Exchange Act, 15 U.S.C. 78o-4(a)(4) (giving the Commission similar authority with respect to municipal securities dealers).

applicable by their terms to broker-dealers regardless of their registration status.[156] To provide foreign broker-dealers relying on the exemptions in Rule 15a-6 with relief from these provisions, the Commission stated in the 1989 Adopting Release, "Nevertheless, the staff would not recommend that the Commission take enforcement action against foreign broker-dealers for want of compliance with those provisions, with the exception of sections 15(b)(4) and 15(b)(6), if the foreign broker-dealers were exempt from broker-dealer registration under the Rule."[157]

Since 1996, the Commission has had general exemptive authority under Section 36 of the Exchange Act to conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of the Exchange Act or any rule or regulation thereunder, by rule, regulation or order, to the extent that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors.[158]

The Commission proposes to amend Rule 15a-6 to exempt foreign broker-dealers from not only the registration requirements of Section 15(a)(1) or 15B(a)(1) of the Exchange Act, but also from the reporting and other requirements of the Exchange Act (other than Sections 15(b)(4) and 15(b)(6)), and the rules and regulations thereunder, that apply specifically to a broker-dealer solely by virtue of its status as a broker or dealer rather than because of its registration with the Commission.

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156 See 1989 Adopting Release, 54 FR at 30015 n.22 ("E.g., sections 15(b)(4) and 15(b)(6) of the Exchange Act, 15 U.S.C. 78o(b)(4) and 78o(b)(6); Rules 15c3-1, 15c3-3, 17a-3, 17a-4, and 17a-5, 17 CFR 240.15c3-1, 15c3-3, 17a-3, 17a-4, and 17a-5").

157 See 1989 Adopting Release, 54 FR at 30015 n.22.

158 See 15 U.S.C. 78mm; see also Capital Markets Efficiency Act of 1996, Sec. 105(b), Pub. Law 104-290, 110 Stat. 3416 (1996) (adding Section 36 to the Exchange Act).

Under the proposed rule, as under the current rule, however, foreign broker-dealers would not be exempt from provisions of the Exchange Act, and the rules and regulations thereunder, that are not specific to broker-dealers, such as Section 10(b) of the Exchange Act, or Rule 10b-5 thereunder.[159] Such rules apply to "persons" regardless of their registration status, and thus apply equally to registered broker-dealers, unregistered broker-dealers and non-broker-dealers. We also do not propose to exempt foreign broker-dealers from Exchange Act Sections 15(b)(4) and 15(b)(6), which give the Commission the authority to sanction broker-dealers and persons associated with broker-dealers, because these sections provide the Commission with flexibility to impose a bar against or place other limitations on associated persons or place limitations on broker-dealers in the circumstances specified in these sections.

As discussed more fully below with respect to each of the exemptions in the proposed rule, the Commission preliminarily believes that exempting foreign broker-dealers from the registration requirements of Sections 15(a)(1) and 15B(a)(1) of the Exchange Act and the reporting and other requirements of the Exchange Act (other than Sections 15(b)(4) and 15(b)(6)), and the rules and regulations thereunder, that apply specifically to a broker-dealer that is not registered with the Commission solely by virtue of its status as a broker or dealer would be necessary or appropriate in the public interest, and would be consistent with the protection of investors.

1. Proposed Rule 15a-6(a)(2)

As discussed above, proposed rule 15a-6(a)(2) would permit a foreign broker-dealer to provide research reports to qualified investors, but not otherwise induce or attempt to induce the

159 The proposed rule also would not affect any obligations a foreign broker-dealer may have under any other law, including the Securities Act.

purchase or sale of any security by qualified investors.[160] Based on conversations with industry participants, we understand that foreign broker-dealers rarely rely on current Rule 15a-6(a)(2). This is in part because of the limitations on solicitation, as well as the requirement that if a foreign broker-dealer has a relationship with a U.S. registered broker-dealer that satisfies the requirement of paragraph (a)(3) of the current rule, any transactions with the foreign broker-dealer in securities discussed in the research reports must be effected pursuant to the provisions of paragraph (a)(3).[161]

Given the de minimis volume of transactions that likely would be conducted,[162] and the level of financial sophistication of the investors that could receive the research reports under this proposed exemption, as well as the fact that the foreign broker-dealer would not otherwise be permitted to induce or attempt to induce the purchase or sale of any security by those investors under the proposed exemption, the Commission preliminarily believes that it would be necessary or appropriate in the public interest, and would be consistent with the protection of investors, to exempt foreign broker-dealers relying on paragraph (a)(2) of the proposed rule from the registration requirements of Sections 15(a)(1) and 15B(a)(1) of the Exchange Act and the reporting and other requirements of the Exchange Act (other than Sections 15(b)(4) and 15(b)(6)), and the rules and regulations thereunder, that apply specifically to a broker-dealer that is not registered with the Commission solely by virtue of its status as a broker or dealer.

The Commission solicits comment on whether it would be necessary or appropriate in the public interest, and consistent with the protection of investors, to exempt foreign broker-dealers

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160 See Part III.C., supra.

161 See 17 CFR 240.15a-6(a)(2)(iii).

162 This estimate is based on information the staff obtained in discussions with industry representatives.

relying on paragraph (a)(2) of the proposed rule from such rules and requirements. If not, which provisions or rules should apply and why?

2. Proposed Rule 15a-6(a)(3)

a. Exemption (A)(1)

As discussed above, foreign broker-dealers relying on proposed Exemption (A)(1) under Rule 15a-6(a)(3) would be required to conduct a foreign business.[163] The proposed rule would define "foreign business" to mean the business of a foreign broker-dealer with qualified investors and foreign resident clients[164] where at least 85% of the aggregate value of the securities purchased or sold in transactions conducted pursuant to both paragraphs (a)(3) and (a)(4)(vi) of the proposed rule by the foreign broker-dealer, calculated on a rolling two-year basis, is derived from transactions in foreign securities, as defined above.[165] As explained above, the Commission believes that making Exemption (A)(1) available only to a foreign broker-dealer conducting a foreign business would provide U.S. investors increased access to foreign securities and markets without creating opportunities for regulatory arbitrage vis-à-vis U.S. securities markets because the foreign broker-dealer's business in U.S. securities would be limited.

Given the requirement that foreign broker-dealers conduct a foreign business and the sophistication of qualified investors, as well as the other investor protections in the proposed rule, the Commission preliminarily believes that it would be necessary or appropriate in the public interest, and would be consistent with the protection of investors to exempt foreign broker-dealers relying on Exemption (A)(1) of the proposed rule from the registration

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163 See Part III.D.1.a., supra.

164 See Part III.E., supra.

165 See proposed Rule 15a-6(b)(3).

requirements of Sections 15(a)(1) and 15B(a)(1) of the Exchange Act and the reporting and other requirements of the Exchange Act (other than Sections 15(b)(4) and 15(b)(6)), and the rules and regulations thereunder, that apply specifically to a broker-dealer that is not registered with the Commission solely by virtue of its status as a broker or dealer.

The Commission solicits comment on whether it would be necessary or appropriate in the public interest, and consistent with the protection of investors, to exempt foreign broker-dealers relying on Exemption (A)(1) from such rules and requirements. If not, which rules should apply and why? Alternatively, and as under current Rule 15a-6(a)(3), should the intermediating U.S. registered broker-dealer be required to comply with certain rules in lieu of the foreign broker-dealer? If so, which rules and why? Should the requirements differ based on whether the securities are U.S. securities or foreign securities and where the transactions are executed? Would exempting foreign broker-dealers from such rules and regulations place U.S. registered broker-dealers at a competitive disadvantage?

b. Exemption (A)(2)

Under proposed Exemption (A)(2), qualified investors that have an account with a U.S. registered broker-dealer would have access to foreign broker-dealers regardless of the types of securities that are involved. Foreign broker-dealers relying on proposed Exemption (A)(2) would be permitted to effect transactions in securities, provided, among other things, that a U.S. registered broker-dealer acts as custodian for any resulting transactions.[166] As a result, a U.S. registered broker-dealer would hold the funds and securities of the qualified investor and be subject to the Commission's rules relating to the safeguarding of customer assets, such as Exchange Act Rule 15c3-1. As with proposed Exemption (A)(1), proposed Exemption (A)(2)

166 See Part III.D.1.b., supra.

would be limited to transactions with qualified investors, which we believe are sophisticated investors that can be expected to understand the risk of dealing with foreign broker-dealers that are not regulated by the Commission.

Given the requirement that a U.S. registered broker-dealer maintain custody of qualified investors' funds and securities from any resulting transactions and the sophistication of qualified investors, as well as the other investor protections in the proposed rule, the Commission preliminarily believes that it would be necessary or appropriate in the public interest, and would be consistent with the protection of investors, to exempt foreign broker-dealers relying on Exemption (A)(2) of the proposed rule from the registration requirements of Sections 15(a)(1) and 15B(a)(1) of the Exchange Act and the reporting and other requirements of the Exchange Act (other than Sections 15(b)(4) and 15(b)(6)), and the rules and regulations thereunder, that apply specifically to a broker-dealer that is not registered with the Commission solely by virtue of its status as a broker or dealer.

The Commission solicits comment on whether it would be necessary or appropriate in the public interest, and consistent with the protection of investors, to exempt foreign broker-dealers relying on Exemption (A)(2) from such rules and requirements. If not, which rules should apply and why? Alternatively, as under current Rule 15a-6(a)(3), should the intermediating U.S. registered broker-dealer be required to comply with certain rules in lieu of the foreign broker-dealer? If so, which rules and why? Should the requirements differ based on whether the securities are U.S. securities or foreign securities and where the transactions are executed? Would exempting foreign broker-dealers from such rules and regulations place U.S. registered broker-dealers at a competitive disadvantage?

3. Proposed Rule 15a-6(a)(4)

As explained above, paragraph (a)(4) of proposed Rule 15a-6 would provide an additional exemption for foreign broker-dealers that effect transactions for certain classes of investors, namely, U.S. persons that act in a fiduciary capacity for an account of a foreign resident client.[167]

Because of the nature and/or location of these persons, the Commission preliminarily believes that it would be necessary or appropriate in the public interest, and would be consistent with the protection of investors, to exempt foreign broker-dealers relying on paragraph (a)(4)(vi) of the proposed rule from the registration requirements of Sections 15(a)(1) and 15B(a)(1) of the Exchange Act and the reporting and other requirements of the Exchange Act (other than Sections 15(b)(4) and 15(b)(6)), and the rules and regulations thereunder, that apply specifically to a broker-dealer that is not registered with the Commission solely by virtue of its status as a broker or dealer.

The Commission solicits comment on whether it would be necessary or appropriate in the public interest, and be consistent with the protection of investors, to exempt foreign broker-dealers relying on paragraph (a)(4)(vi) of the proposed rule from such rules and requirements. If not, which rules should apply and why?

4. Proposed Rule 15a-6(a)(5)

As explained above, paragraph (a)(5) of proposed Rule 15a-6 would allow a foreign broker-dealer that is a member of a foreign options exchange to effect transactions in options on foreign securities listed on that exchange for a qualified investor that has not otherwise been

167 See Part III.E., supra.

solicited by the foreign broker-dealer.[168] Under this exemption, a foreign broker-dealer, a foreign options exchange and representatives of the foreign options exchange could conduct certain activities or communicate with a qualified investor in a manner that might otherwise be considered a form of solicitation, as described above.[169] Transactions effected by or through the foreign broker-dealer with or for qualified investors that result from these activities or communications would not require registration or, in some situations, compliance with proposed Rule 15a-6(a)(3). However, while these activities would not necessarily constitute a form of solicitation, the Commission anticipates that given the broad interpretation of solicitation, it would be difficult, if not impractical, to conduct repeated transactions with the same qualified investor without a foreign broker-dealer engaging in some form of communication that would constitute solicitation. Therefore, the Commission anticipates that most transactions with qualified investors resulting from these activities or communications would need to be completed pursuant to proposed Rules 15a-6(a)(3).

Hence, for the reasons given above in the discussion of paragraphs (a)(2) and (a)(3) of the proposed rule, the Commission preliminarily believes that it would be necessary or appropriate in the public interest, and would be consistent with the protection of investors to exempt foreign broker-dealers relying on paragraph (a)(5) of the proposed rule from the registration requirements of Sections 15(a)(1) and 15B(a)(1) of the Exchange Act and the reporting and other requirements of the Exchange Act (other than Sections 15(b)(4) and 15(b)(6)), and the rules and regulations thereunder, that apply specifically to a broker-dealer that is not registered with the Commission solely by virtue of its status as a broker or dealer.

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168 See Part III.F., supra.

169 See proposed Rules 15a-6(a)(5)(i) - (iii).

The Commission solicits comment on whether it would be necessary or appropriate in the public interest, and be consistent with the protection of investors, to exempt foreign broker-dealers relying on paragraph (a)(5) of the proposed rule from such rules and requirements. If not, which rules should apply and why?

IV. Preliminary Findings

Section 15(a)(2) of the Exchange Act provides that the Commission, by rule or order, as it deems consistent with the public interest and the protection of investors, may conditionally or unconditionally exempt from Section 15(a)(1) any broker or dealer or class of brokers or dealers. Section 36 of the Exchange Act provides general exemptive authority to the Commission to exempt any person or class of persons or transactions from any provision of the Exchange Act, to the extent that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors. As described in Part III.G., above, the Commission preliminarily believes that the proposed exemptions would be necessary or appropriate in the public interest and would be consistent with the protection of investors.

V. General Request for Comment

In addition to the specific requests for comment above, the Commission seeks comment generally on all aspects of the proposed amendments to Rule 15a-6 under the Exchange Act. The Commission anticipates that all prior staff no-action relief under Rule 15a-6 would be superseded if the Commission were to adopt this proposed rule and interpretive guidance. Are there additional issues stemming from the 1989 Adopting Release or related staff guidance that are not addressed in the proposal and that should be addressed by this rule or interpretive guidance? Commenters are invited to provide empirical data to support their views. Comments are of the greatest assistance to our rulemaking initiatives if accompanied by supporting data and analysis of the issues addressed, and if accompanied by alternative suggestions to our proposals when appropriate. Commenters are also welcome to offer their views on any other issues raised by the proposed amendments to Rule 15a-6.

VI. Administrative Law Matters

A. Paperwork Reduction Act Analysis

Certain provisions of current Rule 15a-6 contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[170] The Commission has previously submitted these information collections to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The revised collections of information in the proposed amendments would impose certain burdens on U.S. registered broker-dealers, foreign broker-dealers and U.S. persons acting as fiduciaries as described in proposed Rule 15a-6(a)(4)(vi). The Commission has submitted the revised collections of information, entitled "Rule 15a-6 under the Securities Exchange Act of 1934 – Exemption of Certain Foreign Brokers or Dealers" (OMB control No. 3235-0371), to the OMB for review. 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.[171]

1. Related Collections of Information under Proposed Paragraphs (a)(3)(i)(B) and (C) and (a)(3)(iii)(C) and (D)

Current paragraph (a)(3)(ii)(B) of Rule 15a-6 requires a U.S. registered broker-dealer to determine that the foreign associated persons of a foreign broker-dealer effecting transactions with U.S. institutional investors or major U.S. institutional investors are not subject to a statutory disqualification as defined in Section 3(a)(39) of the Exchange Act, or certain substantially equivalent foreign disciplinary actions. As described above, because the foreign equivalents of

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170 44 U.S.C. 3501 et seq.

171 See 44 U.S.C. 3512.

statutory disqualification are now included in Section 3(a)(39), the proposed rule would no longer separately describe them.[172] In addition, the proposed rule would place the burden on the foreign broker-dealer to determine that its foreign associated persons effecting transactions with a qualified investor are not subject to a statutory disqualification as defined in Section 3(a)(39) of the Exchange Act.[173]

Current paragraph (a)(3)(iii)(C) of Rule 15a-6 requires a U.S. registered broker-dealer to obtain from the foreign broker-dealer, with respect to each foreign associated person, the types of information specified in Rule 17a-3(a)(12) under the Exchange Act,[174] provided that the information required by paragraph (a)(12)(i)(D) of that rule includes sanctions imposed by foreign securities authorities, exchanges, or associations, including statutory disqualification.[175] Proposed paragraph (a)(3)(i)(C) of Rule 15a-6 would require that the foreign broker-dealer have such information regarding its foreign associated persons in its files.

Proposed paragraphs (a)(3)(iii)(C) and (D) of Rule 15a-6 would require that a registered broker-dealer obtain and record a representation from the foreign broker-dealer that the foreign broker-dealer has determined that its foreign associated persons effecting transactions with a qualified investor are not subject to a statutory disqualification as defined in Section 3(a)(39) of the Exchange Act and has the information required by proposed paragraph (a)(3)(i)(C) of Rule 15a-6 in its files.

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172 See Part III.D.3., supra; see also proposed Rule 15a-6(a)(3)(i)(B).

173 See proposed Rule 15a-6(a)(3)(i)(B).

174 See Part III.D.3., supra.

175 See 17 CFR 240.15a-6(a)(3)(iii)(C).

a. Collection of Information

Proposed paragraphs (a)(3)(i)(B) and (C) and (a)(3)(iii)(C) and (D) of Rule 15a-6 all would require "collections of information," as that term is defined in 44 U.S.C. 3502(3). Proposed paragraph (a)(3)(i)(B) would require a foreign broker-dealer to make a determination that its foreign associated persons effecting transactions with a qualified investor are not subject to a statutory disqualification as defined in Section 3(a)(39) of the Exchange Act.[176] Proposed paragraph (a)(3)(i)(C) would require that the foreign broker-dealer have in its files information specified in Rule 17a-3(a)(12) under the Exchange Act, including information related to sanctions imposed by foreign securities authorities, foreign exchanges, or foreign associations.[177] Thus, each requires a collection of information by the foreign broker-dealer.

Proposed paragraph (a)(3)(iii)(C) would require that a U.S. registered broker-dealer obtain a representation from the foreign broker-dealer that the foreign broker-dealer has made the determinations that would be required by proposed paragraph (a)(3)(i)(B) and has in its files the information that would be required by proposed paragraph (a)(3)(i)(C). Proposed paragraph (a)(3)(iii)(C) therefore would require a collection of information by both the foreign broker-dealer and the U.S. registered broker-dealer in that the foreign broker-dealer must provide the representation and the U.S. registered broker-dealer must obtain that representation.

