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 **September 2010,** 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:

MARY L. SCHAPIRO, CHAIRMAN

KATHLEEN L. CASEY, COMMISSIONER

ELISSE B. WALTER, COMMISSIONER

LUIS A. AGUILAR, COMMISSIONER

TROY A. PAREDES, COMMISSIONER

(82 Documents)

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62733 / August 16, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13446

In the Matter of **American Skandia Investment Services, Inc.** **Respondent.**	**ORDER APPROVING PLAN OF DISTRIBUTION, APPOINTING FUND ADMINISTRATOR, AND WAIVING BOND**

On April 17, 2009, the Securities and Exchange Commission ("Commission") issued a settled Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order against American Skandia Investment Services, Inc. ("ASISI") finding that ASISI accommodated widespread market timing in American Skandia Trust ("AST") portfolios or sub-accounts that serve as funding vehicles for variable annuities issued by American Skandia Life Assurance Corporation ("ASLAC") from at least January 2000 through in or around September 2003. See Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Investment Advisers Act Release No. 2867 ("Order"). Among other things, the Commission ordered the Respondent to pay a total of $68 million in disgorgement and civil penalties, which the Respondent paid in full. Pursuant to the Order, ASISI selected Professor Francis E. McGovern, Professor of Law at Duke University, as the Independent Distribution Consultant ("IDC"), to develop a distribution plan for the distribution of disgorgement and penalties (the "Fair Fund"). Since then, the IDC has developed a proposed distribution plan (the "Distribution Plan") in consultation with the staff and ASISI.

The IDC proposed Rust Consulting, Inc. ("Rust") as the Fund Administrator. In accordance with the Commission's Rules on Fair Fund and Disgorgement Plans, 17 C.F.R. § 201.1100, *et seq.*, the Distribution Plan proposes a Fund Administrator and sets forth, among other things, procedures for the distribution of proceeds to funds or shareholders of funds; procedures for the administration of the Fair Fund, including provisions for filing tax returns; and a proposed timeframe for the termination of the Distribution Plan.

Rust Consulting, Inc., proposed in the Distribution Plan as the Fund Administrator, has not posted the bond generally required of third parties under Fair Fund Rule 1105(c). Rather, the Plan incorporates several layers of protection for the Fair Fund. Among other things, under the Plan: (1) the Fund Administrator will have no custody, and only limited control, of the Fair Fund; (2) the Fair Fund will be held by the U.S. Treasury Bureau of Public Debt until the funds are transferred to the Escrow Bank[1] immediately before transmittal of checks or electronic transfers to eligible investors; (3) upon transfer from the U.S. Treasury, funds will be held in an escrow account, separate from the Escrow Bank's assets until presentation of a check or electronic transfer, at which time funds will be transferred to a controlled distribution account; (4) presented checks or electronic transfers will be subject to "positive pay" controls before being honored by the Escrow Bank; and (5) both the Escrow Bank and the Fund Administrator will maintain, throughout this process, insurance and/or a financial institution bond that covers errors and omissions, misfeasance and fraud.

On May 13, 2010, the Commission published a "Notice of Proposed Distribution Plan and Opportunity for Comment" ("Notice") pursuant to Rule 1103 of the Commission's Rules on Fair Fund and Disgorgement Plans, 17 C.F.R. § 201.1103. See Exchange Act Release No. 62106. The Notice advised all interested parties that they may obtain a copy of the Distribution Plan from the Commission's public website, http://www.sec.gov, or by submitting a written request to Christopher R. Conte, Associate Director, United States Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5561.

The Notice also advised that all persons desiring to comment on the Distribution Plan could submit their views, in writing, within thirty (30) days of the date of the Notice, to the Office of the Secretary, United States Securities and Exchange Commission, 100 F Street, N.E., Washington, D.C. 20549-1090; by using the Commission's Internet comment form; or by sending an email to rule-comments@sec.gov. The Commission received no comments on the Distribution Plan and no modification has been made to the Distribution Plan since publication of the Notice.

Accordingly, IT IS HEREBY ORDERED that:

A. Pursuant to Rule 1104 of the Commission's Rules on Fair Fund and Disgorgement Plans, 17 C.F.R. §201.1104, the Distribution Plan is approved.

B. Pursuant to Rule 1105(a) of the Commission's Rules on Fair Fund and Disgorgement Plans, 17 C.F.R. § 201.1105(a), Rust Consulting, Inc. is appointed as Fund Administrator; and

1 The "Escrow Bank" refers to Huntington Bank as defined in paragraph 5 and described in paragraph 54 of the Distribution Plan.

C. The bond requirement of Rule 1105(c) of the Commission's Rules on Fair Fund and Disgorgement Plans, 17 C.F.R. § 201.1105(c), is waived for good cause shown.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62811 / September 1, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14026

In the Matter of **Pinnacle Capital Markets LLC and Michael A. Paciorek,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS, PENALTIES AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTIONS 15(b)(4) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Pinnacle Capital Markets LLC and Michael A. Paciorek ("Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have 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 in which the Commission is a party, and without admitting or denying the findings contained herein, except as to the Commission's jurisdiction over Respondents 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, Penalties and a Cease-and-Desist Order Pursuant to Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

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

Respondents

1. Pinnacle Capital Markets LLC ("Pinnacle") is a North Carolina limited liability company headquartered in Raleigh that has been registered with the Commission as a broker-dealer since October 10, 2002. Pinnacle is a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act and is a member of the Financial Industry Regulatory Authority, Inc. ("FINRA"). Michael A. Paciorek is the president and chief compliance officer of Pinnacle.

Summary

2. These proceedings arise out of Pinnacle's violations of Section 17(a) of the Exchange Act and Rule 17a-8 thereunder, which require a broker-dealer to comply with the reporting, recordkeeping and record retention requirements in regulations implemented under the Bank Secrecy Act ("BSA"),[2] including the requirements in the customer identification program ("CIP") rule applicable to broker-dealers.[3] The CIP rule generally requires a broker-dealer to establish, document, and maintain procedures for identifying customers and verifying their identities. Pinnacle's business primarily involves order processing with direct market access ("DMA") software for foreign institutions comprised mostly of banks and brokerage firms (many carrying omnibus accounts) and foreign individuals. Pinnacle established, documented and maintained a CIP that specified it would identify and verify the identities of all of its customers. However, from October 2003 through August 2006, Pinnacle did not verify the identities of many of its corporate account holders. Further, from October 2003 to November 2009, Pinnacle did not identify or verify the identities of the vast majority of its corporate customers' omnibus accounts' sub-account holders, even though the sub-account holders were Pinnacle's customers for purposes of the CIP rule. Consequently, Pinnacle's documented procedures differed materially from its actual procedures.