Proposed paragraph (a)(3)(iii)(D) would require a U.S. registered broker-dealer to maintain a record of the representations it obtains pursuant to proposed paragraph (a)(3)(iii)(C). This proposed paragraph would require a collection of information by the U.S. registered broker-dealer.

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176 See proposed Rule 15a-6(a)(i)(B).

177 See proposed Rule 15a-6(a)(i)(C).

b. Proposed Use of Information

The collections of information under proposed paragraphs (a)(3)(i)(B) and (C) and proposed paragraphs (a)(3)(iii)(C) and (D) are intended to protect U.S. investors from contacts with foreign associated persons with a disciplinary history.

c. Respondents

As discussed above, proposed paragraphs (a)(3)(i)(B) and (C) and proposed paragraphs (a)(3)(iii)(C) and (D) of Rule 15a-6 would require collections of information by both foreign broker-dealers and U.S. registered broker-dealers. All foreign broker-dealers that take advantage of the exemption from registration under the proposed rule would be required to comply with proposed paragraphs (a)(3)(i)(B) and (C) and proposed paragraph (a)(3)(iii)(C). The Commission estimates that approximately 700 foreign broker-dealers would take advantage of the exemption from registration under the proposed rule and therefore be subject to the collection of information requirements in proposed paragraphs (a)(3)(i)(B) and (C) and proposed paragraph (a)(3)(iii)(C).[178]

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[178] Based on information the staff obtained in discussions with industry representatives, the Commission estimates that approximately 40 U.S. registered broker-dealers would serve as U.S. registered broker-dealers under Exemption (A)(1) under the proposed rule. The Commission estimates that each of these 40 U.S. registered broker-dealers would do so for an average of 10 foreign broker-dealers, so that an estimated total of 400 foreign broker-dealers would utilize Exemption (A)(1) under the proposed rule. The Commission also estimates based on information the staff obtained in discussions with industry that approximately 18 U.S. registered broker-dealers would be engaged under Exemption (A)(2) by foreign broker-dealers relying on the exemption provided by paragraph (a)(3)(iii)(A)(2) of the proposed rule. The Commission believes that Exemption (A)(2) under the proposed rule would be utilized by approximately 300 foreign broker-dealers (an average of 16.67 per each of the 18 U.S. registered broker-dealers acting under Exemption (A)(2) – assuming an even distribution of foreign broker-dealers per U.S. registered broker-dealer operating under the exemption, some U.S. registered broker-dealers would do so for 16 foreign broker-dealers and some would do so for 17 foreign broker-dealers). Therefore, the Commission estimates that a total of

Similarly, all U.S. registered broker-dealers engaged by foreign broker-dealers to assume the responsibilities of a U.S. registered broker-dealer under the proposed rule, under either exemption, would be required to comply with proposed paragraphs (a)(3)(iii)(C) and (D). The Commission estimates that approximately 40 U.S. registered broker-dealers would be engaged by foreign broker-dealers to assume the responsibilities under Exemption (A)(1) and approximately 18 U.S. registered broker dealers would be engaged by foreign broker-dealers to assume the responsibilities under Exemption (A)(2) under the proposed rule, for a total of approximately 58 U.S. registered broker-dealers assuming the responsibilities under paragraph (a)(3)(iii) and therefore be subject to the collection of information requirements in proposed paragraphs (a)(3)(iii)(C) and (D).

d. Reporting and Recordkeeping Burden

The Commission estimates for the purposes of proposed paragraph (a)(3)(i)(B) that each of the approximately 700 foreign broker-dealer respondents would employ approximately 5 foreign associated persons that would effect transactions with qualified investors and would spend approximately 10 hours per year determining that these foreign associated persons are not subject to a statutory disqualification as defined in Section 3(a)(39) of the Exchange Act.[179] The Commission also estimates for the purposes of proposed paragraph (a)(3)(i)(C) that each of the approximately 700 foreign broker-dealer respondents would spend approximately 10 hours per year complying with the terms of that proposed paragraph. Thus, the Commission estimates for

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700 foreign broker-dealers would take advantage of one or both exemptions from registration under the proposed rule.

179 As noted above, the bases for these estimates come from information the staff obtained in discussions with industry representatives. Unless otherwise indicated, each of the Commission's estimates used for the purposes of calculating the number of respondents or the burden imposed upon those respondents is based on such discussions.

the purposes of proposed paragraph (a)(3)(iii)(C) that each of the approximately 700 foreign broker-dealer respondents would spend approximately 5 hours per year providing representations to U.S. registered broker-dealers that they have complied with proposed paragraphs (a)(3)(i)(B) and (C). Therefore, the annual burden imposed by proposed paragraphs (a)(3)(i)(B) and (C) and proposed paragraph (a)(3)(iii)(C) on each of the 700 foreign broker-dealers would be approximately 25 hours for an aggregate annual burden on all foreign broker-dealers of 17,650 hours (700 foreign broker-dealers x 25 hours per foreign broker-dealer).

The Commission estimates for the purposes of proposed paragraphs (a)(3)(iii)(C) and (D) that each U.S. registered broker-dealer acting under Exemption (A)(1) would spend approximately 5 hours each year obtaining and recording representations required by proposed paragraphs (a)(3)(iii)(C) and (D). Similarly, the Commission estimates that each U.S. registered broker-dealer acting under Exemption (A)(2) would spend approximately 8 hours each year obtaining and recording representations required by proposed paragraphs (a)(3)(iii)(C) and (D). Thus, the aggregate annual burden imposed by proposed paragraphs (a)(3)(i)(C) and (D) on all U.S. registered broker-dealers would be approximately 344 hours (40 U.S. registered broker-dealers acting under Exemption (A)(1) multiplied by 5 hours per broker-dealer plus 18 U.S. registered broker-dealers acting under Exemption (A)(2) multiplied by 8 hours per broker-dealer).

e. Collection of Information Is Mandatory

These collections of information would be mandatory for foreign broker-dealers that choose to rely on the exemptions in paragraph (a)(3) of the proposed rule and U.S. registered broker-dealers that intermediate transactions for foreign broker-dealers that choose to rely on the exemptions in paragraph (a)(3) of the proposed rule.

f. Confidentiality

Proposed paragraph (a)(3)(i)(C) would require foreign broker-dealers to have in their files the type of information specified in Rule 17a-3(a)(12) under the Exchange Act, provided that the information required by paragraph (a)(12)(i)(D) of Rule 17a-3 shall include information relating to sanctions imposed by foreign securities authorities, foreign exchanges or foreign associations, including without limitation those described in Section 3(a)(39) of the Exchange Act. Proposed paragraph (a)(3)(iii)(D) would require U.S. registered broker-dealers to maintain a written record of the representations obtained from foreign broker-dealers, as required by proposed paragraph (a)(3)(iii)(C).

All information related to transactions with qualified investors, whether kept by U.S. registered broker-dealers or foreign broker-dealers, would be subject to review and inspection by the Commission and its representatives as required in connection with examinations, investigations and enforcement proceedings. Such information is not required to be disclosed to the public and will be kept confidential by the Commission.

g. Record Retention Period

Proposed paragraphs (a)(3)(i)(B) and (C) and proposed paragraphs (a)(3)(iii)(C) and (D) would not include record retention periods. However, the U.S. registered broker-dealers would have to retain the representations for the period specified under 17 CFR 240.17a-4(b)(7), which requires broker-dealers to preserve all written agreements they enter into relating to their business for a period of not less than three years, the first two years in an easily accessible place.

2. Collection of Information under Proposed Paragraph (a)(3)(i)(D)

a. Collection of Information

Proposed paragraph (a)(3)(i)(D) would require "collections of information," as that term is defined in 44 U.S.C. 3502(3), by foreign broker-dealers. Proposed paragraph (a)(3)(i)(D) would require that a foreign broker-dealer relying on either Exemption (A)(1) or Exemption (A)(2) disclose to qualified investors that the foreign broker dealer is regulated by a foreign securities authority and not by the Commission. Foreign broker-dealers relying on Exemption (A)(1) would also have to disclose to qualified investors whether U.S. segregation requirements, U.S. bankruptcy protections and protections under the SIPA would apply to any funds and securities held by the foreign broker-dealer.

b. Proposed Use of Information

The collections of information required by proposed paragraph (a)(3)(i)(D) are designed to put U.S. investors on notice that foreign broker-dealers operating pursuant to the exemption in Rule 15a-6(a)(3)(iii)(A)(1) are not subject to the same regulatory requirements as U.S. registered broker-dealers. This notice is important because the proposed rule would eliminate the current chaperoning requirements, as described below, and allow a foreign broker-dealer to effect transactions on behalf of qualified investors and custody qualified investor funds and securities relating to any resulting transactions with more limited participation in the transaction by a U.S. registered broker-dealer.[180]

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180 Similarly, because of the limited participation of the U.S. registered broker-dealer and the lack of chaperoning requirements, the proposed rule would require that the foreign broker-dealer be regulated for conducting securities activities in a foreign country by a foreign securities authority.

c. Respondents

As discussed above, the Commission estimates that approximately 400 foreign broker-dealers would rely on Exemption (A)(1) of the proposed rule. All 400 foreign broker-dealers would be required to comply with proposed paragraph (a)(3)(i)(D). The Commission also estimates that approximately 300 foreign broker-dealers would rely on Exemption (A)(2) of the proposed rule. These 300 foreign broker-dealers would only be required to comply with proposed paragraph (a)(3)(i)(D)(1).

d. Reporting and Recordkeeping Burden

Each of the 700 foreign broker-dealers that would rely on either Exemption (A)(1) or Exemption (A)(2) of the proposed rule would have to make certain disclosures required by proposed paragraph (a)(3)(i)(D) to each qualified investor from which the foreign broker-dealer induces or attempts to induce the purchase or sale of any security. The Commission believes that such disclosures would be conveyed in the course of other communications between the foreign broker-dealer and the qualified investor, such as the foreign broker-dealer's standard account-opening documentation. Thus, we expect that the only collection of information burden that proposed paragraph (a)(3)(i)(D) would impose on a foreign broker-dealer would be the hour burden incurred in developing and updating as necessary the standard documentation it will provide to qualified investors. In addition, the Commission does not believe that there would be a significant difference in the burden placed foreign broker-dealers relying on either Exemption (A)(1) or Exemption (A)(2) of the proposed rule by proposed paragraph (a)(3)(i)(D). The Commission estimates that each of the 700 foreign broker-dealers that would rely on either Exemption (A)(1) or Exemption (A)(2) of the proposed rule would spend approximately 2 hours per year in drafting, reviewing or updating as necessary their standard documentation for compliance with proposed paragraph (a)(3)(i)(D). Therefore, the aggregate annual collection of information burden imposed by proposed paragraph (a)(3)(i)(D) on foreign broker-dealers would be approximately 1,400 hours (700 foreign broker-dealers multiplied by 2 hours per foreign broker-dealer).

e. Collection of Information Is Mandatory

This collection of information would be mandatory for foreign broker-dealers that rely on either Exemption (A)(1) or Exemption (A)(2) of the proposed rule.

f. Confidentiality

The disclosures required by proposed paragraph (a)(3)(i)(D) would be conveyed to a qualified investor in the course of communications between the foreign broker-dealer and the qualified investor, such as the foreign broker-dealer's standard account-opening documentation, and therefore would not be confidential.

g. Record Retention Period

Proposed paragraph (a)(3)(i)(D) would not include a record retention period.

3. Related Collections of Information under Proposed Paragraphs (a)(3)(iii)(B) and (D)

a. Collection of Information

Proposed paragraphs (a)(3)(iii)(B) and (D) would require "collections of information," as that term is defined in 44 U.S.C. 3502(3), by U.S. registered broker-dealers. Proposed paragraph (a)(3)(iii)(B) would require that a U.S. registered broker-dealer obtain from a foreign broker-dealer and each of the foreign broker-dealer's foreign associated persons written consents to service of process for any civil action brought by or proceeding before the Commission or a self-regulatory organization (as defined in Section 3(a)(26) of the Exchange Act).[181] Proposed paragraph (a)(3)(iii)(D) would require that the U.S. registered broker-dealer maintain a written record of the consents to service of process obtained pursuant to proposed paragraph (a)(3)(iii)(B).

b. Proposed Use of Information

The collections of information under proposed paragraphs (a)(3)(iii)(B) and (D) are designed to assist the Commission in its regulatory function by ensuring that foreign broker-dealers and their foreign associated persons effecting transactions with qualified investors have consented to service of process.

c. Respondents

All U.S. registered broker-dealers engaged by foreign broker-dealers to assume the responsibilities of a U.S. registered broker-dealer under the proposed exemption would be subject to the collections of information. As discussed above, the Commission estimates that approximately 40 U.S. registered broker-dealers would act under Exemption (A)(1) for foreign broker-dealers relying on the exemption provided by paragraph (a)(3)(iii)(A)(1) of the proposed rule and that approximately 18 U.S. registered broker-dealers would act under Exemption (A)(2). Therefore, the Commission estimates that a total of approximately 58 U.S. registered broker-

181 The consent would indicate that process may be served on the foreign broker-dealer or foreign associated person by service on the U.S. registered broker-dealer in the manner set forth on the U.S. registered broker-dealer's current Form BD. See proposed Rule 15a-6(a)(3)(iii)(B).

dealers would have to comply with the collection of information requirements in proposed paragraphs (a)(3)(iii)(B) and (D).[182]

d. Reporting and Recordkeeping Burden

As discussed above, the Commission estimates that each of the 40 U.S. registered broker-dealers that would serve under Exemption (A)(1) for affiliated foreign broker-dealers under the proposed rule would do so for an average of 10 foreign broker-dealers. The Commission also estimates that each such foreign broker-dealer would have an average of 5 foreign associated persons engaged in business under the proposed rule. Therefore, proposed paragraphs (a)(3)(iii)(B) and (D) would require each U.S. registered broker-dealer acting under Exemption (A)(1) to obtain and record a total of 50 consents to service of process from foreign associated persons and 10 consents to service of process from foreign broker-dealers.

As discussed above, the Commission estimates that each of the 18 U.S. registered broker-dealers that would serve under Exemption (A)(2) for qualified investors would do so for approximately 16.67 foreign broker-dealers. Also as discussed above, the Commission estimates that each such foreign broker-dealer would have an average of 5 foreign associated persons engaged in business under the proposed rule. Therefore, proposed paragraphs (a)(3)(iii)(B) and (D) would require a U.S. registered broker-dealer acting under Exemption (A)(2) to obtain a total of 83.35 consents to service of process from foreign associated persons and 16.67 consents to service of process from foreign broker-dealers.[183]

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182 The Commission understands that U.S. registered broker-dealers acting under Exemption (A)(2) are likely to also act under Exemption (A)(1) under the proposed rule. The Commission requests comment regarding how frequently this would occur.

183 Assuming a relatively even distribution of the estimated 300 foreign broker-dealers across the 18 U.S. registered broker-dealers acting under Exemption (A)(2), proposed paragraphs (a)(3)(iii)(B) and (D) would require some U.S. registered broker-dealers

The Commission further estimates that each affected U.S. registered broker-dealer, acting under either exemption, would spend an average of 0.5 hours in obtaining and recording one consent under proposed paragraphs (a)(3)(iii)(B) and (D). Each U.S. registered broker-dealer acting under Exemption (A)(1) would therefore spend an average of 35 hours per year in its efforts at compliance with proposed paragraphs (a)(3)(iii)(B) and (D) (0.5 hours per consent per representation multiplied by the sum of 50 consents from foreign associated persons plus 10 consents to service of process from foreign broker-dealers plus 10 representations). Similarly, each U.S. registered broker-dealer acting under Exemption (A)(2) would spend an average of 50.01 hours per year in its efforts at compliance with proposed paragraphs (a)(3)(iii)(B) and (D) (0.5 hours per consent per representation multiplied by the sum of 83.35 consents from foreign associated persons plus 16.67 consents to service of process from foreign broker-dealers). Therefore, the Commission estimates an annual aggregate reporting and recordkeeping burden of 2,300.18 hours for compliance with proposed paragraphs (a)(3)(iii)(B) and (D) (35 hours per 40 registered broker-dealers acting under Exemption (A)(1) for a total of 1,400 hours, plus 50.01 hours per 18 registered broker-dealers acting under Exemption (A)(2) for a total of 900.18 hours).

e. Collection of Information Is Mandatory

This collection of information would be mandatory for U.S. registered broker-dealers that intermediate transactions for foreign broker-dealers that choose to rely on the exemption in paragraph (a)(3) of the proposed rule.

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acting under Exemption (A)(2) to obtain and record 83 consents to service of process from foreign associated persons and some to obtain and record 84 consents to service of process from foreign associated persons.

f. Confidentiality

The proposed rule would require that U.S. registered broker-dealers maintain a written record of the information and consents and make such records available to the Commission upon request. All information related to transactions with qualified investors, whether kept by U.S. registered broker-dealers or foreign broker-dealers, would be subject to review and inspection by the Commission and its representatives as required in connection with examinations, investigations and enforcement proceedings. Such information is not required to be disclosed to the public and will be kept confidential by the Commission.

g. Record Retention Period

Proposed paragraphs (a)(3)(iii)(B) and (D) would not include separate record retention periods. However, the U.S. registered broker-dealers would have to retain the consents for the period specified under 17 CFR 240.17a-4(b)(7), which requires broker-dealers to preserve all written agreements they enter into relating to their business for a period of not less than three years, the first two years in an easily accessible place.

4. Related Collections of Information under Proposed Paragraph (a)(4)(vi)(B)

Under the proposed rule, a foreign broker-dealer would be exempt from the registration, reporting and other requirements of the Exchange Act to the extent that it effects transactions in securities with or for, or induces or attempts to induce the purchase or sale of any security by any U.S. person, other than a registered broker-dealer or bank acting pursuant to an exception or exemption from the definition of "broker" or "dealer" in Section 3(a)(4)(B), 3(a)(4)(E), or 3(a)(5)(C) of the Exchange Act or the rules thereunder, that acts in a fiduciary capacity for an account of a foreign resident client.[184] As a condition of this exemption, the foreign broker-dealer would be required, among other things, to obtain and maintain a representation from the U.S. person that the account is managed in a fiduciary capacity for a foreign resident client.[185]

a. Collection of Information

Proposed paragraph (a)(4)(vi)(B) would require "collections of information" as that term is defined in 44 U.S.C. 3502(3) in that it would require foreign broker-dealers to obtain and maintain a representation for each account managed by a U.S. fiduciary that the account is managed in a fiduciary capacity for a foreign resident client. This would require foreign broker-dealers to obtain and record each representation. The proposed paragraph would also require a collection of information by the U.S. fiduciary, which would be required to provide the representation to the foreign broker-dealer.

b. Proposed Use of Information

The collection of information in proposed paragraph (a)(4)(vi)(B) would assist foreign broker-dealers seeking to rely on the exemption under proposed paragraph (a)(4)(vi) in complying with the terms of that exemption and would provide the Commission with access to such information.

c. Respondents

As discussed above, the Commission estimates that approximately 700 foreign broker-dealers that would take advantage of either exemption under proposed paragraphs (a)(3)(iii)(A)(1) and (2).[186] The Commission believes that these estimated 700 foreign broker-

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184 See proposed paragraph (a)(4)(vi).

185 See proposed paragraph (a)(4)(vi)(B).

186 See note 178, supra.

dealers represent the number of foreign broker-dealers that engage in international broker-dealer business and would take advantage of the exemption in proposed paragraph (a)(4)(vi). Even though not all of these 700 foreign broker-dealers may actually utilize the exemption in proposed paragraph (a)(4)(vi), for the purposes of determining the number of foreign broker-dealer respondents for the collection of information in proposed paragraph (a)(4)(vi)(B), the Commission estimates that all 700 foreign broker-dealers that engage in international business and that would otherwise take advantage of the either exemption under proposed paragraph (a)(3)(iii)(A)(1) or (2) would also utilize the exemption in proposed paragraph (a)(4)(vi) and be respondents for the purposes of the collection of information in proposed paragraph (a)(4)(vi)(B).

The Commission estimates that there are 349 U.S. fiduciaries that would be respondents for the purposes of the collection of information in proposed paragraph (a)(4)(vi)(B).

d. Reporting and Recordkeeping Burden

The Commission estimates that each U.S. fiduciary would spend approximately 5 hours per year providing representations in accordance with proposed paragraph (a)(4)(vi)(B). Therefore, the Commission estimates that the aggregate burden imposed by proposed paragraph (a)(4)(vi)(B) on all of the approximately 349 U.S. fiduciaries would be approximately 1,745 hours per year (5 hours multiplied by 349 U.S. fiduciaries).

The Commission also estimates that each foreign broker-dealer would spend approximately 5 hours per year obtaining and recording the representations required by proposed paragraph (a)(4)(vi)(B) from U.S. fiduciaries. Therefore, the Commission estimates that the aggregate burden imposed by proposed paragraph (a)(4)(vi)(B) on all the approximately 700 foreign broker-dealers would be approximately 3,500 hours per year (5 hours multiplied by 700 foreign broker-dealers).

e. Collection of Information Is Mandatory

These collections of information would be mandatory for U.S. fiduciaries and foreign broker-dealers that effect transactions according to the proposed exemption in proposed paragraph (a)(4)(vi) of the proposed rule.

f. Confidentiality

The proposed rule would require that a foreign broker-dealer maintain the representations it would obtain from a U.S. fiduciary regarding the U.S. fiduciary's accounts. All information related to transactions with qualified investors, whether kept by U.S. registered broker-dealers or foreign broker-dealers, would be subject to review and inspection by the Commission and its representatives as required in connection with examinations, investigations and enforcement proceedings. Such information is not required to be disclosed to the public and will be kept confidential by the Commission.

g. Record Retention Period

Proposed paragraph (a)(4)(vi)(B) would not include a record retention period.

5. Request for Comment

The Commission requests comment on the proposed collections of information in order to: (1) evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information would have practical utility; (2) evaluate the accuracy of the Commission's estimates of the burden of the proposed collections of information; (3) determine whether there are ways to enhance the quality, utility and clarity of the information to be collected; (4) evaluate whether there are ways to minimize the burden of the collection of information on those who respond, including through the use of automated collection techniques or other forms of information technology; and (5) evaluate whether the proposed rules would have any effects on any other collection of information not previously identified in this section.

Persons who desire to submit comments on the collection of information requirements should direct their comments to OMB, 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 Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, and refer to File No. S7-16-08. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this document in the Federal Register; therefore, comments to OMB are best assured of having full effect if OMB receives them within 30 days of this publication. Requests for the materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-16-08, and be submitted to the Securities and Exchange Commission, Records Management Office, 100 F Street, NE, Washington, DC 20549-1110.

B. Consideration of Benefits and Costs

1. Expected Benefits

The proposed rule would have several important benefits. First, the proposed rule would allow a broader category of U.S. investors[187] greater access to foreign broker-dealers and foreign

[187] As noted above, the proposed rule would expand the category of U.S. investors with which a foreign broker-dealer may interact under Rule 15a-6(a)(2) from major U.S. institutional investors to qualified investors and generally expand the category of U.S. investors with which a foreign broker-dealer may interact under Rule 15a-6(a)(3) from major U.S. institutional investors and U.S. institutional investors to qualified investors.

markets by expanding and streamlining the conditions under which a foreign broker-dealer could operate without triggering the registration requirements of Section 15(a)(1) or 15B(a)(1) of the Exchange Act. Among the benefits to U.S. investors would be expanded investment and diversification opportunities and lower cost of accessing such opportunities. Because the proposed rule would broaden the category of U.S. investors that may interact with foreign broker-dealers, the expanded investment and diversification opportunities would be available to a greater number of U.S. investors that the Commission believes possess the investment experience to effect transactions with or through unregistered broker-dealers under the safeguards imposed by the proposed rule. This also would be a benefit to foreign broker-dealers, which would have access to an expanded potential client base without being required to register with the Commission as broker-dealers.

In addition, the Commission understands that the current chaperoning requirements have been criticized as impractical and imposing unnecessary operational and compliance burdens, particularly for communications with broker-dealers in time zones outside those of the United States. In this regard, the Commission believes that the investor protections intended to be provided by the presence of associated persons of U.S. registered broker-dealers during in-person or telephonic communications between foreign associated persons of foreign broker-dealers and U.S. investors, as under the current rule, could be achieved by less operationally-challenging methods. Specifically, foreign associated persons that are subject to statutory disqualification specified in Section 3(a)(39) of the Exchange Act would be precluded from contacting qualified

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This would allow foreign broker-dealers, for the first time, to interact with a corporation, company, or partnership that owns and invests on a discretionary basis $25 million or more in investments under paragraph (a)(3). In addition, under the proposed rule, natural persons who own or invest on a discretionary basis not less than $25,000,000 in investments would be included. See Part III.A., supra.

investors and foreign broker dealers would be required to make disclosures to those investors, placing them on notice that the foreign broker-dealer is regulated by a foreign securities authority and not by the Commission and, in the case of Exemption (A)(1), informing them that U.S. segregation requirements, U.S. bankruptcy protections and protections under the SIPA would apply to any funds and securities held by the foreign broker-dealer.[188] Accordingly, the proposed rule would allow a foreign broker-dealer to have unchaperoned visits within the United States and communications, both oral and electronic, with qualified investors, as long as a U.S. registered broker-dealer assumes certain limited responsibilities in connection with the foreign broker-dealer's activities, as described above. As a result, the proposed rule should facilitate communications between foreign broker-dealers and qualified investors to communicate, while utilizing more efficient methods designed to protect qualified investors.

Second, the proposed rule would provide U.S. registered broker-dealers and foreign broker-dealers with greater flexibility in how they conduct business under paragraph (a)(3) of Rule 15a-6. For instance, U.S. registered broker-dealers acting under Exemption (A)(1) would be allowed to maintain copies of books and records in the form prescribed by the foreign securities authority and with the foreign broker-dealer. In general, the proposed rule would allow a foreign broker-dealer to effect transactions on behalf of qualified investors and custody qualified investor funds and securities relating to any resulting transactions with more limited participation in the transaction by a U.S. registered broker-dealer. Among other things, this would have the benefit of eliminating the need for the U.S. registered broker-dealer to "double book" transactions under current Rule 15a-6(a)(3). It would also allow the foreign broker-dealer more flexibility in how it communicates with qualified investors, as described above.

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188 See proposed Rule 15a-6(a)(3)(i)(B) and (D).

Third, while proposed Rule 15a-6 would impose certain costs on U.S. registered broker-dealers acting under either exemption, as discussed below, these costs would be markedly less than under current Rule 15a-6. Most importantly, the proposed rule would significantly reduce the cost for a U.S. registered broker-dealer to intermediate transactions under paragraph (a)(3) of Rule 15a-6.

Under Exemption (A)(1), the U.S. registered broker-dealer would not be required to effect transactions – and perform all of the functions associated with effecting transactions, including, for example, compliance with recording and recordkeeping rules, issuing confirmations and maintaining custody of customer funds and securities – on behalf of the qualified investor. Instead, under the proposed rule, the U.S. registered broker-dealer would only be required to collect and make available to the Commission certain limited information. Specifically, the proposed rule would require a U.S. registered broker-dealer acting under Exemption (A)(1) to maintain certain books and records, including confirmations and statements issued by the foreign broker-dealer to the qualified investor, but would permit the U.S. registered broker-dealer to maintain those books and records in the form, manner and for the periods prescribed by the foreign securities authority regulating the foreign broker-dealer and with the foreign broker-dealer.[189] The Commission believes that all U.S. registered broker-dealers acting under Exemption (A)(1) in Rule 15a-6(a)(3) relationships would take advantage of this option, thereby significantly lowering costs associated with collecting and maintaining books and records, including collection of information burdens under the Paperwork Reduction Act and associated costs. There would also be significant cost savings for U.S. registered broker-dealers

189 See proposed Rule 15a-6(a)(3)(iii)(A)(1) and (2).

acting under Exemption (A)(1) because they would not have to clear and settle transactions, safeguard customer funds and securities, or issue confirmations.

In addition, regardless of whether the U.S. registered broker-dealer acts under Exemption (A)(1) or Exemption (A)(2), the proposed rule would eliminate the current rule's requirement that the U.S. registered broker-dealer make certain determinations regarding the foreign broker-dealer and its associated persons. Under the proposed rule, the U.S. registered broker-dealer would only be required to obtain representations from the foreign broker-dealer regarding that information.[190] This would be a significant cost savings with respect to the current rule because the U.S. registered broker-dealer would not have to make the determination itself for each foreign broker-dealer and its associated persons as under the current rule.

Finally, the proposed rule would reduce a foreign broker-dealer's costs of meeting the conditions of the exemption in two principal ways. First, the proposed amendments would make it less burdensome for foreign broker-dealers to communicate directly with qualified investors. Currently, Rule 15a-6 requires an associated person of a U.S. registered broker-dealer to chaperone certain in-person visits and oral communications between foreign associated persons and U.S. institutional investors, with certain exceptions, and chaperone in-person visits between foreign associated persons and major U.S. institutional investors under certain conditions.[191] The proposed rule would allow a foreign broker-dealer to hold in-person meetings and have oral and electronic communications with qualified investors without the intermediation of an U.S. registered broker-dealer. This would result in significant cost savings.

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190 See proposed Rule 15a-6(a)(3)(iii)(C).

191 See 17 CFR 240.15a-6(a)(3)(ii)(A)(1) and (iii)(B). This would be a cost savings for U.S. registered broker-dealers as well, as they would no longer need to chaperone the in-person visits and oral communications of foreign associated persons with U.S. investors.

Second, the proposed rule would provide a foreign broker-dealer with the alternative of having a U.S. registered broker-dealer act under Exemption (A)(1) or under Exemption (A)(2). These alternatives would allow the foreign broker-dealer and the U.S. registered broker-dealer, as well as the qualified investors, to determine the most cost effective method for complying with the rule.

2. Expected Costs

Of course, reducing the cost of complying with paragraph (a)(3) of Rule 15a-6 may encourage more U.S. registered broker-dealers and foreign broker-dealers to rely on the rule, which would increase the overall costs associated with complying with the requirements of Rule 15a-6. As noted above, the increased flexibility of the proposed rule would provide U.S. investors with increased access to foreign broker-dealers and foreign markets, which would presumably lead to increased transactional activity under Rule 15a-6(a)(3). As a result, foreign broker-dealers may experience some incremental cost increase. In addition, because some of the responsibilities under paragraph (a)(3) of the proposed rule would be shifted to the foreign broker-dealer, foreign broker-dealers may incur some greater costs, some of which are described below. We believe these increased costs would be insignificant. For example, because foreign broker-dealers, as members of foreign exchanges, typically are required to clear and settle transactions in foreign securities, regardless of the requirements of Rule 15a-6(a)(3), shifting the responsibility for clearing and settling from the U.S. registered broker-dealer to foreign broker-dealers would not increase their cost of complying with Rule 15a-6. Similarly, other foreign governments or securities regulators may have laws or rules comparable to the provisions in Section 3(a)(39) of the Exchange Act related to statutory disqualification. Requiring foreign broker-dealers to review the fitness of their associated persons under the provisions of Section

3(a)(39), in addition to meeting the requirements of equivalent foreign laws or rules, would impose an incremental cost on those foreign broker-dealers.

Shifting some of the responsibilities under paragraph (a)(3) of the proposed rule to foreign broker-dealers would have an effect on the business activities of U.S. registered broker-dealers. For example, shifting the responsibility for clearing and settling from the U.S. registered broker-dealer to foreign broker-dealers would reduce the compensation received by U.S. registered broker-dealers for these and other services. The elimination of the chaperoning requirements of the current rule may also reduce income to U.S. registered broker-dealers that perform such services for foreign broker-dealers.

In addition, as described above, certain provisions of the proposed rule would impose "collection of information" requirements within the meaning of the Paperwork Reduction Act on foreign broker-dealers, U.S. registered broker-dealers and U.S. fiduciaries.[192] For each of the collections of information that would be imposed by the proposed rule, the relevant respondent or respondents would incur an hour burden in complying with the collection of information requirements. For example, as described above, proposed paragraph (a)(3)(i)(B) would require that a foreign broker-dealer make a determination that its foreign associated persons effecting transactions with a qualified investor are not subject to a statutory disqualification. As explained, we estimate each foreign broker-dealer that takes advantage of the exemption under the proposed rule would spend approximately 10 hours per year in making the determination required by proposed paragraph (a)(3)(i)(B). While not a burden for the purposes of the PRA, the foreign broker-dealer would also incur certain costs related to the 10 hours per year spent making the determination required by proposed paragraph (a)(3)(i)(B). Specifically, the

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192 See Part VI.A., supra.

determination likely would be made by an employee of the foreign broker-dealer to whom the broker-dealer must pay a salary or hourly wage. Therefore, the salaries and wages foreign broker-dealers, U.S. registered broker-dealers and U.S. fiduciaries must pay to the employees who would perform the work required by the collections of information imposed by the proposed rule would be additional costs of meeting the exemption in the proposed rule. These costs are described in the following paragraphs.

a. Collection of Information Costs to Foreign Broker-Dealers

As described above in the Paperwork Reduction Act Analysis, proposed paragraphs (a)(3)(i)(B), (a)(3)(i)(C), (a)(3)(i)(D), (a)(3)(iii)(C) and (a)(4)(vi)(B) each would impose collection of information requirements on foreign broker-dealers. Other than proposed paragraph (a)(3)(i)(C), these collections of information would require the foreign broker-dealer to make certain legal determinations, provide or obtain legal representations or draft disclosures. Therefore, the Commission believes that the type of work required by each requirement would be performed by a compliance attorney at each foreign broker-dealer. Proposed paragraph (a)(3)(i)(C), however, is a record-keeping requirement and the Commission believes that this type of work would be performed by a compliance clerk at each foreign broker-dealer.

The Commission estimates that foreign broker-dealers pay compliance attorneys at an hourly rate of (U.S.) $270.00 and compliance clerks at an hourly rate of (U.S.) $62.00.[193] Based on the estimates of the hourly burden imposed by proposed paragraphs (a)(3)(i)(B), (a)(3)(i)(B),

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193 See Securities Industry and Financial Markets Association's "Management & Professional Earnings in the Securities Industry – 2007" (available at: http://www.sifma.org/research/ surveys/ professional-earning.shtml). The SIFMA study reflects a survey of U.S. earnings. We estimate that the earnings of comparable employees at foreign broker-dealers are similar, but solicit comment on whether foreign salaries vary and, if so, how.

(a)(3)(i)(D), (a)(3)(iii)(C) and (a)(4)(vi)(B) on foreign broker-dealers, the Commission further estimates that foreign broker-dealers would incur a total cost of (U.S.) $6,560.00 per year complying with the collection of information requirements that would be imposed by those paragraphs.[194]

b. Collection of Information Costs to U.S. Registered Broker-Dealers

As described above in the Paperwork Reduction Act Analysis, proposed paragraphs (a)(3)(iii)(B), (C) and (D) each would impose collection of information requirements on U.S. registered broker-dealers. These collections of information would require the U.S. registered broker-dealer to obtain and record certain legal representations made by foreign broker-dealers. The Commission believes that this type of work would be performed by a compliance attorney at each U.S. registered broker-dealer. The Commission estimates that U.S. registered broker-dealers pay compliance attorneys at an hourly rate of (U.S.) $270.00. Based on the estimates of the hourly burden imposed by proposed paragraphs (a)(3)(iii)(B), (C) and (D) on U.S. registered broker-dealers, the Commission further estimates that U.S. registered broker-dealers intermediating transactions for foreign broker-dealers relying on Exemption (A)(1) would incur a total cost of (U.S.) $10,800.00 per year complying with the collection of information requirements that would be imposed by those paragraphs.[195] The Commission estimates that U.S. registered broker-dealers intermediating transactions for foreign broker-dealers relying on

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194 10 hours per year at $270.00 per hour complying with proposed paragraph (a)(3)(i)(B), 10 hours per year at $62.00 per hour complying with proposed paragraph (a)(3)(i)(C), 2 hours per year at $270.00 per hour complying with proposed paragraph (a)(3)(i)(D), 5 hours per year at $270.00 per hour complying with proposed paragraph (a)(3)(iii)(C) and 5 hours per year at $270.00 per hour complying with proposed paragraph (a)(4)(vi)(B). See Part VI.A., supra.

195 5 hours per year at $270.00 per hour and 35 hours per year at $270.00 per hour. See id.