3. By failing to document accurately its customer verification procedures, Pinnacle willfully violated Section 17(a) of the Exchange Act and Rule 17a-8 thereunder.[4]

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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] Currency and Foreign Transactions Reporting Act of 1970 (commonly referred to as the Bank Secrecy Act), 12 U.S.C. § 1829b, 12 U.S.C. §§ 1951-1959, and 31 U.S.C. § 5311-5330.

[3] 31 C.F.R. § 103.122.

[4] The Financial Industry Regulatory Authority ("FINRA") has fined Pinnacle $300,000 for violating NASD Rules 3011(a) and (b) and 2110 by failing to establish and implement Anti-Money Laundering procedures reasonably designed to verify the identity of its customers stemming in part from the facts

4. In addition, as the firm's compliance officer, Paciorek was obligated to ensure that Pinnacle complied with its anti-money laundering ("AML") obligations, including the obligation to maintain an accurate CIP. Paciorek's failure to do so was a cause of Pinnacle's violations.

Findings

5. Pinnacle is a small broker-dealer based in Raleigh with registered representatives stationed in the United Kingdom, Argentina and Canada who act as independent contractors and whose primary function is to seek and introduce new customers to Pinnacle. Pinnacle's business primarily involves order processing with direct market access software for foreign institutions comprised mostly of banks and brokerage firms (many carrying omnibus accounts) and foreign individuals. More than 99% of Pinnacle's customers reside outside the United States. Pinnacle's customers are both corporate and retail customers holding both corporate and individual accounts ("regular" accounts). Many of Pinnacle's corporate customers that are foreign entities also hold omnibus accounts through which, in some instances, these foreign entities in turn carry sub-accounts for their own corporate or retail customers. These foreign entity omnibus sub-accounts are not the foreign entities' own proprietary accounts.

6. Pinnacle treats the sub-account holders of the foreign entity omnibus accounts ("omnibus sub-account holders") in the same manner as it does its regular account holders. The vast majority of Pinnacle's regular account holders, as well as the omnibus sub-account holders, use DMA software to enter securities trades directly and instantly through their own computers. As a result, these account holders, including the omnibus sub-account holders, have direct, unfiltered control over how securities transactions are effected in the accounts. The foreign entity holding the omnibus account does not intermediate these trades. Using the DMA software, the omnibus sub-account holders are able to directly and instantly effect securities transactions without having the foreign entity intermediate the transaction. The DMA software allows the omnibus sub-account holders to route their securities transactions directly to the relevant market centers, including the New York Stock Exchange and the NASDAQ system, without intermediation. The omnibus sub-account holder's transactions are executed and confirmed through the DMA software provided to the sub-account holders, without intermediation.

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underlying the instant action, and for failing to detect and report suspicious activity. *See* Letter of Acceptance, Waiver and Consent No. 2006006637101. As part of its settled action with FINRA, Pinnacle also consented to a censure and certain undertakings.

7. As of 2004, Pinnacle had a documented AML program that included a CIP section. Among other things, Pinnacle's CIP provided that, upon creation of a new account, the "designated person" at Pinnacle should "follow the 'New Account Checklist (Corporate or Retail)' in order to gather and verify customer information." In most instances, Michael Paciorek, Pinnacle's president and chief compliance officer, was the designated person for AML compliance purposes. The CIP set forth procedures for the identification and verification of the corporate accounts and the individual accounts and called for this information to be recorded in a document that was to be kept with the customer's account form.

8. With respect to business or corporate accounts, Pinnacle's CIP procedures required the designated person to follow the Corporate New Account checklist in order to gather and verify customer information and to maintain all information collected with the customer's account form.

9. For verification of this information, Pinnacle's CIP procedures required the designated person to: (1) obtain a copy of the document confirming the existence of the business (e.g., certificate or articles of incorporation); (2) obtain a financial statement regarding the business; and (3) in appropriate circumstances, conduct a site visit. Actual verification was required to be made at least five days from the account opening and documentation of the verification was to be kept and evidenced on the checklist.

10. Pinnacle's written CIP listed the information that Pinnacle should obtain from new individual customers.

11. The verification procedures set forth in Pinnacle's CIP required the designated person to verify the individual customer's identity by, among other things: (a) reviewing a current unexpired photo on a government-issued identification and visibly comparing the photograph with the customer; (b) confirming the address, date of birth and other information provided by the customer by either (i) viewing a utility bill, or (ii) contacting the customer; (c) utilizing an information verification process, such as a credit report; (d) inquiring and documenting a conversation about the source of the customer's assets and income to determine whether the inflow and outflow of money and securities was consistent with the customer's financial status; and (e) gaining an understanding of what the customer's likely trading pattern would be so that any deviations from the patterns could be detected.

12. Between 2003 and November 2009, Pinnacle collected identifying information for its regular account holders. However, it did not verify information regarding corporate accounts as documented in its CIP procedures, and it did not collect or verify all identifying information for the vast majority of its approximately 3,000 omnibus sub-account holders.

13. With respect to the procedures governing the verification of corporate accounts, Pinnacle collected identifying information for its corporate accounts as outlined in its written CIP; however, its verification procedures were deficient in such a way that

Pinnacle did not, and in some instances could not, verify some of its customers' identities. For example, between October 2003 and August 2006, Pinnacle did not verify a significant number of its corporate account holders' identities. Specifically, out of a sampling of 55 corporate accounts opened between October 2003 and August 2006, Pinnacle either did not verify or could not verify the identities of 34 of those account holders.

14. For the majority of this sample of corporate brokerage accounts, Pinnacle either did not obtain the information listed in Paragraph 9 or obtained those documents in foreign languages that no one on Pinnacle's staff could understand. Pinnacle also did not record any non-documentary steps to verify the identities of these corporate account holders in ways required by its CIP. Pinnacle therefore failed to follow the verification procedures set forth in its CIP.

15. With respect to the procedures governing the identification of the omnibus account sub-account holders, in some but not all instances, Pinnacle collected from its corporate customer omnibus account holders limited identifying information about the corporate customers' omnibus sub-account holders, such as a name and occupation. Addresses and other identifying information were not obtained. With the exception of this limited information, Pinnacle and its representatives did not know the identities of the omnibus sub-account holders.