Exemption (A)(2) would incur a total cost of (U.S.) $13,527.00 per year complying with the collection of information requirements that would be imposed by those paragraphs.[196]

c. Collection of Information Costs to U.S. Fiduciaries

As described above in the Paperwork Reduction Act Analysis, proposed paragraph (a)(4)(vi)(B) would impose collection of information requirements on U.S. fiduciaries in the form of a legal representation provided to foreign broker-dealers that, for each account managed by a U.S. fiduciary, the account is managed in a fiduciary capacity for a foreign resident client. The Commission believes that these legal representations would be made by a compliance attorney at each U.S. fiduciary.

The Commission estimates that U.S. fiduciaries pay compliance attorneys at an hourly rate of (U.S.) $270.00. Based on the estimates of the hourly burden imposed by proposed paragraphs (a)(4)(vi)(B) on U.S. fiduciaries, the Commission further estimates that U.S. fiduciaries would incur a total cost of (U.S.) $1,350.00 per year complying with the collection of information requirements that would be imposed by that paragraph (5 hours per year at $270.00 per hour = $1,350.00 per year).[197]

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196 8 hours per year at $270.00 per hour and 50.1 hours per year at $270.00 per hour. See id. As discussed above in the PRA analysis, U.S. registered broker-dealers intermediating transactions for foreign broker-dealers relying on Exemption (A)(1) would spend different amounts of time complying with the collection of information requirements of proposed paragraphs (a)(3)(iii)(B), (C) and (D) than U.S. registered broker-dealers intermediating transactions for foreign broker-dealers relying on Exemption (A)(2). See Part VI.A., supra. Therefore, the monetary costs incurred in complying with these paragraphs would also be different for intermediating U.S. registered broker-dealers, depending on the exemption relied upon by the foreign broker-dealer. See id.

197 See id.

3. Comment Solicited

We solicit comment on the costs and benefits to U.S. investors, foreign broker-dealers, U.S. registered broker-dealers and others who may be affected by the proposed amendments to Rule 15a-6. We request views on the costs and benefits described above as well as on any other costs and benefits that could result from adoption of the proposed rule amendments. The Commission renews its request for comment on the Commission's estimates of the hour burdens that would be imposed by the collections of information in the proposed rule and also solicits comment on its calculation of the monetary cost of those burdens. In particular, the Commission requests comment on whether the work required by the collections of information would be performed by the individuals identified. For the cost of work that would be performed by employees of foreign broker-dealers, is it reasonable to assume that such employees generally earn salaries and wages similar to comparable employees of U.S. registered broker-dealers, after conversion to U.S. dollars? Commenters are requested to provide empirical data and other factual support for their views, if possible.

C. Consideration of Burden on Competition, and on Promotion of Efficiency, Competition and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition and capital formation.[198] Exchange Act Section 23(a)(2) requires the Commission, in making rules under the Exchange Act, to consider the impact that any such rule would have on competition. This section also prohibits the Commission from adopting any rule that would

198 15 U.S.C. 78c(f).

impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[199]

The Commission believes the proposed amendments would not impose any burden on competition not necessary or appropriate in furtherance of the Exchange Act. By streamlining the conditions under which a foreign broker-dealer may operate without triggering the registration requirements of Section 15(a)(1) or 15B(a)(1) of the Exchange Act and the reporting and other requirements of the Exchange Act (other than Sections 15(b)(4) and 15(b)(6)), the proposed amendments to Rule 15a-6 should promote competition by enhancing the ability of foreign broker-dealers to compete with U.S. registered broker-dealers in the U.S. market, particularly with respect to transactions in foreign securities.[200]

We note, in particular, that making Exemption (A)(1) available only to a foreign broker-dealer conducting a predominantly foreign business would provide U.S. investors increased access to foreign expertise and foreign securities and markets without creating opportunities for regulatory arbitrage vis-à-vis U.S. securities markets.[201] As discussed above, this is particularly important because, under Exemption (A)(1), for the first time, a foreign broker-dealer would be able to provide full-service brokerage services (including maintaining custody of funds and securities from resulting transactions) to U.S. investors.[202] We are proposing an 85% percent threshold for determining whether a foreign broker-dealer conducts a predominantly foreign business because a lower threshold may allow a foreign broker-dealer to conduct significant business in U.S. securities with U.S. investors without being regulated by the Commission.

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199 15 U.S.C. 78w(a)(2).

200 See generally, Part III.D.1., supra.

201 See Part III.D.1.a., supra.

202 See id.

While we believe that the 85% threshold would be effective in eliminating the opportunities for regulatory arbitrage, allowing foreign broker-dealers to conduct any business in U.S. securities could affect the competitive positions of U.S. registered broker-dealers and foreign broker-dealers.[203]

Exemption (A)(2), which would not require a foreign broker-dealer to conduct a predominantly foreign business, would allow foreign broker-dealers to compete more directly with U.S. registered broker-dealers without limitation on the type of security, U.S. or foreign. In order to preserve measures of investor protection, however, the proposed rule would require a U.S. registered broker-dealer to keep books and records and act as custodian of funds and securities.[204]

We solicit comment on whether the proposed amendments would promote competition, including whether investors would be more or less likely to choose to invest in foreign markets under the proposed rule.

The Commission also believes the proposed amendments would promote efficiency. As U.S. investors increasingly invest in securities whose primary market is outside the United States, the ability of these investors to obtain ready access to foreign markets has grown in importance.[205] In some cases, foreign broker-dealers may offer such access to these U.S. investors by more efficient means than a U.S. registered broker-dealer could. For example, a foreign broker-dealer may more efficiently provide a U.S. investor with the means to execute trades quickly in a wide range of foreign securities markets. A foreign broker-dealer may also

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203 See Part III.D.1.a.ii., supra.

204 See Part III.D.1.b.i., supra.

205 See Part III.A., supra.

offer expertise and access to research reports concerning foreign companies, industries and market environments.[206] Allowing foreign broker-dealers to provide these services to certain classes of U.S. investors without registering, but subject to the conditions of proposed Rule 15a-6, would further stimulate the competition and efficiencies promoted by the current rule.

The proposed amendments to Rule 15a-6 are intended to promote efficiency by reducing the costs of compliance for both U.S. registered broker-dealers and foreign broker-dealers conducting transactions pursuant to paragraph (a)(3). As discussed above, the proposed rule should decrease the burden on U.S. registered broker-dealers acting under both Exemption (A)(1) and Exemption (A)(2) for foreign broker-dealers. While some of this burden would be shifted to foreign broker-dealers, overall the burden of complying with the proposed rule would be lessened. As a result, we believe that the proposed rule would enable U.S. investors to more efficiently gain access to foreign broker-dealers.

Although the proposed amendments may facilitate capital formation and capital raising by foreign broker-dealers by increasing the available pool of U.S. investors foreign broker-dealers can contact directly, the Commission does not believe that they would have any significant effect on capital formation. We note that U.S. investors can currently obtain access to foreign securities through U.S. broker-dealers.

We solicit comment on whether the proposed amendments would impose a burden on competition or whether they would promote efficiency, competition and capital formation. Commenters are requested to provide empirical data and other factual support for their views if possible.

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206 See generally, Part III.D.1., supra.

D. Consideration of the Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[207] the Commission must advise the Office of Management and Budget as to whether the proposed amendments to Rule 15a-6 constitute a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it would result or is likely to result in: an annual effect on the economy of $100 million or more (either in the form of an increase or a decrease); a major increase in costs or prices for consumers or individual industries; or a significant adverse effect on competition, investment, or innovation.

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

E. Regulatory Flexibility Certification

Section 3(a) of the Regulatory Flexibility Act ("RFA") requires the Commission to undertake an initial regulatory flexibility analysis of the impact of a proposed rule on small entities, unless the Commission certifies that the rule, if adopted, would not have a significant economic impact on a substantial number of small entities. The application of the RFA to proposed Rule 15a-6 is limited, because its exemptive provisions would be restricted to foreign broker-dealers, which need not be considered under the RFA. In addition, to the extent that the proposed rule, if adopted, would impose any costs on U.S. registered broker-dealer affiliates of such foreign broker-dealers or on other domestic broker-dealers, those costs are not significant

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207 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).

and would not impact a substantial number of small domestic broker-dealers. Staff discussions with industry have indicated that small domestic broker-dealers generally are not engaged in Rule 15a-6(a)(3) arrangements with foreign broker-dealers, and have not indicated that this would change in the event the conditions of the rule were amended. Accordingly, the Commission certifies that the proposed rule, if adopted, would not have a significant economic impact on a substantial number of small entities.

VII. Statutory Basis

Pursuant to the Exchange Act and particularly sections 3, 10, 15, 17, 23, 30 and 36 thereof, 15 U.S.C. 78c, 78j, 78o, 78q, 78w, 78dd and 78mm, the Commission proposes to amend § 240.15a-6 of Title 17 of the Code of Federal Regulations in the manner set forth below.

VIII. Text of Proposed Amendments

Lists of Subjects

17 CFR Part 240

Broker-dealers, Reporting and recordkeeping requirements, Securities.

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

PART 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. By revising § 240.15a-6 to read as follows:

§ 240.15a-6 Exemption of certain foreign brokers or dealers.

(a) A foreign broker or dealer shall be exempt from the registration requirements of sections 15(a)(1) and 15B(a)(1) of the Act and the reporting and other requirements of the Act (other than sections 15(b)(4) and 15(b)(6)), and the rules and regulations thereunder, that apply specifically to a broker or dealer that is not registered with the Commission solely by virtue of its status as a broker or dealer, with respect to a particular transaction or solicitation, to the extent that the foreign broker or dealer operates in compliance with paragraph (a)(1), (a)(2), (a)(3), (a)(4) or (a)(5) of this section with respect to such transaction or solicitation.

(1) Unsolicited trades. The foreign broker or dealer effects transactions in securities with or for persons that have not been solicited by the foreign broker or dealer.

(2) Research reports. The foreign broker or dealer furnishes research reports to qualified investors, and effects transactions in the securities discussed in the research reports with or for those qualified investors, provided that the following conditions are satisfied:

(i) The research reports do not recommend the use of the foreign broker or dealer to effect trades in any security;

(ii) The foreign broker or dealer does not initiate contact with those qualified investors to follow up on the research reports, and does not otherwise induce or attempt to induce the purchase or sale of any security by those qualified investors;

(iii) If the foreign broker or dealer has a relationship with a registered broker or dealer that satisfies the requirements of paragraph (a)(3) of this section, any transactions with the foreign broker or dealer in securities discussed in the research reports are effected pursuant to the provisions of paragraph (a)(3) of this section; and

(iv) The foreign broker or dealer does not provide research to U.S. persons pursuant to any express or implied understanding that those U.S. persons will direct commission income to the foreign broker or dealer.

(3) Solicited trades. The foreign broker or dealer induces or attempts to induce the purchase or sale of any security by a qualified investor, provided that the following conditions are satisfied:

(i) The foreign broker or dealer:

(A) Provides the Commission (upon request or pursuant to agreements reached between any foreign securities authority and the Commission or the U.S. government) with any information or documents within the possession, custody, or control of the foreign broker or dealer, any testimony of foreign associated persons, and any assistance in taking the evidence of other persons, wherever located, that the Commission requests and that relates to transactions under paragraph (a)(3) of this section, except that if, after the foreign broker or dealer has exercised its best efforts to provide the information, documents, testimony, or assistance, including requesting the appropriate governmental body and, if legally necessary, its customers (with respect to customer information) to permit the foreign broker or dealer to provide the information, documents, testimony, or assistance to the Commission, the foreign broker or dealer is prohibited from providing this information, documents, testimony, or assistance by applicable foreign law or regulations, then this paragraph (a)(3)(i)(A) shall not apply and the foreign broker or dealer will be subject to paragraph (c) of this section;

(B) Determines that the foreign associated person of the foreign broker or dealer effecting transactions with the qualified investor is not subject to a statutory disqualification specified in section 3(a)(39) of the Act;

(C) Has in its files, and will make available upon request by a registered broker or dealer satisfying the requirements described in paragraph (a)(3)(iii) of this section or the Commission, the types of information specified in § 240.17a-3(a)(12), provided that the information required by paragraph (a)(12)(i)(D) of § 240.17a-3 shall include sanctions imposed by foreign securities authorities, foreign exchanges, or foreign associations, including without limitation those described in section 3(a)(39) of the Act; and

(D) Discloses to the qualified investor:

(1) That the foreign broker or dealer is regulated by a foreign securities authority and not by the Commission; and

(2) Solely when the foreign broker or dealer is relying on paragraph (a)(3)(iii)(A)(1) of this section, that U.S. segregation requirements, U.S. bankruptcy protections and protections under the Securities Investor Protection Act will not apply to any funds or securities held by the foreign broker or dealer;

(ii) The foreign associated person of the foreign broker or dealer effecting transactions with the qualified investor conducts all securities activities from outside the United States, except that the foreign associated person may conduct visits to qualified investors within the United States, provided that transactions in any securities discussed during visits by the foreign associated person with qualified investors are effected pursuant to paragraph (a)(3) of this section; and

(iii) A registered broker or dealer:

(A) Is responsible for either:

(1) Maintaining copies of all books and records, including confirmations and statements issued by the foreign broker or dealer to the qualified investor, relating to any resulting transactions, except that such books and records may be maintained:

(i) In the form, manner and for the periods prescribed by the foreign securities authority regulating the foreign broker or dealer; and

(ii) With the foreign broker or dealer, provided that the registered broker or dealer makes a reasonable determination that copies of any or all of such books and records can be furnished promptly to the Commission, and promptly provides to the Commission any such books and records, upon request; or

(2) (i) Maintaining books and records, including copies of all confirmations issued by the foreign broker or dealer to the qualified investor, relating to any resulting transactions; and

(ii) Receiving, delivering and safeguarding funds and securities in connection with the transactions on behalf of the qualified investor in compliance with § 240.15c3-3;

(B) Obtains from the foreign broker or dealer and each foreign associated person written consent to service of process for any civil action brought by or proceeding before the Commission or a self-regulatory organization (as defined in section 3(a)(26) of the Act), providing that process may be served on them by service on the registered broker or dealer in the manner set forth on the registered broker's or dealer's current Form BD (17 CFR 249.501);

(C) Obtains from the foreign broker or dealer a representation that the foreign broker or dealer has complied with the requirements of paragraphs (a)(3)(i)(B) and (C) of this section; and

(D) Maintains records of the written consents required by paragraph (a)(3)(iii)(B) and the representations required by paragraph (a)(3)(iii)(C) of this section, and makes these records available to the Commission upon request.

(4) Counterparties and specific customers. The foreign broker or dealer effects transactions in securities with or for, or induces or attempts to induce the purchase or sale of any security by:

(i) A registered broker or dealer, whether the registered broker or dealer is acting as principal for its own account or as agent for others, or a bank acting pursuant to an exception or exemption from the definition of "broker" or "dealer" in section 3(a)(4)(B), 3(a)(4)(E), or 3(a)(5)(C) of the Act or the rules thereunder;

(ii) The African Development Bank, the Asian Development Bank, the Inter-American Development Bank, the International Bank for Reconstruction and Development, the International Monetary Fund, the United Nations and their agencies, affiliates and pension funds;

(iii) A foreign person temporarily present in the United States, with whom the foreign broker or dealer had a bona fide, pre-existing relationship before the foreign person entered the United States;

(iv) Any agency or branch of a U.S. person permanently located outside the United States, provided that the transactions occur outside the United States;

(v) U.S. citizens resident outside the United States, provided that the transactions occur outside the United States, and that the foreign broker or dealer does not direct its selling efforts toward identifiable groups of U.S. citizens resident abroad; or

(vi) Any U.S. person, other than a registered broker or dealer or a bank acting pursuant to an exception or exemption from the definition of "broker" or "dealer" in section 3(a)(4)(B), 3(a)(4)(E), or 3(a)(5)(C) of the Act or the rules thereunder, that acts in a fiduciary capacity for an account of a foreign resident client, provided the foreign broker or dealer:

(A) Only effects transactions in securities with or for, or induces or attempts to induce the purchase or sale of securities by, the U.S. person in the U.S. person's capacity as a fiduciary to an account of a foreign resident client; and

(B) Obtains and maintains a representation from the U.S. person that the account is managed in a fiduciary capacity for a foreign resident client.

(5) Familiarization with foreign options exchanges. The foreign broker or dealer effects transactions in options on foreign securities listed on a foreign options exchange of which it is a member for a qualified investor that has not been solicited by the foreign broker or dealer, except that:

(i) A representative of the foreign options exchange located in a foreign office or a representative office in the United States may:

(A) Communicate with persons that the representative of the foreign options exchange reasonably believes are qualified investors, including through participation in programs and seminars in the United States, regarding the foreign options exchange, the options on foreign securities traded on the foreign options exchange and, if applicable, the foreign options exchange's OTC options processing service;

(B) Provide persons that the representative of the foreign options exchange reasonably believes are qualified investors with a disclosure document that provides an overview of the foreign options exchange and the options on foreign securities traded on that exchange, including the differences from standardized options in the U.S. options market and special factors relevant to transactions by U.S. persons in options on the foreign options exchange; and

(C) Make available to persons that the representative of the foreign options exchange reasonably believes are qualified investors, solely upon request of the investor, a list of participants on the foreign options exchange permitted to take orders from the public and any registered broker or dealer affiliates of such participants;

(ii) The foreign broker or dealer may:

(A) Make available to qualified investors the foreign options exchange's OTC options processing service; and

(B) Provide qualified investors, in response to an unsolicited inquiry concerning options on foreign securities traded on the foreign options exchange, with a disclosure document that provides an overview of the foreign options exchange and the options on foreign securities traded on that exchange, including the differences from standardized options in the U.S. domestic options market and special factors relevant to transactions by U.S. persons in options on that exchange; and

(iii) The foreign exchange may make available to qualified investors through the foreign broker or dealer the foreign options exchange's OTC options processing service.

(b) Definitions. When used in this section:

(1) The term foreign associated person shall mean any natural person domiciled outside the United States who is an associated person, as defined in section 3(a)(18) of the Act, of the foreign broker or dealer and who participates in the solicitation of a qualified investor under paragraph (a)(3) of this section.

(2) The term foreign broker or dealer shall mean any non-U.S. resident person (including any U.S. person engaged in business as a broker or dealer entirely outside the United States, except as otherwise permitted by this section) that is not an office or branch of, or a natural person associated with, a registered broker or dealer, whose securities activities, if conducted in

the United States, would be those of a "broker" or "dealer," as defined in section 3(a)(4) or 3(a)(5) of the Act, and that:

(i) Solely for purposes of paragraph (a)(3) of this section, is regulated for conducting securities activities, including the specific activities in which the foreign broker or dealer engages with the qualified investor, in a foreign country by a foreign securities authority; and

(ii) Solely for purposes of paragraphs (a)(3)(iii)(A)(1) and (a)(4)(vi) of this section, conducts a foreign business.