16. Michael Paciorek was Pinnacle's president and chief compliance officer during the entire period relevant to this Order. Throughout this period, Paciorek directed all of Pinnacle's actions with respect to its CIP procedures and the identification and verification of its customers.

Legal Discussion

17. Section 17(a) of the Exchange Act and Rule 17a-8 thereunder require a broker-dealer to comply with the reporting, recordkeeping and record retention requirements in the regulations implemented under the BSA, which includes the CIP rule.[5] The CIP rule requires that broker-dealers establish procedures for making and maintaining records of all information obtained to comply with the rule, including records describing the methods and results of any measures undertaken to verify the identities of customers.[6]

[5] The BSA, as amended by the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (Pub. L. 107-56), directed the Department of Treasury and the Commission to jointly issue regulations requiring, among other things, broker-dealers to implement reasonable procedures to verify the identity of any person seeking to open an account (to the extent reasonable and practicable) and to maintain records of the information used to verify the person's identity. *See* Exchange Act Release No. 34-47752 (April 29, 2003), 68 FR.25113 (May 9, 2003).

[6] 31 C.F.R. § 103.122(b)(3).

18. Pinnacle's written CIP specified that it would identify and verify the identities of its customers.

19. Pinnacle did not, in many instances, verify the identities of its customers that were corporate account holders. In many cases, Pinnacle failed to take steps toward verifying its corporate customers' identities, and in other instances, could not verify its corporate customers' identities because it collected verification documents in languages no one at Pinnacle could understand. In addition, Pinnacle did not record its non-documentary steps to verify the identities of these corporate account holders as required by its CIP. Accordingly, because Pinnacle neither verified the identities of all of its corporate account holders nor recorded its non-documentary verification steps, Pinnacle did not accurately document its CIP as required under the CIP rule.

20. Pinnacle also did not collect identifying information or verify the identities of its corporate customers' omnibus sub-account holders. In addition to being customers of the foreign entities holding the omnibus accounts, the omnibus sub-account holders are Pinnacle's customers for purposes of the CIP rule because the omnibus sub-account holders effect securities transactions directly and without the intermediation of the customer omnibus account holders.[7] The omnibus sub-account holders effect transactions for their own accounts, do not act on behalf of the foreign entity, and are not proprietary accounts of the foreign entity. Accordingly, because Pinnacle did not identify the omnibus sub-account holders or verify their identities, Pinnacle did not accurately document its CIP as required under the CIP rule.

21. As a result of the conduct described above, Pinnacle willfully violated Section 17(a) of the Exchange Act and Rule 17a-8 thereunder by failing to document accurately its CIP.

22. As a result of the conduct described above, Paciorek was a cause of Pinnacle's violations of Section 17(a) of the Exchange Act and Rule 17a-8 thereunder.

IV.

[7] On October 1, 2003, staff from the Commission's Division of Trading and Markets (f/k/a Division of Market Regulation) and the Financial Crimes Enforcement Network ("FinCEN"), a bureau within the Department of Treasury that administers the BSA, published a "Question and Answer" ("Q&A") regarding a broker-dealer's CIP obligations with respect to transactions in omnibus accounts and sub-accounts. *See* Question and Answer Regarding the Broker-Dealer Customer Identification Program Rule (31 CFR 103.122) *at* http://sec.gov/divisions/marketreg/qa-bdidprogram.htm. The Q&A addressed non-exclusive circumstances under which a broker-dealer could treat an omnibus account holder as the only customer for the purposes of the CIP rule and would not also be required to treat the underlying beneficial owner as a customer. Among other things, the Q&A contemplated a scenario in which all securities transactions in the omnibus account or sub-account would be initiated by the financial intermediary holding the omnibus account, and the beneficial owner of the omnibus account or sub-account would have no direct control of the transactions effected in the account. In contrast, Pinnacle's foreign entity omnibus accounts were not true intermediated relationships, as Pinnacle treated the omnibus sub-account holders as its own customers. Specifically, the omnibus sub-account holders directly effected transactions through their sub-accounts with the DMA software, routing the trades to the relevant market centers, including the New York Stock Exchange and the NASDAQ system, without intermediation.

In determining to accept the Offer, the Commission considered remedial acts undertaken by Respondents and the cooperation afforded the Commission staff.[8]

V.

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

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondents shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Exchange Act and Rule 17a-8 thereunder;

B. Pinnacle is censured pursuant to Section 15(b)(4) of the Exchange Act;

C. Pursuant to Section 21B of the Exchange Act, Pinnacle shall, within 30 days of the entry of this Order, pay a civil money penalty of $25,000.00 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, United States Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover of a letter that identifies Pinnacle Capital Markets LLC and Michael A. Paciorek as the Respondents in these proceedings and the file number of these proceedings. A copy of the cover letter and money order or check shall be sent to Tom Sporkin, Chief of the Office of Market Intelligence, Division of Enforcement, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-5631.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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[8] As noted, *see supra* note 4, Pinnacle agreed to certain undertakings in settling the related action with FINRA .

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62812 / September 1, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14027

In the Matter of **Villa Pasta, Inc.,** **VIP Global Capital, Inc.,** **Virtual World of Sports, Inc.** **(f/k/a Accord Ventures, Inc.),** **Viva Gaming & Resorts, Inc.,** **VJG4, Inc.,** **Voice IT Worldwide, Inc.** **The Voyager Group, Inc., and** **Vu-Data Corp.,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Villa Pasta, Inc., VIP Global Capital, Inc., Virtual World of Sports, Inc. (f/k/a Accord Ventures, Inc.), Viva Gaming & Resorts, Inc., VJG4, Inc., Voice IT Worldwide, Inc., The Voyager Group, Inc., and Vu-Data Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Villa Pasta, Inc. (CIK No. 1084008) is a dissolved Colorado corporation located in Palmer Lake, Colorado with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Villa Pasta 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 $11,011 for the prior three months.

2. VIP Global Capital, Inc. (CIK No. 837488) is a Colorado corporation located in Denver, Colorado with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). VIP 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, 1995, which reported a net loss of over $1.05 million for the prior three months. On January 6, 1997, VIP filed a Chapter 7 petition in the U.S. Bankruptcy Court for the District of Colorado, which was terminated on March 16, 2005.