(3) The term foreign business shall mean the business of a foreign broker or dealer with qualified investors and foreign resident clients where at least 85% of the aggregate value of the securities purchased or sold in transactions conducted pursuant to both paragraphs (a)(3) and (a)(4)(vi) of this section by the foreign broker or dealer calculated on a rolling two-year basis is derived from transactions in foreign securities, except that the foreign broker or dealer may rely on the calculation made for the prior year for the first 60 days of a new year.

(4) The term foreign resident client shall mean:

(i) Any entity not organized or incorporated under the laws of the United States and not engaged in a trade or business in the United States for federal income tax purposes;

(ii) Any natural person not a U.S. resident for federal income tax purposes; and

(iii) Any entity not organized or incorporated under the laws of the United States 85 percent or more of whose outstanding voting securities are beneficially owned by persons in paragraphs (b)(4)(i) and (b)(4)(ii) of this section.

(5) The term foreign security shall mean:

(i) An equity security (as defined in 17 CFR 230.405) of a foreign private issuer (as defined in 17 CFR 230.405);

(ii) A debt security (as defined in 17 CFR 230.902) of a foreign private issuer (as defined in 17 CFR 230.405);

(iii) A debt security (as defined in 17 CFR 230.902) issued by an issuer organized or incorporated in the United States in connection with a distribution conducted solely outside the United States pursuant to Regulation S (17 CFR 230.903);

(iv) A security that is a note, bond, debenture or evidence of indebtedness issued or guaranteed by a foreign government (as defined in 17 CFR 230.405) that is eligible to be registered with the Commission under Schedule B of the Securities Act of 1933; and

(v) A derivative instrument on a security described in paragraph (b)(5)(i), (b)(5)(ii), (b)(5)(iii), or (b)(5)(iv) of this section.

(6) The term OTC options processing service shall mean a mechanism for submitting an options contract on a foreign security that has been negotiated and completed in an over-the-counter transaction to a foreign options exchange so that the foreign options exchange may replace that contract with an equivalent standardized options contract that is listed on the foreign options exchange and that has the same terms and conditions as the over-the-counter options.

(7) The term registered broker or dealer shall mean a person that is registered with the Commission under section 15(b), 15B(a)(2), or 15C(a)(2) of the Act.

(8) The term United States shall mean the United States of America, including the States and any territories and other areas subject to its jurisdiction.

(c) Withdrawal of exemption. The Commission, by order after notice and opportunity for hearing, may withdraw the exemption provided in paragraph (a)(3) of this section with respect to the subsequent activities of a foreign broker or dealer or class of foreign brokers or dealers conducted from a foreign country, if the Commission finds that the laws or regulations of that foreign country have prohibited the foreign broker or dealer, or one of a class of foreign brokers or dealers, from providing, in response to a request from the Commission, information or documents within its possession, custody, or control, testimony of foreign associated persons, or assistance in taking the evidence of other persons, wherever located, related to activities exempted by paragraph (a)(3) of this section.

By the Commission.

Florence E. Harmon

Florence E. Harmon
Acting Secretary

Dated: June 27, 2008

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 2750 / June 30, 2008

Admin. Proc. File No. 3-12084

In the Matter of

ROBERT RADANO

5501 Kirkwood Drive
Bethesda, Maryland 20816

OPINION OF THE COMMISSION

INVESTMENT ADVISER PROCEEDING

Ground for Remedial Action

Injunction

Managing director and sole owner of investment advisory firm was enjoined from committing future violations of the antifraud and investment adviser provisions of the Advisers Act. Held, it is in the public interest to bar respondent from association with any investment adviser subject to a right to reapply after five years.

APPEARANCES:

Robert Radano, pro se. 1/

Kathleen A. Ford and Rami Sibay, for the Division of Enforcement.

1/ Although Radano delivered the oral argument on his own behalf, he was accompanied by James Goldstein, of Goldstein & Hayes, P.C., who filed an appearance. Radano had been represented throughout most of this administrative proceeding by Russell G. Ryan, of King & Spalding LLP, who withdrew his representation on December 10, 2007.

Document 43 of 48

Appeal filed: April 14, 2006
Last brief received: July 3, 2006
Oral argument: May 5, 2008

I.

Robert Radano, the managing director and sole owner of Washington Investment Network ("WIN" or the "Firm"), an investment advisory firm registered as an investment adviser in the State of Connecticut, 2/ appeals from the decision of an administrative law judge. The law judge barred Radano from association with any investment adviser, based on a finding that Radano had been enjoined from future violations of antifraud provisions and a provision prohibiting investment advisers from associating with a barred individual, of the Investment Advisers Act of 1940. 3/ We base our findings on an independent review of the record, except with respect to those findings of the law judge not challenged on appeal.

II.

On July 31, 2002, the Commission filed a civil complaint against Radano and his co-defendants Steven M. Bolla, a former principal of WIN, Bolla's wife, Susan Bolla, and WIN in the United States District Court for the District of Columbia (the "Complaint"). 4/ The Complaint alleged, among other things, that Radano allowed Bolla to continue associating with WIN after Bolla had been barred, and that Radano failed to disclose Bolla's bar to any WIN clients. The Complaint charged WIN as a primary violator, and Radano with aiding and abetting WIN's alleged violations, of Sections 203(f), 206(1), and 206(2) of the Advisers Act. 5/ A bench

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2/ Radano is also registered as an investment adviser in the State of Connecticut.

3/ 15 U.S.C. § 80b-1 et seq.

4/ SEC v. Steven M. Bolla, Wash. Inv. Network, Susan Bolla, and Robert Radano, 401 F. Supp. 2d 43 (D.D.C. 2005). In connection with these proceedings, both Steven Bolla, who was charged with several violations of the securities laws, and Susan Bolla, who was charged with violations identical to those of Radano's, settled with the Commission prior to the trial. They consented to the entry by the district court of final judgments enjoining them from violations of the securities laws, and Steven Bolla agreed to pay a $175,000 fine. See SEC Settles Fraud Charges Against Steven and Susan Bolla, Litigation Rel. No. 18837 (Aug. 18, 2004), 83 SEC Docket 2052.

5/ 15 U.S.C. §§ 80b-3(f), 80b-6(1), and 80b-6(2). Advisers Act Section 203(f) makes it unlawful for any investment adviser to permit a barred person to become or remain an associated person without the Commission's consent, if the investment adviser "knew, or in the exercise of reasonable care, should have known, of such [bar] order." 15 U.S.C.
(continued...)

trial was held on July 26-28, 2004. On September 22, 2005, the district court found that WIN violated the Advisers Act provisions alleged and that Radano had aided and abetted WIN's violations. 6/ The district court also enjoined Radano from future violations of those provisions and fined Radano $15,000. 7/ Radano appealed the district court's decision to the United States Court of Appeals for the District of Columbia Circuit. 8/

On October 13, 2005, we authorized the institution of administrative proceedings against Radano to determine whether he had been enjoined and, if so, what remedial action would be appropriate in the public interest. On December 16, 2005, the Division of Enforcement (the "Division") moved for summary disposition pursuant to Rule 250 of the Commission's Rules of Practice. 9/ On March 24, 2006, the law judge granted the Division's motion for summary disposition, finding that "Radano [did] not contend there [was] any genuine issue in regard to any material fact in this proceeding." 10/ The law judge barred Radano from association with any investment adviser. This appeal followed.

On February 6, 2007, the United States Court of Appeals for the District of Columbia Circuit affirmed the district court's injunctive decision against Radano, finding that WIN violated Advisers Act Sections 203(f), 206(1), and 206(2) and that Radano aided and abetted

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5/ (...continued)
§ 80b-3(f). Advisers Act Section 206(1) makes it unlawful "to employ any device, scheme, or artifice to defraud any client or prospective client." 15 U.S.C. § 80b-6(1). Advisers Act Section 206(2) makes it unlawful "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." 15 U.S.C. § 80b-6(2).

6/ SEC v. Bolla, 401 F. Supp. 2d 43.

7/ Id. at 74. In the same case, the district court enjoined WIN from future violations of the same provisions of the Advisers Act and fined the Firm $50,000. WIN is not a party to this proceeding. On May 6, 2008, the district court vacated the $15,000 civil money penalty that it had imposed on Radano. See infra note 17.

8/ Radano's appeal was filed on November 14, 2005. See SEC v. Wash. Inv. Network and Robert Radano, No. 05-5433 (D.C. Cir.).

9/ 17 C.F.R. § 201.250. A motion for summary disposition may be granted "if there is no genuine issue with regard to any material fact and the party making the motion is entitled to summary disposition as a matter of law." 17 C.F.R. § 201.250(b).

10/ Robert Radano, Initial Dec. Rel. No. 310 (Mar. 24, 2006), 87 SEC Docket 2304.

these violations. 11/ The appeals court also affirmed the district court's imposition of penalties on WIN and Radano and "uph[e]ld the injunction," although the appeals court found that the language of the injunction was "insufficiently specific" and "fail[ed] to clarify 'the act or acts sought to be restrained,'" and thus did not satisfy Federal Rule of Civil Procedure 65(d). 12/ The appeals court was concerned that the injunction was "overly broad" in that "it might subject defendants to contempt for activities having no resemblance to the activities that led to the injunction." 13/ The appeals court therefore remanded the case to the district court "to amend the injunction to describe more specifically the act or acts sought to be restrained." 14/

On October 29, 2007, the district court issued an amended injunctive order pursuant to the appeals court's remand instructions. 15/ As relevant here, the district court ordered that WIN and Radano:

> [A]re permanently restrained and enjoined from violating Section 203(f) of the [Advisers Act] by willfully becoming, or being, associated with an investment adviser without the consent of the [Commission] if the [Commission] has issued an order against them suspending them or barring them from being associated with an investment adviser, or by permitting a person who was the subject of [a Commission] order barring or suspending him or her from associating with an investment adviser to become, or remain, a person associated with an investment adviser without the consent of the [Commission] if either WIN or Radano knew, or in the exercise of reasonable care, should have known, of such order. 16/

The district court also ordered that WIN and Radano:

> [A]re permanently restrained and enjoined from violating Sections 206(1) and 206(2) of the [Advisers Act] by the use of any means or instruments of interstate

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11/ SEC v. Wash. Inv. Network, 475 F.3d 392 (D.C. Cir. 2007).

12/ Id. at 407. As relevant here, Federal Rule of Civil Procedure 65(d) requires an injunctive order to "be specific in terms" and "describe in reasonable detail . . . the act or acts sought to be restrained . . . ." The district court order enjoined defendants from "future violations of Sections 203(f), 206(1), and 206(2) of the Advisers Act[.]"

13/ Id.

14/ Id.

15/ SEC v. Steven M. Bolla, Wash. Inv. Network, Susan Bolla, and Robert Radano, 519 F. Supp. 2d 76 (D.D.C. 2007) (amended injunctive order).

16/ Id. at 77.

> commerce or by the use of the mails, directly or indirectly: (a) employing any device, scheme, or artifice to defraud any client or prospective client; or (b) engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. 17/

III.

The district court found that Radano and Bolla established WIN in 1997 in anticipation of Commission disciplinary proceedings being brought against Bolla. WIN and Radano, the district court found, were investment advisers. Radano stated in his brief that, "through their contacts with various accountants, [he and WIN] located affluent individuals with significant assets and referred them to a 'wrap fee' program sponsored by Lockwood Financial Services, Inc., an SEC-registered broker-dealer and affiliated investment adviser with more than $6 billion in client assets under management." According to the district court, "[o]nce the WIN client was set up with Lockwood, Mr. Radano and Mr. Bolla's . . . primary duty was to monitor the account relationship, to look over the shoulder of the managers on an individual account basis . . . and [ensure] that the account was consistent with . . . the parameters outlined by the client." 18/ Radano stated in his brief that "[i]n exchange for WIN's referral of clients to Lockwood and sporadic account monitoring and follow-up contact with the clients, Lockwood paid WIN a quarterly consulting fee from each client's account for so long as that client stayed with Lockwood."

At the time of WIN's formation, Commission staff was investigating Bolla's conduct with respect to another, unrelated investment advisory firm, and Radano and Bolla feared that those proceedings could lead to Bolla's being barred. The district court found that, consequently, although Bolla and Radano were "held out as the face of WIN," 19/ Radano and Susan Bolla

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17/ Id. at 78. Radano does not challenge the amended injunctive order. However, on November 13, 2007, Radano moved to set aside that portion of the district court's final judgment imposing a $15,000 monetary penalty against him. On May 6, 2008, the district court vacated that portion of its order imposing the monetary penalty against Radano, holding that the "Advisers Act does not authorize the [Commission] to seek, or grant this Court jurisdiction to impose, monetary penalties upon Defendant Radano for his aiding and abetting violations of that Act." SEC v. Bolla, 2008 U.S. Dist. LEXIS 36401 (May 6, 2008). The district court also stated that the "remainder of the Court's October 29, 2007 Order shall remain in effect." Id. The district court's ruling on Radano's monetary penalty does not affect our consideration of Radano's administrative appeal.

18/ Bolla, 401 F. Supp. 2d at 60.

19/ Id. at 49.

were presented as the owners of the Firm, with Susan Bolla as a "nominal" owner. 20/ Despite her ownership interest, Susan Bolla, who had no securities industry experience, had no substantive role at the Firm and, "[a]t most," performed certain clerical functions such as answering the telephone and filing. 21/ The district court found that WIN's ownership structure was designed "as a front for Mr. Bolla to continue to operate with his wife as a mere nominee to officially mask his true interest and control." 22/

The district court found that Bolla had referred a substantial amount of his clients' assets to Lockwood and that these referrals generated significant advisory fees. At the time that WIN was formed, Radano had no investment advisory clients but hoped to develop a client base through a relationship with Lockwood. WIN was to serve as a "mere pass-through [entity] for the payment" of advisory fees earned by Bolla and Radano. 23/ Bolla was responsible for WIN's finances; he deposited advisory fees that were received into a WIN checking account he had opened and made payments to himself, Radano, and others, on WIN's behalf, out of this account. Bolla also apparently was responsible for WIN's relationship with Lockwood. Bolla and Radano worked in different locations and had only sporadic contact with each other. By the summer of 2000, the district court found, Radano had a "handful of clients," who generated approximately $10,000 per year in advisory fees from Lockwood. 24/ Bolla, who had referred $30-$40 million in client assets to Lockwood, generated approximately $150,000 per year in such fees.

By early 2000, Radano was aware that Bolla's bar was imminent in that Bolla was negotiating a settlement in connection with the Division's investigation of Bolla. In June 2000, Bolla settled with the Commission by agreeing to be barred from associating with any investment adviser. 25/ Despite entry of the bar, the district court found, Bolla continued to remain associated with WIN until March 2001, and he did so with Radano's awareness and acquiescence. During this time, Bolla, among other things, continued to handle the Firm's

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20/ Id. at 64.

21/ Id. at 49.

22/ Id. at 63.

23/ Id. at 49.

24/ Id. at 50.

25/ See James L. Foster, Laurie F. Foster, Steven M. Bolla, and William E. Busacker, Jr., Investment Advisers Act Rel. No. 1881 (June 20, 2000), 72 SEC Docket 2163 (settled order barring Bolla from association with any investment adviser, with right to reapply after five years from date of entry of order).

finances and received more than $79,000 in advisory fees. He also continued to advise and serve as a "point of contact" for WIN clients. 26/

Radano learned of the bar a day or two after it had been entered when Lockwood's clearing agent notified him that, as a result of the bar, Bolla could no longer be listed as the investment adviser for the WIN/Lockwood clients whose accounts were held in custody by the clearing agent. Although the district court found that Radano took certain action in response to the bar, such as attempting to obtain WIN's checkbook from Bolla, it concluded that those steps were inadequate to avoid liability. The district court specifically rejected Radano's claim of good faith based on the efforts he made to notify Lockwood of Bolla's bar and to get that firm to stop paying Bolla advisory fees. According to the district court, Radano contacted Lockwood "because it was in his economic interest to separate Mr. Bolla from Lockwood as soon as possible."

Significantly, the district court noted, Radano "took no steps to inform the [Commission] or any other agency of the possible violations" but, instead, allowed Bolla to continue his financial control of the Firm and "gladly accepted certain client referrals" from Bolla. 27/ The district court found that "[r]ather than taking his clients with him and dissolving WIN, Mr. Radano maintained a business association with Mr. Bolla through WIN in the hopes of obtaining some of his valuable book of clients." 28/ The district court concluded that, "[d]espite his intelligence and experience in the securities industry, Mr. Radano chose the lure of continued business with Lockwood and potential profit from Mr. Bolla's book of clients over his obligations under [Advisers Act] Section 203(f)." 29/

The district court found further that Radano aided and abetted the Firm's violations of the antifraud provisions of the Advisers Act by misleading WIN clients and prospective clients about Bolla's disciplinary record and registration status. The district court found that Radano and WIN owed a "fiduciary" duty to their clients – which gave rise to a duty of disclosure – based on the fact that the clients trusted WIN "to connect them with effective money managers and to keep an eye on their accounts once they were forwarded to Lockwood." 30/ Alternatively, the district court found that a duty of disclosure was created once "Radano began discussing the whereabouts of Mr. Bolla with WIN clients and prospective clients," which required him to

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26/ Bolla, 401 F. Supp. 2d at 54.

27/ Id. at 65.

28/ Id.

29/ Id.