3. Virtual World of Sports, Inc. (f/k/a Accord Ventures, Inc.) (CIK No. 1071832) is a revoked Nevada corporation located in La Jolla, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Virtual World is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2000, which reported a net loss of $481,542 for the prior three months. As of August 27, 2010, the company's stock (symbol "VWOS") was traded on the over-the-counter markets.

4. Viva Gaming & Resorts, Inc. (CIK No. 1105411) is a dissolved Florida corporation located in Las Vegas, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Viva 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 over $3.48 million for the prior nine months. As of August 27, 2010, the company's stock (symbol "VIGA") was traded on the over-the-counter markets.

5. VJG4, Inc. (CIK No. 1129722) is an inactive Washington corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). VJG4 is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 2001, which reported a net loss of $7,835 for the prior six months.

6. Voice IT Worldwide, Inc. (CIK No. 103657) is a dissolved Colorado corporation located in San Diego, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Voice IT 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 over $1.96 million for the prior nine months.

7. The Voyager Group, Inc. (CIK No. 1120401) is a void Delaware corporation located in Carlsbad, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). The Voyager Group is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended April 30, 2001, which reported a net loss of $771,244 for the prior nine months. As of August 27, 2010, the company's stock (symbol "VGPI") was traded on the over-the-counter markets.

8. Vu-Data Corp. (CIK No. 878148) is a Nevada corporation located in San Diego, California with a class of securities registered with the Commission pursuant to

Exchange Act Section 12(g). Vu-Data is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 1995, which reported a net loss of $550,524 for the prior nine months.

B. DELINQUENT PERIODIC FILINGS

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

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

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

III.

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

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

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Walter
Commissioner Aguilar
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62810 / September 1, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-11793

In the Matter of Southwest Securities, Inc., Daniel R. Leland, Kerry M. Rigdon, and Kevin J. Marsh, Respondents.	Order Appointing Fund Administrator and Waiving the Bond Requirement

On January 10, 2005, Respondents consented to the entry of an Order Instituting Public Administrative Proceedings, Making Findings, and Imposing Remedial Sanctions Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Section 203(f) of the Investment Advisers Act of 1940, and Instituting Cease-and-Desist Proceedings and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 and Section 9(f) of the Investment Company Act of 1940 ("Order"). The Order found, among other things, that between October 2002 and September 2003, the Respondents failed reasonably to supervise three registered representatives who engaged in an illegal market timing scheme. The Order established a Fair Fund under Section 308(a) of the Sarbanes-Oxley Act of 2002.

Pursuant to the Order, a plan was proposed for the distribution of the Fair Fund. The Fair Fund is comprised of $10,276,002 paid by the Respondents, plus accumulated interest, less any federal, state, or local taxes on the interest.

The Division of Enforcement ("Division") seeks approval of the appointment of Gilardi & Co., L.L.C. ("Gilardi") as Fund Administrator for the Proposed Plan of Distribution and approval of the waiver of the bond requirement for Gilardi for the good cause shown in the proposed plan and pursuant to Rule 1105(c) of the Commission's Rules on Fair Fund and Disgorgement Plans.

The proposed plan contemplates the distribution of funds now at the Department of Treasury Bureau of Public Debt to mutual funds that had marketing arrangements with the Respondents during the period from October 2002 through September 2003; or, in the case of mutual funds that have been merged into other mutual funds, to their successors in interest. The Fair Fund will be disbursed by Treasury, and Gilardi will not have possession of the Fair Fund or discretion regarding disbursements from the Fair Fund.

IT IS HEREBY ORDERED that Gilardi is appointed as the Fund Administrator and that the bond requirement of the Fund Administrator is waived for good cause shown.

By the Commission

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Walter and
Commissioner Aguilar
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62809 / September 1, 2010

Administrative Proceeding File No. 3-11793

In the Matter of

Southwest Securities, Inc.,
Daniel R. Leland, Kerry M. Rigdon,
and Kevin J. Marsh,

Respondents.

Notice of Proposed Plan of Distribution and Opportunity for Comment

Notice is hereby given, pursuant to Rule 1103 of the Securities and Exchange Commission's ("Commission") Rules on Fair Fund and Disgorgement Plans, 17 C.F.R. § 201.1103, that the Division of Enforcement has filed with the Commission the proposed plan ("Distribution Plan") for the distribution of monies in *In the Matter of Southwest Securities, Inc., et al.* The Commission issued an Order Instituting Public Administrative Proceedings, Making Findings, and Imposing Remedial Sanctions Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Section 203(f) of the Investment Advisers Act of 1940, and Instituting Cease-and-Desist Proceedings and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 and Section 9(f) of the Investment Company Act of 1940 as to the Respondents, Administrative Proceeding File No. 3-11793 on January 10, 2005 (Exchange Act Rel. No. 51002) (the "Order").

OPPORTUNITY FOR COMMENT

Pursuant to this Notice, all interested parties are advised that they may obtain a copy of the Distribution Plan from the Commission's public website, http://www.sec.gov, or by submitting a written request to Stephen Webster, Assistant Regional Director, United States Securities and Exchange Commission, 801 Cherry Street, 19th Floor, Fort Worth, Texas, 76102. All persons who desire to comment on the Distribution Plan may submit their comments, in writing, no later than thirty days from the date of this Notice:

1. to the Office of the Secretary, United States Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090;

2. by using the Commission's Internet comment form (http://www.sec.gov/litigation/admin.shtml); or

3. by sending an e-mail to rule-comments@sec.gov.

Comments submitted by email or via the Commission's website should include "Administrative Proceeding File Number 3-11793" in the subject line. Comments received will be available to the public. Persons should submit only information that they wish to make publicly available.

THE DISTRIBUTION PLAN

The Distribution Plan provides for distribution of disgorgement, civil penalties, and prejudgment interest in the amount of $10,276,002 paid by the Respondents. The proposed plan provides for distribution of the monies among the mutual funds that had marketing arrangements with the Respondents that are the subject of the Order during the period from October 2002 through September 2003; or, in the case of mutual funds that have been merged into other mutual funds, to their successors in interest. Accordingly, the funds are not being distributed according to a claims-made process.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 200

[Release No. 34-62821]

Delegation of Authority to the Director of its Division of Enforcement

Agency: Securities and Exchange Commission.

Action: Final rule.

SUMMARY: The Commission is amending its rules to delegate authority to the Director of the Division of Enforcement, in connection with the collection of delinquent debts arising from actions to enforce the federal securities laws, to terminate collection activity or discharge debts, to accept or reject offers to compromise debts, and to accept or reject offers to enter into payment plans. This action is intended to facilitate the Commission's debt resolution process.

EFFECTIVE DATE: [Insert date of publication in the Federal Register].

FOR FURTHER INFORMATION CONTACT: Kenneth H. Hall, 202-551-4936, Office of Chief Counsel, Division of Enforcement, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6553.

SUPPLEMENTARY INFORMATION: The Division of Enforcement seeks actively to collect amounts imposed in the civil actions that it files in federal district court and in administrative proceedings; these amounts represent disgorgement of ill-gotten gains from violations of the federal securities laws and civil penalties. The Division pursues debts through further litigation, including contempt proceedings, against the debtor, and is authorized to refer delinquent debts to the U.S. Department of the Treasury for administrative collection activity, including offset of debts against amounts otherwise owed by the government to the debtor and administrative garnishment of a debtor's wages.

Based upon a debtor's financial condition, as substantiated by creditable evidence, the Commission may determine to accept a debtor's offer to pay the debt in installments, or to compromise, *i.e.*, satisfy the debt by payment of a lesser amount than the outstanding balance. In addition, when all reasonable steps have been taken to collect a debt, the Commission may authorize its staff to terminate collection activity or discharge the debt. Termination of collection activity preserves the debt as an obligation of the debtor, and does not bar future activity to collect the debt should that become practicable. Discharge of the debt is essentially a forgiveness of the debtor's obligation to pay, which may have tax consequences for the debtor. The Commission is delegating to the Director of the Division of Enforcement the authority to resolve certain debts arising from actions to enforce the federal securities laws; in particular, the Director is authorized to terminate collection activity or discharge debts, to accept offers to compromise debts (when the principal amount of the debt is $5 million or less) or to reject any offers to compromise debts, and to accept or reject offers to enter into payment plans. This delegation will improve the efficiency of the Division's debt collection program.

In any case the Division Director deems appropriate, the recommendation that a debt be resolved through termination of collection activity, discharge or by payment plan or compromise, may be submitted to the Commission for review.

Administrative Law Matters:

The Commission finds, in accordance with Section 553(b)(3)(A) of the Administrative Procedure Act ("APA") (5 U.S.C. 553(b)(3)(A)) that this amendment relates solely to agency organization, procedure, or practice, and does not relate to a substantive rule. Accordingly, notice, opportunity for public comment, and publication of the amendment prior to its effective date are unnecessary. For the same reason, and because this amendment does not substantively affect the rights or obligations of non-agency parties, the provisions of the Small Business Regulatory Enforcement Fairness Act, 5 U.S.C. 804(3)(C), are not applicable. Additionally, the provisions of the Regulatory Flexibility Act, which apply only when notice and comment are required by the APA or other law, 5 U.S.C. 603, are not applicable. Section 23(a)(2) of the Securities Exchange Act of 1934, 15 U.S.C. 78w(a)(2), requires the Commission, in adopting rules under that Act, to consider the anticompetitive effects of any rules it adopts. The Commission does not believe that the amendment the Commission is adopting today will have any impact on competition. Finally, this amendment does not contain any collection of information requirements as defined by the Paperwork Reduction Act of 1980, as amended.

List of Subjects in 17 CFR Part 200

Administrative practice and procedure, Authority delegations (Government agencies).

Text of Amendment

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

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

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

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

* * * * *

2. Section 200.30-4 is amended by adding paragraph (a)(15) to read as follows:

§ 200.30-4 Delegation of authority to Director of Division of Enforcement.

* * * * *

(a) * * *

(15) With respect to debts arising from actions to enforce the federal securities laws, to terminate collection activity or discharge debts, to accept offers to compromise debts when the principal amount of the debt is $5 million or less, to reject offers to compromise debts, and to accept or reject offers to enter into payment plans.

* * * * *

By the Commission

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: September 1, 2010

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 240 and 249

Release No. 34-62824; File No. S7-19-10

RIN 3235-AK69

Temporary Registration of Municipal Advisors

AGENCY: **Securities and Exchange Commission.**

ACTION: **Interim final temporary rule; Request for comments.**

SUMMARY: The Commission is adopting an interim final temporary rule that establishes a means for municipal advisors, as defined in the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] ("Dodd-Frank Act"), to satisfy temporarily the requirement that they register with the Commission by October 1, 2010.

DATES: Effective Date: October 1, 2010 through December 31, 2011. Comments should be received on or before [insert date 30 days after date of publication in the Federal Register].

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/interim-final-temp.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File No. S7-19-10 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

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1 See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010).

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 No. S7-19-10. 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 website (http://www.sec.gov/rules/interim-final-temp.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 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: Martha Mahan Haines, Assistant Director and Chief, Office of Municipal Securities, at (202) 551-5681; Ira L. Brandriss, Special Counsel, Office of Market Supervision, at (202) 551-5651; Steve L. Kuan, Special Counsel, Office of Market Supervision, at (202) 551-5624; Rahman J. Harrison, Special Counsel, Office of Market Supervision, at (202) 551-5663; Steven Varholik, Special Counsel, Office of Market Supervision, at (202) 551-5615; Leigh W. Duffy, Attorney-Adviser, Office of Market Supervision, at (202) 551-2938; or any of the above at Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6628.

SUPPLEMENTARY INFORMATION:

The Commission is adopting new Rule 15Ba2-6T[2] under the Securities Exchange Act of 1934[3] (the "Exchange Act") as an interim final temporary rule. The rule will expire at 11:59 p.m. Eastern Time on December 31, 2011. The Commission is soliciting comments on all aspects of the interim final temporary rule. The Commission will carefully consider any comments received and intends to respond as necessary or appropriate. The Commission expects to consider a proposal for a final permanent registration program, including detailed requirements for the registration of municipal advisors, and to seek public comment on the proposal before its adoption. Persons interested in commenting on the final permanent municipal advisor registration program should submit comments to the subsequent proposal.

I. Introduction

As part of the Dodd-Frank Act, signed into law by President Obama on July 21, 2010, Congress amended Section 15B(a) of the Exchange Act[4] to, among other things, make it unlawful for municipal advisors, as defined below,[5] to provide certain advice or solicit municipal entities or certain other persons without registering with the Commission.[6] The registration requirement for municipal advisors becomes effective on October 1, 2010, meaning that

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2 17 CFR 240.15Ba2-6T.