30/ Id. at 69.

disclose Bolla's disciplinary record. 31/ The district court found that Radano was "reticent and reserved" about revealing Bolla's bar to the Firm's clients because he wanted them to maintain their relationship with WIN by transferring their accounts from Bolla to him. 32/

The district court found that Radano, in failing to tell clients about Bolla, provided an "inaccurate, skewed version of WIN as an investment entity." 33/ Although the district court noted that Radano told clients that Bolla was no longer affiliated with the Firm, it considered such disclosure inadequate because there is a "substantial difference between telling an investor that a principal had 'left the firm' and notifying [him] that the principal 'has been barred.'" 34/ As the district court noted, when "[c]onfronted with the fact that his/her investment adviser had been barred, the reasonable investor would likely question the firm, wondering whether the other investment advisers could also be trusted to fulfill their ethical obligations." 35/

Although the district court found that Radano misled at least a dozen WIN clients or prospective clients, it focused on his actions with respect to two of Bolla's WIN clients who testified at the trial. The district court ruled that Radano "made material misstatements or omissions of a material fact on behalf of WIN to actual WIN clients and prospective clients [for whom] he personally was seeking to be named investment adviser" when he failed to disclose Bolla's disciplinary history to them. 36/ For example, when one of those clients, who had been a client of Bolla's at WIN, contacted Radano four months after Bolla had been barred, the client testified that Radano did not disclose Bolla's disciplinary history to her, but instead informed her that Bolla was out of the office and had moved on. Similarly, another former client of Bolla's at WIN testified that Radano failed to disclose Bolla's disciplinary history to her when she contacted Radano more than nine months after Bolla's bar. Instead, Radano informed her that Bolla was going to pursue the insurance side of the business, which she understood to mean that Bolla was still working at the Firm.

Finding that Radano "opted to pursue the potential financial gain resulting from easy transfers of accounts over the hard acknowledgment that his business partner had been barred," the district court concluded that Radano breached his duty of disclosure and, thereby, aided and

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31/ Id. at 70.

32/ Id. at 73.

33/ Id. at 71.

34/ Id. at 72.

35/ Id.

36/ Id. at 68.

abetted WIN's violations of Advisers Act Sections 206(1) and (2). 37/ In doing so, the district court found that Radano acted with intent, and therefore satisfied the requisite scienter standard, in that his "hopes of retaining those clients that Mr. Bolla had introduced to WIN trumped his good judgment and his fiduciary duty to them." 38/

The district court found that an injunction was warranted because there was "compelling evidence" of a reasonable likelihood that Radano would commit future violations. 39/ In particular, the district court found that Radano's violations were "flagrant, deliberate, and part of a pattern." 40/ Finding "troubling" Radano's efforts "to shift blame, hide behind corporate structures, and minimize the vital, material information at issue," the district court concluded that an injunction was necessary because of Radano's willful conduct and his continuing refusal to acknowledge his fiduciary duties. 41/

In affirming the district court decision, the appeals court found, among other things, that WIN was an investment adviser because it "had an obligation to advise new clients regarding various investment options and a continuing obligation to monitor each client's investment account." 42/ As an investment adviser, the Firm had a "fiduciary duty" 43/ to disclose to its clients that Bolla, "the principal figure directing WIN's activities," 44/ had been barred. The appeals court agreed with the district court that "Radano, driven by self-interest, intentionally breached his fiduciary obligations and those of WIN" in violation of the antifraud provisions. 45/ The appeals court further found that Bolla continued to manage the Firm's finances after he had been barred and that Radano was "complicit in the arrangement . . . even going so far as to make a fee payment to Bolla on behalf of WIN." 46/

37/ Id. at 72.

38/ Id. at 73.

39/ Id. at 74.

40/ Id.

41/ Id.

42/ Wash. Inv. Network, 475 F.3d at 399.

43/ Id. at 405.

44/ Id. at 396.

45/ Id. at 406.

46/ Id. at 402.

IV.

Under Sections 203(e) and (f) of the Advisers Act, consistent with the public interest, we may impose remedial sanctions against a person associated with an investment adviser if, among other things, the associated person has been enjoined from engaging in or continuing any conduct or practice in connection with any activity of an investment adviser. 47/

We find that Radano was enjoined for conduct or practices related to the activity of an investment adviser. We also find that WIN was an investment adviser, and Radano a person associated with an investment adviser, within the meaning of the Advisers Act. As relevant here, Advisers Act Section 202(a)(11) defines an investment adviser as "any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities . . . ." 48/ WIN received compensation for offering its clients investment advice in connection with the clients' participation in certain wrap fee programs. As the appeals court found, all of this evidence left "no doubt WIN had an ongoing obligation to give investment advice and did not merely act as a referral service." 49/ We conclude, as did the appeals court, that, "[b]ecause WIN's business entailed advising clients in choosing among different investment managers who had distinct investment styles, and because it also advised clients in regard to 'asset allocation,' WIN's activities easily [fell] within the [Advisers] Act's definition of investment adviser." 50/

In addition, Advisers Act Section 202(a)(17) defines a "person associated with an investment adviser" as "any partner, officer, or director of such investment adviser (or any person performing similar functions), or any person directly or indirectly controlling or controlled by such investment adviser, including any employee of such investment adviser . . . ." 51/ As WIN's managing director and owner, and based on his role in advising WIN clients, Radano falls within the statutory definition of a person associated with an investment adviser. 52/ Based on

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47/ 15 U.S.C. §§ 80b-3(e)(4) and 80b-3(f).

48/ 15 U.S.C. § 80b-2(a)(11). Advisers Act Section 202(a)(16) defines "person" as "a natural person or a company." 15 U.S.C. § 80b-2(a)(16).

49/ Wash. Inv. Network, 475 F.3d at 400.

50/ Id.

51/ 15 U.S.C. § 80b-2(a)(17).

52/ Although Radano does not claim before us that he was not associated with an investment adviser, he argued before the district court that neither he nor WIN was an investment adviser within the meaning of the statute. Instead, he described himself and WIN as (continued...)

our finding that Radano was enjoined and that he was associated with an investment adviser, we are authorized to impose remedial sanctions if we believe they are warranted by the public interest. In doing so, we look to the district court's findings, as affirmed by the appeals court.

Radano concedes that he was enjoined based on findings of violation and that he cannot challenge those findings in this proceeding. 53/ Radano also does not dispute that Bolla remained associated with the Firm after he was barred. Rather, Radano challenges the bar imposed by the law judge as "unwarranted and excessive," arguing that "his conduct bore no resemblance to the kinds of egregious frauds that typically result in the career death of a lifetime bar." He further asserts that "there were numerous mitigating facts that the [law judge] either overlooked or erroneously disregarded as insignificant."

In determining the need for remedial sanctions under Advisers Act Section 203(f), we consider the factors identified in Steadman v. SEC. 54/ These factors include the egregiousness of a respondent's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the likelihood that the respondent's occupation will present opportunities for future violations. Based on our consideration of those factors, and under all the circumstances of this case, we have determined that the public interest requires that Radano be barred subject to a right to reapply after five years.

Radano's violations were egregious and demonstrated a high degree of scienter. Radano neglected his "obligations under [Advisers Act] Section 203(f)" apparently in favor of the

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52/ (...continued)
"consultants" to Lockwood. In rejecting that characterization, the district court observed that it has long been held that "persons who manage . . . the funds of others for compensation are 'investment advisers' within the meaning of the statute," Bolla, 401 F. Supp. 2d at 59 (quoting Abrahamson v. Fleschner, 568 F.2d 862, 870 (2d Cir. 1977)) (internal quotations omitted), and concluded that "the record is replete with indicia that WIN and Mr. Radano fall within the definition of 'investment adviser' and were bound in their dealings by the parameters of the Advisers Act." Id. at 59-60.

53/ Although Radano generally does not challenge the court's findings, he takes issue with the Division's contention that he "fabricated" a document to establish that, soon after entry of Bolla's bar, Radano had severed Susan Bolla's ownership interest in WIN. At oral argument, Radano again forcefully denied fabricating the document in question. We note that our sanctioning analysis herein is not dependent in any way on whether or not Radano fabricated the document.

54/ 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981).

"potential profit from Mr. Bolla's book of clients." 55/ To that end, Radano permitted Bolla to continue his association with WIN for nine months after the entry of the bar against Bolla. 56/ During that time, Radano allowed Bolla to continue managing WIN's finances, to continue receiving checks from Lockwood, and to continue depositing those checks into Bolla's WIN checking account. The appeals court noted that, while "Radano's failure in this regard might be dismissed as mere managerial incompetence," his conduct "rose to the level of a violation of [Advisers Act S]ection 203(f) once the bar order took effect and Radano still took no steps on behalf of WIN to prevent Bolla's continuing control over WIN and its finances." 57/

The district court found that Radano also accepted client referrals from Bolla and maintained his business association with Bolla through WIN "in the hopes of obtaining some of [Bolla's] valuable book of clients." 58/ Radano, however, failed to disclose Bolla's disciplinary history to WIN clients and to Radano's prospective clients. The appeals court noted that the district court "found Radano, driven by self-interest, intentionally breached his fiduciary obligations and those of WIN, 'well aware that he could potentially increase his salary fifteen-fold' by taking over Bolla's accounts." 59/ Indeed, Radano misled over a dozen of these clients by concealing from them the fact that Bolla had been barred. 60/ Noting that the district court found that WIN had acted with scienter "based solely on Radano's motives as WIN's managing director," the appeals court stated that "[i]n a situation like that presented here, where a small firm, acting solely through the agency of a single individual, has intentionally deceived, manipulated, or defrauded its clients, the conclusion is unavoidable that the individual in question has knowledge of the firm's wrongdoing." 61/

55/ 401 F. Supp. 2d at 65.

56/ The appeals court construed Advisers Act Section 203(f) to prohibit "investment advisers from standing aside passively while a barred individual takes control of the firm . . . ." Wash. Inv. Network, 475 F.3d at 401-02.

57/ Id. at 402.

58/ 401 F. Supp. 2d at 65.

59/ Wash. Inv. Network, 475 F.3d at 406.

60/ Radano asserted at oral argument that the "vast majority" of WIN clients were informed of Bolla's bar, except for the two clients who testified at the trial. The record does not support this assertion.

61/ Id. at 402.

We have stated previously that an "investment adviser is a fiduciary in whom clients must be able to put their trust." 62/ The district court found that Radano, as an investment adviser, had a fiduciary relationship with WIN's clients, and that these clients trusted Radano to advise them regarding the assets they had invested through WIN. Radano betrayed that trust when he withheld material information in his conversations with WIN clients and was not forthcoming about Bolla's bar, thus leaving them with an inaccurate and skewed impression of the Firm. We note that the appeals court stated that "WIN's evasiveness in these conversations constituted fraudulent behavior in violation of [Advisers Act S]ection 206." 63/ We also recognize that an investment adviser has an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts," as well as an affirmative obligation "to employ reasonable care to avoid misleading" his clients. 64/ This Radano did not do. Nor was Bolla "an incidental player in WIN's business." 65/ According to the appeals court, "[w]hen such a critical player in an investment advisory firm is barred from the business on account of misconduct, the firm has a fiduciary duty to disclose that fact to its clients, and in particular to clients who previously dealt exclusively with that individual." 66/

Radano asserts that "no investor suffered any harm as a result of anything [he] did or failed to do." He further asserts, in this connection, that the "wrap fee sponsor to which [he] referred investors was a solid and reputable one that achieved exceptional good results for those referred to it." The quality of the investment advice received by WIN clients, however, is not the issue in this case. Rather, the issue is whether those clients were notified about Bolla's bar so that they could make an informed decision about whether to continue their relationship with the

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62/ Ahmed Mohamed Soliman, 52 S.E.C. 227, 231 (1995). Cf. Hammon Capital Mgmt. Corp., 48 S.E.C. 264 (1985) (revoking investment adviser's registration and barring its president from association with any investment adviser where the firm failed to disclose a change in its business address and failed to file required annual reports for three years).

63/ Wash. Inv. Network, 475 F.3d at 404.

64/ SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963) (internal citations omitted). See also Michael Batterman, 57 S.E.C. 1031, 1043 (2004) (noting investment adviser's "affirmative duty" to disclose material facts and "affirmative obligation" to exercise reasonable care to avoid misleading clients), aff'd, No. 05-0404 (2d Cir. 2005) (unpublished).

65/ Wash. Inv. Network, 475 F.3d at 405.

66/ Id.

Firm, notwithstanding the bar. 67/ Radano's failure to provide that notification prevented clients from making such an informed decision. 68/ The appeals court noted that "Radano did not take formal steps on behalf of WIN to inform WIN's clients of the bar order, along with an explanation of how the bar order might affect their interests and a neutral discussion of the options these clients might have." 69/ Instead, the appeals court observed, Radano "resorted to dodgy statements that obscured the truth." 70/ Thus, when Radano was faced with the choice between complying with regulatory requirements and expanding his client base, he chose the latter. Radano did not fulfill his duty to inform WIN clients of Bolla's bar because of the risk that such disclosure could harm Radano's business interests. Radano's determination to place his own interest squarely ahead of those of his and the Firm's clients evidences a troubling lack of integrity that is inconsistent with the high standards to which investment advisers, and the persons associated with them, are subject. Although Radano's clients did not lose money as a result of his fraudulent conduct, that conduct was motivated, as the district court held, by a desire to retain or gain clients, and thereby generate for himself additional client referral fees. As such,

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67/ Radano cites further, as a mitigating factor, that Bolla's bar was public information, readily available on the Commission's website and in other unspecified public sources. We do not consider this very compelling, for WIN clients had no reason to check such sources for information about Bolla or other Firm personnel. Rather, they were entitled to rely on WIN and Radano to bring such information to their attention. The availability of the information is not at issue here. It was Radano's responsibility to disclose the information, not the clients' burden to discover it. As the appeals court stated, the "existence of the bar order may have been public information, but it was not information that was so widely disseminated that an average small investor could be expected to be aware of it." Wash. Inv. Network, 475 F.3d at 405.

68/ Radano attempts to minimize the severity of his misconduct by claiming that only two WIN clients were alleged to have been misled, and that those clients were not his but Bolla's clients. Although it discussed in detail Radano's communications with two WIN clients, the district court found expressly that Radano failed to disclose Bolla's bar to the approximately one dozen WIN clients that Bolla referred to him and to whom Radano spoke directly. The district court also held that Radano's motivation in doing so was to maintain existing, or establish new, client relationships. The district court found that Radano's "affirmative representations to certain clients triggered" a "duty to inform his clients or prospective clients of Mr. Bolla's bar in a truthful and accurate manner." 401 F. Supp. 2d at 70.

69/ Wash. Inv. Network, 475 F.3d at 402.

70/ Id. at 403.

Radano's behavior constituted a fundamental breach of the high standards to which, as a securities professional associated with an investment adviser, he was subject. 71/

Nor are we moved by Radano's claim that when, after a three-year investigation, Bolla's bar was entered, Radano acted without prompting to sever WIN's ties to Bolla. In our view, Bolla's bar order, of which Radano was informed by Lockwood's clearing agent shortly after it was entered, should have been sufficient prompting for Radano to sever WIN's ties to Bolla or, failing that, for Radano to act to disassociate himself and his clients from an illegal arrangement. Yet, for another nine months, Radano chose to continue Bolla's association apparently in the hopes of gaining Bolla's clients, and the fees they generated, for himself. The appeals court observed that, "[b]ecause Bolla had, prior to the bar order, held himself out as one of WIN's managing directors, WIN needed to take immediate steps to terminate its relationship with Bolla. Radano's actions as the managing director of WIN make clear WIN did not." 72/ Instead, "Radano was complicit in the arrangement, treating it as part of a necessary transition . . . ." 73/ We note in this connection that, to the extent Radano sought to end Bolla's relationship with Lockwood after entry of the bar, he apparently acted because it was in his economic interest to do so, in the belief that Lockwood would redirect the fees generated by Bolla's clients to Radano instead.

Radano acted with scienter over an extended period and with a troubling lack of respect for regulatory requirements. Radano's failure to sever his and the Firm's ties to Bolla and his failure to disclose Bolla's disciplinary status to WIN clients constitute serious misconduct. By permitting Bolla's continued ties to the Firm, Radano undermined our efforts to protect the public by excluding Bolla from the investment advisory industry. Such behavior, which has the potential to weaken significantly the effectiveness of the Commission's enforcement program, cannot be tolerated. 74/

71/ See Marc N. Geman, 54 S.E.C. 1226, 1261 (2001) (finding that chief executive officer of investment adviser aided and abetted the firm's fraud against wrap account customers by failing to disclose information about the firm's trading practices and, thereby, impermissibly furthered the firm's own "best interests at the expense of its customers"), aff'd, 334 F.3d 1183 (10th Cir. 2003).

72/ Wash. Inv. Network, 475 F.3d at 402.

73/ Id.

74/ Radano asserts that the Division took no enforcement action against other, large institutional investment advisers, such as Lockwood, that continued to associate with Bolla after entry of the bar. Radano repeated this assertion at oral argument, referring to himself as a "consultant" rather than an investment adviser and stating that the "small consultant takes the entire pounding." See supra note 52. As discussed, Radano's and (continued...)

Radano maintains that, as a result of the Commission's investigation and injunctive proceeding, and the resulting legal fees, he has already been "severely punished and deterred." 75/ Radano asserts further that this was his "first disciplinary infraction," that it occurred over a "relatively short period" approximately seven years ago, and that it arose from relationships that have long since terminated, and thus are unlikely to occur again. 76/

74/ (...continued)
WIN's status as investment advisers was determined in the injunctive proceeding and is not now before us. To the extent that Radano is arguing here that he was subject to selective prosecution, we note that, to prevail on such a claim, Radano must establish that he was singled out for enforcement action while others similarly situated were not, and that his prosecution was motivated by arbitrary or unjust considerations such as his race, religion, or the desire to prevent his exercise of a constitutionally protected right. See, e.g., United States v. Huff, 959 F.2d 731, 735 (8th Cir. 1992); Eagletech Commc'ns, Inc., Exchange Act Rel. No. 54095 (July 5, 2006), 88 SEC Docket 1225, 1231. Radano has failed to allege or prove any of these elements, and we find that Radano was not the victim of improper selective prosecution. Moreover, while the record before us does not permit a determination of why proceedings were brought against some but not others involved in this case, such determinations are within the "discretion of the prosecutor." As we have stated previously, "[a] refusal to prosecute is a 'classic illustration of a decision committed to agency discretion' and agency decisions about the best use of staff time are a matter for prosecutorial judgment." Dolphin and Bradbury, Inc., Exchange Act Rel. No. 54143 (July 13, 2006), 88 SEC Docket 1298, 1318 (citations omitted), aff'd, 512 F.3d 634 (D.C. Cir. 2008).

75/ We note that the injunctive and administrative remedies serve different purposes, one to restrain further violative activity, and the other to determine whether it would be in the public interest to restrict a respondent's activities in the securities industry. See A.J. White & Co., 45 S.E.C. 459, 463 (1974).