3 15 U.S.C. 78a et seq.

4 15 U.S.C. 78o-4(a). All references in this Release to the Exchange Act refer to the Exchange Act as amended by the Dodd-Frank Act.

5 See infra Section II.A.

6 See Section 975(a)(1)(B) of the Dodd-Frank Act; 15 U.S.C. 78o-4(a)(1)(B).

municipal advisors must be registered on that date in order to continue their municipal advisory services.[7]

The Commission is today adopting, on an interim final temporary basis, new Rule 15Ba2-6T[8] under the Exchange Act, which will permit municipal advisors to temporarily satisfy the registration requirement. The adoption of Rule 15Ba2-6T serves as a transitional step to the implementation of a final permanent registration program, makes relevant information available to the public and municipal entities, and permits municipal advisors to continue their business after October 1, 2010. A municipal advisor may temporarily satisfy the statutory registration requirement by submitting certain information electronically through the Commission's public website on new Form MA-T, which is designed for this purpose.[9]

Because entry of information into Form MA-T will require establishing an account and securing access credentials (username and password) as explained in more detail below, municipal advisors are advised to allow ample time to establish an account and obtain such credentials and complete the form before October 1, 2010.[10] The form and instructions for

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7 See Section 975(i) of the Dodd-Frank Act.

8 17 CFR 240.15Ba2-6T.

9 17 CFR 249.1300T. A municipal advisor that completes the temporary registration form and receives confirmation from the Commission that the form was filed will be temporarily registered for purposes of Section 15B. See also infra notes 47-48 and accompanying text.

10 In order to establish an account and obtain access credentials with the temporary registration system for Form MA-T on the Commission's secure website, a submitter will need to fill out general user information fields such as name, address, phone number, e-mail address, organization name and employer identification number, and user account information (i.e., username and password), and to select and answer a security question. Once accepted by the temporary registration system, the submitter will receive an e-mail notification that the account has been established and the submitter will be able to access and complete Form MA-T. The Commission staff anticipates that submitters will ordinarily obtain access credentials the same day that they are requested. However, to avoid the possibility of delay, all municipal advisors are encouraged to allow ample time

requesting access credentials will be accessible through a link located on the Commission's website, www.sec.gov, beginning on or about September 1, 2010.

II. Discussion

Section 15B(a)(1) of the Exchange Act, as amended by Section 975(a)(1)(B) of the Dodd-Frank Act, makes it unlawful for a municipal advisor to provide advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, or to undertake a solicitation of a municipal entity or obligated person, unless the municipal advisor is registered with the Commission.[11] Section 15B(a)(2) of the Exchange Act, as amended by Section 975(a)(2) of the Dodd-Frank Act, provides that a municipal advisor may be registered by filing with the Commission an application for registration in such form and containing such information and documents concerning the municipal advisor and any person associated with the municipal advisor as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.

The Commission is adopting an interim final temporary rule, Rule 15Ba2-6T, in order to provide a method for municipal advisors to temporarily satisfy the statutory registration requirement of Section 15B(a)(1) of the Exchange Act (as amended by Section 975(a)(1) of the Dodd-Frank Act) until the Commission has promulgated a final permanent registration program. The interim final temporary rule will expire on December 31, 2011.

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to establish an account and obtain access credentials and complete Form MA-T by October 1, 2010.

11 For definitions of the terms "municipal entity," "obligated person," "municipal financial product," and "solicitation of a municipal entity or obligated person," see infra, notes 13-17.

As described in detail below, Form MA-T will require a municipal advisor to indicate the purpose for which it is submitting the form (i.e., initial application for, or amendment or withdrawal of temporary registration), provide certain basic identifying and contact information concerning its business, indicate the nature of its municipal advisory activities, and supply information about its disciplinary history and the disciplinary history of its associated municipal advisor professionals. The Commission carefully considered alternatives to the adoption of an interim final temporary rule before deciding to adopt Rule 15Ba2-6T. It considered, for example, whether it would be preferable to issue a broad-based exemption from the Dodd-Frank Act's registration requirement[12] in order to allow the Commission time to consider a final permanent registration program before municipal advisors would be required to submit any registration form. In light of the October 1, 2010 effective date that Congress set for Section 975 of the Dodd-Frank Act, delaying implementation of any registration for municipal advisors and not accommodating temporary registration would not appear to achieve the purposes intended by Congress in selecting an October 1, 2010 registration date.

The Commission also considered and weighed the relative costs and benefits of requiring disciplinary information in the context of the temporary registration contemplated by Form MA-T. The Commission has determined to require disclosure of disciplinary information on Form MA-T because of the value it will have for the Commission's oversight of municipal advisors and their activities in the municipal securities market, and because of the importance of such disciplinary information to investors, issuers and others in choosing a municipal advisor, engaging in transactions with a municipal advisor, or participating in transactions in municipal

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12 See Section 15B(a)(4) of the Exchange Act, as amended by Section 975(a)(4) of the Dodd-Frank Act.

securities issued in offerings for which a municipal advisor provided municipal advisory services.

The Commission believes that providing a temporary registration process for municipal advisors, pursuant to an interim final temporary rule effective on October 1, 2010, is a necessary and appropriate way to proceed, is consistent with the intent of Congress in enacting Section 975, and is a tailored way to provide investors and municipal entities with basic and important information quickly while the Commission considers a permanent registration program. The Commission requests comment generally on the decision to require temporary registration on Form MA-T and the specific information required to be reported on the form. The Commission also requests comment on the Commission's determinations discussed above and on whether there are alternatives not discussed above that the Commission should consider.

A. Definition of Municipal Advisor

Section 15B(e) of the Exchange Act, as amended by Section 975(e) of the Dodd-Frank Act, defines the term "municipal advisor" to mean a person (who is not a municipal entity or an employee of a municipal entity) (1) that provides advice to or on behalf of a municipal entity[13] or obligated person[14] with respect to municipal financial products[15] or the issuance of municipal

13 "Municipal entity" is defined to mean any State, political subdivision of a State, or municipal corporate instrumentality of a State, including: any agency, authority, or instrumentality of the State, political subdivision, or municipal corporate instrumentality; any plan, program, or pool of assets sponsored or established by the State, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof; and any other issuer of municipal securities. See Section 15B(e) of the Exchange Act, as amended by Section 975(e) of the Dodd-Frank Act.