76/ Radano, citing largely settled cases, argues that all relevant precedent precludes the sanction of a lifetime bar in this proceeding. Those cases generally are inapposite because their facts are distinguishable from those of this case. For example, Radano cites to Groh Asset Mgmt., Inc., Advisers Act Rel. No. 2308 (Sept. 30, 2004), 83 SEC Docket 3285, 3289, a settled case in which an investment adviser and its president, without admitting or denying the Commission's findings, consented to a censure and the imposition of a $45,000 fine, and agreed to cease and desist from committing future violations of the Advisers Act, where respondents disseminated to potential clients false and misleading advertising that overstated the firm's assets. We note that fraud violations typically warrant the most severe sanctions. See, e.g., Marshall E. Melton, 56 S.E.C. 695, 713 (2003) (asserting that "ordinarily, and in the absence of evidence to the contrary, it will be in the public interest" to, among other things, "bar from participation in the
(continued...)

We have considered all of these factors, as well as certain other circumstances, including that the record did not "identify any actual losses to investors resulting from" Radano's misconduct and that the income he derived from WIN was "relatively small." 77/ Although we agree with the law judge that a bar is amply justified in this instance, given Radano's "otherwise unblemished career in the securities industry," 78/ and based on our consideration of the entire record, we have determined to couple that bar with a right to reapply after five years. In our view, a bar subject to a right to reapply after five years should "impress upon [Radano] the seriousness of his" misconduct and "reduce the likelihood of any recurrence." 79/ Moreover, requiring Radano's removal from the industry for a substantial period of time will protect investors and "help to ensure his compliance with" the applicable Advisers Act provisions in the event he is subsequently permitted to return to the industry. 80/ We believe that such a bar will serve to protect the public by, among other things, authorizing the Commission staff "to monitor

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76/ (...continued)
securities industry . . . a respondent who is enjoined from violating the antifraud provisions" of the federal securities laws); Geman, 54 S.E.C. at 1228 (barring chief executive of investment adviser that defrauded wrap account clients). Nonetheless, it is well established that the determination of the appropriate sanction depends on the facts and circumstances of each case and is not dependent on the sanctions imposed in other cases, even if those other cases present similar facts. See Butz v. Glover Livestock Comm'n Co., 411 U.S. 182, 187 (1973); Batterman, 57 SEC at 1042.

77/ The Rockies Fund, Inc., Exchange Act Rel. No. 54892 (Dec. 7, 2006), 89 SEC Docket 1517, 1529, appeal filed, No. 07-1438 (D.C. Cir. Oct. 29, 2007).

78/ Martin B. Sloate, 52 S.E.C. 1233, 1236 (1997).

79/ Steven E. Muth, Securities Act Rel. No. 8622 (Oct. 3, 2005), 86 SEC Docket 1217, 1250.

80/ Leslie A. Arouh, 57 S.E.C. 1099, 1121 (2004) (imposing bar subject to a right to reapply after two years based on finding that respondent engaged in a fraudulent scheme). See also Abraham & Sons Capital, Inc., 55 S.E.C. 252 (2001) (barring, with a right to reapply after five years, president of investment adviser who, among other things, defrauded clients).

and require conditions under which" any association by Radano with an investment adviser will be permitted in the future. 81/

An appropriate order will issue. 82/

By the Commission (Chairman COX and Commissioners ATKINS and CASEY).

Florence E. Harmon
Acting Secretary

81/ Muth, 86 SEC Docket at 1250.

82/ We have considered all of the contentions advanced by the parties. We have rejected or sustained these contentions to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 2750 / June 30, 2008

Admin. Proc. File No. 3-12084

In the Matter of

ROBERT RADANO

5501 Kirkwood Drive
Bethesda, Maryland 20816

ORDER IMPOSING REMEDIAL SANCTIONS

On the basis of the Commission's opinion issued this day, it is

ORDERED that Robert Radano, be, and he hereby is, barred from association with any investment adviser subject to a right to reapply after five years.

By the Commission.

Florence E. Harmon

Florence E. Harmon
Acting Secretary

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

INVESTMENT COMPANY ACT OF 1940
Rel. No. 28323 / June 30, 2008

Admin. Proc. File No. 3-12429

In the Matter of

SCOTT G. MONSON

OPINION OF THE COMMISSION

CEASE-AND-DESIST PROCEEDING

Grounds for Remedial Action

Causing Violations of Forward Pricing Rule

General Counsel of registered broker-dealer charged with causing broker-dealer's violations of Investment Company Act Rule 22c-1. Held, proceeding is dismissed.

APPEARANCES:

Eric Lee Dobberteen, of Clark & Trevithick, P.C., and Shane W. Tseng, of Arnold & Porter LLP, for Scott G. Monson.

Gregory C. Glynn and Karen Matteson, for the Division of Enforcement.

Appeal filed: July 3, 2007
Last brief received: September 28, 2007

I.

The Division of Enforcement ("Division") appeals from the decision of an administrative law judge dismissing cease-and-desist proceedings against Scott G. Monson, the former general counsel of broker-dealer JB Oxford & Company ("JBOC" or the "Firm") and its publicly-traded

Document 44 of 48

parent company, JB Oxford Holdings, Inc. 1/ The order instituting these proceedings ("OIP") alleged that JBOC facilitated thousands of late trades in over 600 mutual funds for several institutional clients from June 2002 through September 2003, in violation of Rule 22c-1 of the Investment Company Act of 1940, which requires funds, their principal underwriters, dealers, and others authorized by the funds' prospectuses to consummate transactions in the funds to sell and redeem fund shares at a price based on the current net asset value ("NAV") next computed after receipt of an order to buy or redeem. 2/ The OIP alleged that Monson was a cause of these violations because of his role in drafting a "Mutual Fund Procedural Agreement" (the "Agreement"). The Agreement permitted the client to "confirm and activate" mutual fund trades after 4:00 p.m. Eastern time. As alleged in the OIP, JBOC used the Agreement to establish trading relationships with several new clients who engaged in late trading. The OIP alleged that Monson was a cause of JBOC's violations because he knew or should have known that his work on the Agreement would contribute to those violations.

As the case has come to us on appeal, the Division contends that Monson caused JBOC's violations because he negligently departed from the standard of care for attorneys by failing to "ascertain whether the [A]greement, as used and to be used, would comply with . . . applicable laws and regulations governing his highly regulated client." Although such a claim potentially warrants our consideration of factors that have motivated the Commission's traditional reluctance to bring an administrative action against a lawyer for the negligent rendering of non-public legal advice to his or her own client, there is no need to do so here because, as discussed more fully below, the record does not show by a preponderance of the evidence that Monson acted negligently with respect to the Agreement. We base our decision upon an independent review of the record except with respect to those findings not challenged on appeal. 3/

II.

Monson joined JBOC's predecessor company in 1989 after a brief career focusing on family law, real estate law, misdemeanor criminal defense, and property law. Monson admittedly knew nothing about securities when he joined the Firm. Monson has never held any securities licenses

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1/ In 2003, JBOC transferred its accounts to another wholly-owned subsidiary of JB Oxford Holdings, Inc., Stocks 4 Less, Inc. JBOC was renamed National Clearing Corporation ("NCC") and provided clearing and execution services to broker-dealers and also acted as a market-maker. In 2006, NCC filed with the Commission an application to withdraw its registration as a broker-dealer, and its registration has since been terminated.

2/ 17 C.F.R. § 270.22c-1. The illegal practice of permitting a purchase or redemption order received after the fund calculates its NAV (typically 4:00 p.m. Eastern time) to receive the same day's NAV is referred to as "late trading."

3/ Monson moved to supplement the record pursuant to Commission Rule of Practice 452, 17 C.F.R. § 201.452, by seeking to admit an April 6, 2007 letter from Monson's counsel to the administrative law judge regarding a change in Monson's employment status. Because this letter was already included in the record before us, Monson's motion is denied as moot.

and, he testified, learned primarily while on the job throughout his career at JBOC. At all relevant times, Monson was the only practicing lawyer on staff at JBOC. 4/ Monson spent the vast majority of his time ("90, 95 percent") working on litigation matters, including suits brought by JBOC's customers, arbitrations, subpoena responses, production of documents, and customer complaints. Monson also served as a resource for other departments when they came to him for specific legal guidance, but had no supervisory authority over any departments or individuals, other than his own administrative assistant.

In approximately May 2002, JBOC's Chief Executive Officer, James Lewis, developed a new relationship on the Firm's behalf with an institutional client in Europe interested in mutual fund trading. 5/ Lewis met with Monson and with Kraig Kibble, JBOC's Assistant Vice President in charge of Operations who held several securities licenses. 6/ During this meeting, Lewis assigned Monson the task of drafting a contract setting forth the terms of mutual fund trading Lewis had negotiated with the new client. Lewis directed Monson to concentrate on the Agreement's indemnification provisions and to obtain additional account insurance through the Securities Investor Protection Corporation ("SIPC"). Lewis assigned Kibble the task of determining the trade cutoff times to be included in the Agreement.

Monson created a draft using a sample form agreement provided by the new client as the basis for his work, focusing on drafting the indemnification and fee provisions. The section regarding trade submission times was left largely unchanged from the provisions in the sample

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4/ James Lewis, President and Chief Executive Officer of JBOC as well as President and Chief Operating Officer of JBOC's parent, was a lawyer by training, but, according to Monson, did not "act[] in a capacity as a lawyer on behalf of the companies."

5/ In a related proceeding, Lewis, without admitting or denying the allegations in the complaint, consented to the entry of a district court order enjoining him from future violations of Section 10(b) of the Securities Exchange Act of 1934 and Exchange Act Rule 10b-5 and imposing a civil penalty of $200,000 plus disgorgement of $1.00 in settlement of charges related to the Firm's facilitation of late trades. SEC v. JB Oxford Holdings, Inc., Case No. CV 04-07084PA (VBKx) (C.D. Cal. Jan. 25, 2006). Lewis also settled related Commission administrative proceedings. Without admitting or denying the allegations in the OIP, Lewis agreed to be barred from associating with any broker-dealer for five years. James G. Lewis, Order Instituting Proceedings, Securities Exchange Act Rel. No. 53210 (Feb. 2, 2006), 87 SEC Docket 911.

6/ Like Lewis, Kibble consented to the entry of a district court order enjoining him from future violations of Exchange Act Section 10(b) and Rule 10b-5 without admitting or denying the allegations in the complaint; he was ordered to pay a civil penalty of $50,000. SEC v. JB Oxford Holdings, Inc., Case No. CV 04-07084PA (VBKx) (C.D. Cal. Oct. 7, 2005). Kibble also settled Commission administrative proceedings. Without admitting or denying the allegations in the OIP, Kibble agreed to be barred from associating with any broker-dealer for four years. Kraig L. Kibble, Order Instituting Administrative Proceedings, Exchange Act Rel. No. 52728 (Nov. 3, 2005), 86 SEC Docket 1998.

form agreement. The sample agreement, and Monson's early draft, provided that the customer must submit its list of proposed transactions by "3:30 p.m. New York time" and confirm the trades by "4:00 p.m. New York time." The record is unclear whether it was Kibble or Lewis who later directed Monson to change the Agreement to provide that the customer could submit proposed orders until 4:15 p.m. and confirm them by 4:45 p.m. However, no version of the Agreement stated that JBOC would secure the same day's NAV for trades entered by the cutoff time.

Monson did not have experience in mutual fund trading and did not know how mutual funds were priced. He testified that he did not recognize that the Agreement contemplated violations of the securities laws, and he asked no questions about the timing of the trading activity contemplated by the Agreement. No one at the Firm consulted Monson about the propriety of the Agreement or its terms with the possible exception of Jonathan Cotledge, who worked in JBOC's mutual fund department. Cotledge testified that he asked Monson "whether it is all right to trade after 4:00." However, Cotledge, at the time, believed that trading after 4:00 p.m. was legal; he testified that he simply wished to know whether, from an operational and practical standpoint, it was possible to enter trades after 4:00 p.m. At the hearing, Cotledge did not recall what Monson's answer was. Monson was not asked about this conversation.

The Agreement Monson drafted was ultimately used by JBOC to establish trading relationships with seven clients. These seven clients placed and/or confirmed many mutual fund orders with JBOC after 4:00 p.m., the time at which all of the funds in which these clients traded calculated their NAV, as provided in the funds' prospectuses. Nevertheless, instead of receiving the next calculated fund share price, these seven clients' trades received that same day's (stale) NAV. 7/

III.

Under Section 9(f) of the Investment Company Act of 1940, a person may be subject to remedial action as a cause of a violation of Investment Company Act Rule 22c-1 if the Division establishes that (1) a primary violation occurred; (2) an act or omission by the respondent contributed to the violation; and (3) the respondent knew or should have known that his conduct would contribute to the violation. 8/ The law judge found that the Division established the first

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7/ In a related civil proceeding, the Commission won partial summary judgment against JBOC, which the district court found had facilitated late trades and violated Rule 22c-1. SEC v. JB Oxford Holdings, Inc., No. CV 04-07084PA (VBKx) (C.D. Cal. Aug. 24, 2005). JBOC eventually settled the civil proceeding. Without admitting or denying the allegations against it, JBOC agreed to be permanently enjoined from committing future violations of Rule 22c-1 and the antifraud provisions of Exchange Act Section 10(b) and Rule 10b-5 thereunder and to pay combined disgorgement and penalty amounts of over $2 million. See SEC Settles Civil Fraud Charges Against JB Oxford Holdings, National Clearing Corporation, and Three Former Officers for Fraudulent Late Trading and Market Timing, Lit. Rel. No. 19641 (Apr. 5, 2006), 87 SEC Docket 473.

8/ 15 U.S.C. § 80a-9(f). The "should have known" language in Section 9(f) invokes a simple negligence standard for liability when the primary violation does not require

(continued...)

two elements, and Monson has not appealed those findings. However, with respect to the third element of causing under Section 9(f), the law judge stated that "the record clearly shows that Monson did not intentionally violate Rule 22c-1." He further found that the Division failed to meet its burden to show that "Monson should have known that his conduct would result in JBOC's late trading."

Specifically, the law judge found that the Division failed to demonstrate that Monson, whose ignorance of Rule 22c-1 and mutual fund trading in general is undisputed, should have known that his work on the Agreement would contribute to JBOC's violations because he was negligent in failing to "'spot the issue' that Rule 22c-1 could be implicated." In rejecting the Division's contention, the law judge observed that "Monson's scope in drafting the Procedural Agreement was limited." The law judge also pointed out that Monson's first draft included times that complied with Rule 22c-1, and that Monson inserted new, later times only at the direction of others: "Based on Monson's limited scope in drafting the Procedural Agreement and his reliance on Lewis, as CEO, Kibble, as Assistant Vice President of Operations, and Cotledge, who had operations experience, Monson did not act negligently in accepting the trade times that they instructed." Moreover, the law judge noted that the Agreement, on its face, "does not raise sufficient 'red flags,'" because the Agreement does not explicitly provide that post-4:00 p.m. trades would receive that day's NAV. The law judge credited the testimony of Monson's expert that "a lawyer of ordinary skill and capacity 'would not have recognized that the insertion of a time after 4:00 p.m. Eastern time in the draft procedural agreement could involve a violation of Rule 22c-1'" and found that "[i]t was not until someone other than Monson interpreted and implemented the Procedural Agreement that a violation occurred."

IV.

On appeal, the Division does not argue that Monson knew that his acts or omissions would contribute to JBOC's violation of Rule 22c-1. Instead, it argues that Monson should have known that his work on the Agreement would have contributed to JBOC's violation. The Division contends that "the ultimate question in determining Monson's negligence," and therefore whether he can be found to have caused his company's violation, "is what a reasonable attorney in Monson's position, acting with due care, would have done." Monson allegedly "failed to conform to basic professional standards regarding competence."

Thus characterized on appeal, the charges against Monson hinge on his role as a legal advisor to JBOC. The Division essentially contends that, by not having requisite knowledge of the securities laws and by failing to conduct further legal inquiry regarding trade timing issues in connection with the drafting of the Agreement, Monson was negligent in providing legal advice to his client.

8/ (...continued)
scienter. Cf. KPMG, LLP v. SEC, 289 F.3d 109, 120 (D.C. Cir. 2002) (holding that the plain language of Exchange Act § 21C(a), 15 U.S.C. § 78u-3(a), identical to Investment Company Act § 9(f), is "classic negligence language").

Over twenty-five years ago, in William R. Carter, 9/ we recognized particular concerns attendant to disciplining lawyers based on faulty legal advice and noted a distinction between actions with scienter and those without scienter. We held that, to sanction a lawyer pursuant to former Rule of Practice 2(e) for having aided and abetted a securities law violation, 10/ the Commission had to show "that respondents were aware or knew that their role was part of an activity that was improper or illegal." 11/ In confirming this "intent requirement" for aiding and abetting, we emphasized the "[s]ignificant public benefits [that] flow from the effective performance of the securities lawyer's role." 12/ We also recognized that, "[i]n the course of rendering securities law advice, the lawyer is called upon to make difficult judgments, often under great pressure and in areas where the legal signposts are far apart and only faintly discernible." 13/ We expressed concern that, to the extent lawyers exercising their professional judgment are excessively motivated by "fear of legal liability or loss of the ability to practice before the Commission," clients may well decide not to consult lawyers on difficult issues. 14/

Given these considerations, we eschewed a standard that would expose an attorney to professional discipline "merely because his advice, followed by the client, is ultimately determined to be wrong." 15/ The intent requirement, we said, is crucial to an allegation of wrongdoing by a lawyer because it "provides the basis for distinguishing between those professionals who may be appropriately considered as subjects of professional discipline and those who, acting in good faith, have merely made errors of judgment or have been careless." 16/

For some time after Carter, the Commission exercised restraint under Rule 2(e) by initiating "proceedings against attorneys only where the attorney's conduct has already provided the basis for a judicial or administrative order finding a securities law violation in a non-Rule 2(e) proceeding." 17/ When we acknowledged this practice, in connection with a 1988 rulemaking regarding Rule 2(e), we stated that "the Commission, as a matter of policy, generally refrains from using its administrative forum to conduct de novo determinations of the professional obligations of

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9/ 47 S.E.C. 471 (1981).

10/ Our former Rule 2(e) has been expanded and recodified as current Rule 102(e) of the Commission's Rules of Practice, 17 C.F.R. § 201.102(e).

11/ Carter, 47 S.E.C. at 504.

12/ Id.

13/ Id.

14/ Id.

15/ Id.

16/ Id.

17/ Disciplinary Proceedings Involving Professionals Appearing or Practicing Before the Commission, 53 Fed. Reg. 26,427, 26,431 (July 15, 1988).

attorneys." 18/ We also noted that we sought to "minimize[] the risk . . . that public disciplinary proceedings may have a chilling effect on zealous representation of a client, particularly when the attorney appears before the Commission as an advocate in an enforcement matter." 19/ Consistent with these practices and policies, and with our reasoning in Carter, we have refrained from bringing disciplinary proceedings against lawyers under Rule 2(e) and its successor, Rule 102(e), based on negligent legal advice. 20/

Concerns about the scope of liability that have motivated our restraint with respect to Rule 102(e) actions against lawyers similarly are present in litigated administrative enforcement actions such as this case alleging that a lawyer caused another person's violation of the securities laws. The charges against Monson as framed by the Division – that Monson departed from professional standards of competence in rendering private legal advice to their clients – raise the same risks we identified in Carter and other proceedings: an encroachment by the Commission on regulation of attorney conduct historically performed by the states; 21/ interference with lawyers' ability to

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18/ Disciplinary Proceedings Involving Professionals Appearing or Practicing Before the Commission, 53 Fed. Reg. at 26,431. In 1982, then-Commission general counsel Edward Greene gave a speech supportive of this practice. See Edward F. Greene, Lawyer Disciplinary Proceedings Before the Securities and Exchange Commission, Remarks to the New York County Lawyer's Ass'n, 14 Sec. Reg. & L. Rep. (BNA) 168 (Jan. 20, 1982) (hereinafter "Greene").

19/ Disciplinary Proceedings Involving Professionals Appearing or Practicing Before the Commission, 53 Fed. Reg. at 26,431 & n.32. As Greene observed in his speech, "[l]awyers may view the Commission's disciplinary actions as requiring them to divide their loyalties, and their clients may perceive that the threat of disciplinary actions interferes with effective representation." Greene at 170.

20/ The Commission retains authority under Section 4C(a) of the Exchange Act, 15 U.S.C. § 78d-3(a), and Rule 102(e)(1)(ii) of the Commission's Rules of Practice to deny to any person the privilege of appearing or practicing before it if the Commission finds the person "to have engaged in unethical or improper professional conduct." Although since 1988 the Commission has instituted at least one disciplinary proceeding against a lawyer in circumstances that did not involve a prior finding of a securities law violation, such cases have been infrequent and, true to the holding in Carter, have involved allegations of scienter-based misconduct.

21/ See Disciplinary Proceedings Involving Professionals Appearing or Practicing Before the Commission, 53 Fed. Reg. at 26,431; Simon Lorne & W. Hardy Callcott, Administrative Actions Against Lawyers Before the SEC, 50 Bus. Law. 1293, 1320-21 (1995) (hereinafter "Lorne & Callcott") ("Questions regarding the activities of lawyers that are couched in terms of the standard of ordinary care more clearly verge into the territory of professional ethics and state law and away from the statutory mandate and expertise of a federal agency such as the SEC."). We recognize that Congress in Section 307 of the Sarbanes-Oxley Act required the Commission to adopt minimum standards of

(continued...)

provide unbiased, independent legal advice regarding the securities laws; 22/ and chilled advocacy on behalf of clients in proceedings before the Commission. 23/ As far as we are aware, we have not sanctioned attorneys in litigated enforcement proceedings based on alleged negligent acts or omissions they may have committed in providing non-public legal advice to clients.

This is not to say that lawyers have fallen outside the Commission's regulatory purview. To the contrary, the Commission has established that it will pursue cases against lawyers who allegedly violate the securities laws with scienter, 24/ render misleading opinions used in public

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21/ (...continued)
professional conduct for attorneys appearing and practicing before the Commission in the representation of issuers, see 15 U.S.C. § 7245, which we did, see 17 C.F.R. Part 205, and nothing in this opinion is intended to affect those requirements.

22/ Carter, 47 S.E.C. at 504.

23/ Disciplinary Proceedings Involving Professionals Appearing or Practicing Before the Commission, 53 Fed. Reg. at 26,431 & n.32. To be clear, none of the concerns mentioned in the text would warrant restraint in initiating proceedings alleging scienter-based misconduct by lawyers that threatens the integrity of Commission processes. See infra notes 24-26 and accompanying text.

24/ See Benjamin G. Sprecher, 52 S.E.C. 1296 (1997) (imposing penny stock bar on attorney with special expertise in securities law who "masterminded an elaborate fraudulent scheme involving a merger . . . to evade the registration requirements of the Securities Act" based on criminal conviction for conspiracy to sell unregistered securities and make false statements to the Commission as well as perjury and obstruction of justice); see also SEC v. Fehn, 97 F.3d 1276 (9th Cir. 1996) (affirming district court injunction against attorney on the grounds that he substantially assisted his client in the preparation of misleading disclosure statements and improperly advised his clients regarding material omissions in those disclosure statements); H. Thomas Fehn, Exchange Act Rel. No. 40697 (Nov. 20, 1998), 68 SEC Docket 1875 (accepting Fehn's consent to be denied the privilege of appearing or practicing for eighteen months before the Commission under Rule 102(e) based on the injunction affirmed by the Ninth Circuit in SEC v. Fehn); SEC v. Calvo, 689 F. Supp. 53 (D. Conn. 1988) (granting summary judgment to SEC and imposing injunction on attorney found to have recklessly violated, and recklessly aided and abetted violations of, antifraud provisions during public stock offering).

disclosures, 25/ or engage in conduct that would render a non-lawyer liable for the same activity under comparable circumstances. 26/

The present case, however, does not require us to address further the appropriate parameters of lawyer liability in administrative enforcement actions because the record does not show by a preponderance of the evidence that Monson acted negligently in drafting the Agreement. In drafting the Agreement, Monson was told by management to focus on the amount of SIPC insurance needed to cover the anticipated investment by the new client and to ensure that the indemnification and fee provisions were properly drafted. The responsibility for determining the trade cut-off times – the aspect of the Agreement that ultimately made the trading arrangement illegal – was given to another Firm official, and Monson was never asked to evaluate regulatory issues related to those trading times. In addition, Monson's regular professional responsibilities as general counsel, and his understanding of what the Firm expected of him, are inconsistent with a finding that he was negligent because the Firm did not generally rely on Monson to determine whether the Firm's activities complied with securities laws and regulations.

Moreover, we do not find that circumstances surrounding the new trading arrangement necessarily should have alerted Monson, given his background and responsibilities, to the need for inquiry. The Agreement could have been fully implemented by the parties without engaging in

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25/ See Ira Weiss, Exchange Act Rel. No. 52875 (Dec. 2, 2005), 86 SEC Docket 2588 (finding that school district's bond counsel negligently violated Securities Act Sections 17(a)(2) and (3) through the issuance of a misleading, unqualified opinion that he knew would be communicated to, and relied upon by, prospective investors, and through his review and approval of the issuer's official statement that referenced his opinion), aff'd, 468 F.3d 849 (D.C. Cir. 2006).

26/ See, e.g., Conrad C. Lysiak, 51 S.E.C. 841, 842 (1993) (finding that company's compliance officer, who was also "an experienced securities lawyer [and the company's] outside general counsel for many years," failed to enforce reasonable supervisory measures necessary to prevent violations of NASD rules), aff'd, 47 F.3d 1175 (9th Cir. 1995) (Table); Restatement (Third) of the Law Governing Lawyers § 56 cmt. b (2000) ("Lawyers are subject to the general law. If activities of a nonlawyer in the same circumstances would render the nonlawyer civilly liable or afford the nonlawyer a defense to liability, the same activities by a lawyer in the same circumstances generally render the lawyer liable or afford the lawyer a defense.").

Irrespective of the Commission's record in litigating enforcement actions against lawyers for negligent, non-public legal advice, the Commission might assert a scienter-based charge against a lawyer for conduct related to legal advice when the facts appear to support such a charge, and then, based on many different factors including its discretion, accept a settlement with the lawyer that alleges only a negligence-based violation. Cf. Lorne & Callcott at 1322-23 (arguing that any Commission policy to abjure from bringing administrative enforcement proceedings against negligent attorneys should not operate to deny attorneys the choice to settle proceedings in the administrative context).

violative conduct. Although the Division points to Cotledge's inquiry as a "red flag," it is unclear from the circumstances that Monson should have been concerned about the implications of Cotledge's question; Cotledge testified that, when he asked Monson whether entering post-4:00 p.m. trades was "all right," Cotledge was interested only in learning whether the contemplated trading was permissible from an operations – not a legal – perspective.

Under all the circumstances, and based on our de novo review of the record in this case, we have concluded that the record before us does not establish by a preponderance of the evidence that Monson was negligent. 27/ We accordingly dismiss this proceeding. 28/

An appropriate order will issue. 29/

By the Commission (Chairman COX and Commissioners ATKINS and CASEY).

Florence E. Harmon
Acting Secretary

27/ The Division takes exception to the law judge's decision to grant Monson's motion in limine to exclude the testimony of two expert witnesses. The law judge concluded after reviewing the reports of all three of the Division's proffered expert reports that their testimony was duplicative and offered the Division the choice of presenting any one of the three experts, of the Division's own choosing. Rule of Practice 320, 17 C.F.R. § 201.320, provides that "the hearing officer may receive relevant evidence and shall exclude all evidence that is irrelevant, immaterial or unduly repetitious." As we have previously noted, the Supreme Court has made clear that "judges have broad discretion in determining whether to admit or exclude evidence, and 'this is particularly true in the case of expert testimony.'" Pagel, Inc., 48 S.E.C. 223, 230 (1985) (quoting Hamling v. United States, 418 U.S. 87, 108 (1974)). Having reviewed the reports of all three experts, we conclude that the law judge did not abuse his discretion in limiting the Division to one expert's testimony.

28/ Monson has requested oral argument. Under Rule of Practice 451(a), 17 C.F.R. § 201.451(a), we grant requests for oral argument with respect to the review of initial decisions of hearing officers except in "exceptional circumstances." However, because the issues in this case have been thoroughly briefed, and given the resolution of this matter, we believe there is "no prejudice" to Monson in denying his request for oral argument. D.E. Wine Invs., Inc., 54 S.E.C. 1213, 1221 n.25 (2001). We therefore deny his request.

29/ We have considered all of the contentions 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.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT COMPANY ACT OF 1940
Rel. No. 28323 / June 30, 2008

Admin. Proc. File No. 3-12429

In the Matter of

SCOTT G. MONSON

ORDER DISMISSING PROCEEDINGS

On the basis of the Commission's opinion issued this day, it is

ORDERED that the administrative proceeding against Scott G. Monson be, and it hereby is, dismissed.

By the Commission.

Florence E. Harmon
Acting Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Rel. No. 8937 / June 30, 2008

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 58062 / June 30, 2008

INVESTMENT COMPANY ACT OF 1940
Rel. No. 28324 / June 30, 2008

Admin. Proc. File No. 3-12626

In the Matter of THOMAS C. BRIDGE, JAMES D. EDGE, and JEFFREY K. ROBLES	ORDER GRANTING PARTIAL PROTECTIVE ORDER AS TO JAMES D. EDGE

On June 2, 2008, James D. Edge 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 did not oppose Edge's request for a protective order.

1/ 17 C.F.R. § 201.322.

2/ 17 C.F.R. § 201.322(a).

3/ 17 C.F.R. § 201.322(b).

Document 45 of 48

The documents Edge submitted contain sensitive information and, at this stage in the proceeding, we believe that the harm resulting from complete disclosure outweighs the benefits. 4/ However, because we have determined that disclosure of certain information included in the documents will be necessary to our consideration of this proceeding, we shall grant the requested protected order subject to certain limitations. 5/

Accordingly, IT IS ORDERED that:

1. Except as otherwise provided in this Order, the documents Edge provided shall be disclosed only to the parties to this proceeding, 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.

4/ See Gregory O. Trautman, Securities Exchange Act Rel. No. 57475 (Mar. 11, 2008), __ SEC Docket __ (granting request for order protecting personal financial information in connection with petition for review and noting that the "harm resulting from complete disclosure outweighs the benefits").

5/ See Trautman, __ SEC Docket __ (determining that disclosure of certain information included in the documents at issue was necessary to the Commission's consideration of the proceeding); Kevin Hall, CPA, Exchange Act Rel. No. 56242 (Aug. 13, 2007), 91 SEC Docket 1071, 1072 (same); David Henry Disraeli, Exchange Act Rel. No. 56012 (July 5, 2007), 90 SEC Docket 3175, 3175 (same).

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.

Florence E. Harmon
Acting Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Rel. No. 8939 / June 30, 2008

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 58064 / June 30, 2008

INVESTMENT COMPANY ACT OF 1940
Rel. No. 28326 / June 30, 20008

Admin. Proc. File No. 3-12626

In the Matter of THOMAS C. BRIDGE, JAMES D. EDGE, and JEFFREY K. ROBLES	ORDER GRANTING PARTIAL PROTECTIVE ORDER AS TO THOMAS C. BRIDGE

On June 3, 2008, Thomas C. Bridge 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 did not oppose Bridge's request for a protective order.

1/ 17 C.F.R. § 201.322.

2/ 17 C.F.R. § 201.322(a).

3/ 17 C.F.R. § 201.322(b).

Document 46 of 48

The documents Bridge submitted contain sensitive information and, at this stage in the proceeding, we believe that the harm resulting from complete disclosure outweighs the benefits. 4/ However, because we have determined that disclosure of certain information included in the documents will be necessary to our consideration of this proceeding, we shall grant the requested protected order subject to certain limitations. 5/

Accordingly, IT IS ORDERED that:

1. Except as otherwise provided in this Order, the documents Bridge provided shall be disclosed only to the parties to this proceeding, 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.

4/ See Gregory O. Trautman, Securities Exchange Act Rel. No. 57475 (Mar. 11, 2008), __ SEC Docket __ (granting request for order protecting personal financial information in connection with petition for review and noting that the "harm resulting from complete disclosure outweighs the benefits").

5/ See Trautman, __ SEC Docket __ (determining that disclosure of certain information included in the documents at issue was necessary to the Commission's consideration of the proceeding); Kevin Hall, CPA, Exchange Act Rel. No. 56242 (Aug. 13, 2007), 91 SEC Docket 1071, 1072 (same); David Henry Disraeli, Exchange Act Rel. No. 56012 (July 5, 2007), 90 SEC Docket 3175, 3175 (same).

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.

Florence E. Harmon

Florence E. Harmon
Acting Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Rel. No. 8938 / June 30, 2008

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 58063 / June 30, 2008

INVESTMENT COMPANY ACT OF 1940
Rel. No. 28325 / June 30, 2008

Admin. Proc. File No. 3-12626

In the Matter of THOMAS C. BRIDGE, JAMES D. EDGE, and JEFFREY K. ROBLES	ORDER GRANTING PARTIAL PROTECTIVE ORDER AS TO JEFFREY K. ROBLES

On June 2, 2008, Jeffrey K. Robles 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 did not oppose Robles' request for a protective order.

1/ 17 C.F.R. § 201.322.

2/ 17 C.F.R. § 201.322(a).

3/ 17 C.F.R. § 201.322(b).

Document 47 of 48

The Commission recognizes that the documents Robles submitted contain sensitive information. At this stage in the proceeding, we believe that the harm resulting from complete disclosure outweighs the benefits. 4/ However, because we have determined that disclosure of certain information included in the documents will be necessary to our consideration of this proceeding, we shall grant the requested protected order subject to certain limitations. 5/

Accordingly, IT IS ORDERED that:

1. Except as otherwise provided in this Order, the documents Robles provided shall be disclosed only to the parties to this proceeding, 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.

4/ See Gregory O. Trautman, Securities Exchange Act Rel. No. 57475 (Mar. 11, 2008), __ SEC Docket __ (granting request for order protecting personal financial information in connection with petition for review and noting that the "harm resulting from complete disclosure outweighs the benefits").

5/ See Trautman, __ SEC Docket __ (determining that disclosure of certain information included in the documents at issue was necessary to the Commission's consideration of the proceeding); Kevin Hall, CPA, Exchange Act Rel. No. 56242 (Aug. 13, 2007), 91 SEC Docket 1071, 1072 (same); David Henry Disraeli, Exchange Act Rel. No. 56012 (July 5, 2007), 90 SEC Docket 3175, 3175 (same).

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.

Florence E. Harmon

Florence E. Harmon
Acting Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 58061 / June 30, 2008

Admin. Proc. File No. 3-12965

In the Matter of

TELCOBLUE, INC.

ORDER DISMISSING PROCEEDING

On February 22, 2008, administrative proceedings were instituted against TelcoBlue, Inc. ("TelcoBlue"), pursuant to Section 12(j) of the Securities Exchange Act of 1934. 1/ On February 20, 2008, however, TelcoBlue had filed with the Commission a Form 15-12B, pursuant to Rule 12g-4(a)(1)(i) of the Exchange Act, 2/ seeking to deregister its securities voluntarily. In the Form 15-12B, TelcoBlue certified that it sought termination based on Exchange Act Rule 12g-4(a)(1)(i), which permits the termination of registration if the issuer certifies that the class of securities being deregistered is "held of record . . . by less than 300 persons." 3/ TelcoBlue certified in the Form 15-12B that its approximate number of holders of record was 243, as of February 19, 2008. The Form 15-12B became effective automatically, upon the expiration of ninety days, on May 20, 2008.

On June 16, 2008, the Division of Enforcement filed a motion to dismiss the proceeding, based on the deregistration of TelcoBlue's securities. 4/ We have determined to grant the Division's motion. TelcoBlue no longer has a class of securities registered under Section 12 of the Exchange Act. Because revocation or suspension of registration are the only remedies

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1/ 15 U.S.C. § 78l(j).

2/ 17 C.F.R. § 240.12g-4(a)(1)(i).

3/ An issuer may withdraw its Form 15 at any time before the termination of registration becomes effective. See 17 C.F.R. § 240-12g-4(b).

4/ TelcoBlue has not filed a response to the Division of Enforcement's motion.

Document 48 of 48

available in this proceeding instituted pursuant to Exchange Act Section 12(j), we find it appropriate to dismiss the proceeding. 5/

Accordingly, it is ORDERED that this proceeding be, and it hereby is, dismissed.

By the Commission.

Florence E. Harmon
Acting Secretary

5/ See Enamelon, Inc., Securities Exchange Act Rel. No. 52956 (Dec. 15, 2005), 86 SEC Docket 2944 (dismissing Section 12(j) proceeding with respect to a respondent that "no longer ha[d] a class of securities registered under Section 12 of the Exchange Act").