14 "Obligated person" is defined to mean any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person, committed by contract or other arrangement to support the payment of all or part of the obligations on the municipal securities to be sold in an offering of municipal securities. See id.

securities,[16] including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues; or (2) that undertakes a solicitation[17] of a municipal entity. The definition specifically includes "financial advisors, guaranteed investment contract brokers, third-party marketers, placement agents, solicitors, finders, and swap advisors" that provide municipal advisory services.[18] The definition of "municipal advisor" explicitly excludes a broker, dealer, or municipal securities dealer serving as an underwriter,[19] as well as

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15 "Municipal financial product" is defined to mean municipal derivatives, guaranteed investment contracts, and investment strategies. "Investment strategies" includes plans or programs for the investment of the proceeds of municipal securities that are not municipal derivatives, guaranteed investment contracts, and the recommendation of and brokerage of municipal escrow investments. See id.

16 The statute specifically includes within the meaning of municipal advisor, someone who provides advice with respect to the structure, timing, terms, and other similar matters concerning municipal financial products or issues. See id.

17 "Solicitation of a municipal entity or obligated person" is defined to mean a direct or indirect communication with a municipal entity or obligated person made by a person, for direct or indirect compensation, on behalf of a broker, dealer, municipal securities dealer, municipal advisor, or investment adviser (as defined in Section 202 of the Investment Advisers Act of 1940, 15 U.S.C. 80b-2) that does not control, is not controlled by, or is not under common control with the person undertaking such solicitation for the purpose of obtaining or retaining an engagement by a municipal entity or obligated person of a broker, dealer, municipal securities dealer, or municipal advisor for or in connection with municipal financial products, the issuance of municipal securities, or of an investment adviser to provide investment advisory services to or on behalf of a municipal entity. See id.

18 These entities, however, are only included if they provide advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities (including advice with respect to the structure, timing, terms and other similar matters concerning such financial products or issues) or undertake a solicitation of a municipal entity. See Section 975(e) of the Dodd-Frank Act. The term "municipal advisory services" as used herein means advice with respect to municipal financial products, the issuance of municipal securities, and the solicitation of a municipal entity.

19 The term "underwriter" is defined in Section 2(a)(11) of the Securities Act of 1933. 15 U.S.C. 77b(a)(11). A broker, dealer or municipal securities dealer who provides municipal advisory services while acting in a capacity other than as an underwriter would, however, be a municipal advisor.

attorneys offering legal advice or providing services that are of a traditional legal nature and engineers providing engineering advice are also excluded.[20]

The Dodd-Frank Act also excludes from the definition "any investment adviser registered under the Investment Advisers Act of 1940, or persons associated with such investment advisers who are providing investment advice."[21] The Commission interprets this exclusion to mean that a registered investment adviser or an associated person of a registered investment adviser is excluded from the definition of "municipal advisor" if the investment adviser or associated person of the adviser provides municipal advisory services, so long as those services are investment advice for purposes of the Investment Advisers Act. A registered investment adviser or an associated person of a registered investment adviser must register with the Commission as a municipal advisor if the adviser or associated person of an adviser provides any municipal advisory services other than investment advice within the meaning of the Investment Advisers Act.[22]

The Commission similarly interprets the exclusion in the Dodd-Frank Act of "any commodity trading advisor registered under the Commodity Exchange Act or persons associated with a commodity trading advisor who are providing advice related to swaps." Accordingly, a commodity trading advisor or any person associated with a commodity trading advisor is excluded from the definition of "municipal advisor" if the commodity trading advisor or associated person of the commodity trading advisor provides municipal advisory services, so long as those services are advice related to swaps. A commodity trading advisor or an associated

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20 Id.

21 See Section 975(e) of the Dodd-Frank Act.

22 The Commission believes that such interpretation is in furtherance of the goals of the Dodd-Frank Act to regulate municipal advisors, a category of persons previously unregulated.

person of a commodity trading advisor must register with the Commission as a municipal advisor if the commodity trading advisor or an associated person of a commodity trading advisor provides any municipal advisory services that are not advice related to swaps.

B. Temporary Registration on Form MA-T

Pursuant to new Rule 15Ba2-6T, as of October 1, 2010, in order temporarily to satisfy the new registration requirement for municipal advisors, and thereby legally be permitted to perform, or continue to perform, municipal advisory services, a municipal advisor will need to have completed and submitted new Form MA-T through the Commission's website at www.sec.gov by October 1, 2010. Because entry of information into Form MA-T will require the securing of access credentials, as explained in more detail below, municipal advisors are advised to allow ample time to establish an account and obtain access credentials (username and password) and complete the form by October 1, 2010. Form MA-T will require a municipal advisor to indicate the purpose for which it is submitting the form (i.e., initial temporary registration, amendment to temporary registration, or withdrawal from temporary registration), provide certain basic identifying and contact information concerning its business, indicate the nature of its municipal advisory activities, and supply information about its disciplinary history and the disciplinary history of its associated municipal advisor professionals.[23]

More specifically, the information to be supplied will include:

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23 Every temporary registration and each amendment to a temporary registration or withdrawal from temporary registration filed pursuant to the rule shall constitute a "report" within the meaning of Sections 15B(c), 17(a), 18(a) and 32(a) and other applicable provisions of the Exchange Act. See Rule 15Ba2-6T(c). As a consequence, it would be unlawful for a municipal advisor to willfully make or cause to be made, a false or misleading statement of a material fact or omit to state a material fact in the Form MA-T.

Basic Information

1. Purpose for submission of Form MA-T. A municipal advisor must indicate whether it is submitting the form for initial temporary registration as a municipal advisor, is submitting an amendment to a temporary registration as a municipal advisor, or is submitting a withdrawal from temporary registration as a municipal advisor. If the municipal advisor is submitting an amendment or withdrawing from temporary registration, it will also be necessary to provide the Municipal Advisor Registration Number assigned to the municipal advisor at the time of its initial temporary registration. This information is needed in order to determine the purpose for which Form MA-T is being submitted and to appropriately cross-reference amendments and withdrawals to the original temporary registration. The inclusion of these items will allow the same form, Form MA-T, to be used for multiple purposes: initial temporary registration, amendments to temporary registrations and withdrawals from temporary registration.

   The Commission seeks comment on the use of Form MA-T for these three purposes, whether use of the same form for multiple purposes may be confusing for registrants, and whether it would be preferable to have a separate form for each of these purposes. Will these requirements be confusing or otherwise difficult for a municipal advisor to comply with?

2. Identifying and contact information. A municipal advisor must indicate the full legal name of the municipal advisor and, if different, the name under which it conducts its business, the address of its principal office and place of business, the telephone number and the facsimile number, if any, at that location, and its general e-mail address and website, if any. In addition, the municipal advisor must supply its mailing address, if it

is different from its principal office and place of business, as well as the name and title of a person whom the municipal advisor has authorized to receive information and respond to questions about the registration (the "contact person") and the address, telephone number and facsimile number, if any, and e-mail address, if any, of the contact person.

The Commission is requesting this identifying and contact information to determine whether a particular municipal advisor has submitted a temporary registration, to contact a person at the municipal advisor if Commission staff have any questions or wish to arrange for an inspection, and to send information to the municipal advisor.

The Commission requests comment concerning the appropriateness of requiring this identifying and contact information, including whether additional information should be required or whether different information would be better suited for this purpose. In particular, might it be confusing or otherwise difficult for a municipal advisor to supply this information?

3. Other regulatory identifying information. Form MA-T also requires a municipal advisor to provide its Employer Identification Number (used with respect to Internal Revenue Service matters), but not – in the case of a sole proprietor, for example – a Social Security Number. If the municipal advisor is also registered with the Commission as an investment adviser, broker, dealer, or municipal securities dealer, it will be required to provide its related SEC file number or numbers. In addition, if the municipal advisor has a number (a "CRD Number") assigned to it either under the Financial Industry Regulatory Authority's ("FINRA") Central Registration Depositary ("CRD") system or the Investment Adviser Registration Depository ("IARD") system, it will be required to provide its CRD Number.

The Commission seeks this information to more effectively cross-reference those entities registered as municipal advisors to those who are registered as brokers, dealers, municipal securities dealers or investment advisers. This ability to cross-reference will allow the Commission to assemble more complete information concerning a municipal advisor who is also registered as a broker, dealer, municipal securities dealer or investment adviser and to plan for and carry out efficient and effective examinations of such entities.[24] In addition, by obtaining all of a registrant's regulatory file numbers, the Commission will be able to cross-reference disciplinary information that is submitted to the CRD or IARD systems with that submitted on Form MA-T.

The Commission seeks comment concerning the requirement to supply SEC file numbers and CRD Numbers. Will this requirement be confusing or otherwise difficult for a municipal advisor to comply with? Would the use of other identifying numbers be more useful or appropriate or should no identifying numbers be required?

Nature of Municipal Advisory Activities

Form MA-T requires the municipal advisor to indicate the general types of municipal advisory services that it provides. The following eight activities are listed, together with a checkbox for each: (1) advice concerning the issuance of municipal securities, (2) advice concerning the investment of the proceeds of municipal securities, (3) advice concerning guaranteed investment contracts, (4) recommendation and/or brokerage of municipal escrow investments, (5) advice concerning the use of municipal derivatives (e.g., swaps), (6) solicitation of business from a municipal entity or obligated person for an unaffiliated person or firm (e.g., third party marketers, placement agents, solicitors and finders), (7) preparation of feasibility

[24] See 15 U.S.C. 78o-4(c)(7).

studies, tax or revenue projections, or similar products in connection with offerings or potential offerings of municipal securities, and (8) other. Registrants who check "other" activities will be required to provide a narrative description of such activities. Activities one to six above are derived from the definition of municipal advisor in the Dodd-Frank Act.[25] Activity number seven above (the preparation of feasibility studies, tax or revenue projections, or similar products in connection with offerings or potential offerings of municipal securities) was included because these services are sometimes provided by financial advisors (some of whom may be municipal advisors) to municipal entities. This information, together with information under item eight (other), will assist the Commission in understanding the scope of activities in which a municipal advisor engages.

The Commission is seeking this information in order to better understand the activities of municipal advisors. This information is necessary to understand the basis for registration and will assist Commission staff to better plan and prepare for inspections and examinations[26] of municipal advisors.

The Commission seeks comment concerning the requirement for a municipal advisor to supply information in Form MA-T concerning the general types of municipal advisory services it provides. In particular, will it be confusing or otherwise difficult for a municipal advisor to provide this information? Are the categories of municipal advisory services appropriate or should additional or other categories be included? Are there considerations relating to the business of municipal advisors, or of some types of municipal advisors, that the Commission may not have taken into account in connection with this list of municipal advisory services?

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25 See Section 15B(e)(4) of the Exchange Act as added by Section 975(e)(4) of the Dodd-Frank Act.

26 See Section 17(a)(1) of the Exchange Act, as amended by Section 975(h) of the Dodd-Frank Act.

Disciplinary Matters

Section 975 of the Dodd-Frank Act amended section 15B of the Exchange Act to direct the Commission, by order, to censure, place limitations on the activities, functions, or operations, suspend for a period not exceeding twelve months, or revoke the registration of any municipal advisor, if it finds [27] that such municipal advisor has committed or omitted any act, or is subject to an order or finding, enumerated in subparagraph (A),[28] (D),[29] (E),[30] (H),[31] or (G)[32] of paragraph (4) of section 15(b) of the Exchange Act; has been convicted of any offense specified Section 15(b)(4)(B)[33] of the Exchange Act within ten years of the commencement of the proceedings under section 15(c); or is enjoined from any action, conduct, or practice specified in Section 15(b)(4)(C)[34] of the Exchange Act.[35] Item 3 of Form MA-T includes questions intended to solicit information from a municipal advisor concerning any of its activities or activities of certain of its associated persons that could subject the municipal advisor to disciplinary actions by the Commission under such subparagraphs of Section 15(b)(4) of the Exchange Act.

In addition to its value generally for the Commission's oversight of the municipal securities markets, the Commission seeks this information because it may indicate that a

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27 Such findings must be on the record after notice and opportunity for hearing and include a finding that the particular disciplinary action is in the public interest. See Section 15B(c)(2) of the Exchange Act, as amended by Section 975(c)(3) of the Dodd-Frank Act. See also 17 CFR 201.

28 See 15 U.S.C. 78o(b)(4)(A).

29 See 15 U.S.C. 78o(b)(4)(D).

30 See 15 U.S.C. 78o(b)(4)(E).

31 See 15 U.S.C. 78o(b)(4)(H).

32 See 15 U.S.C. 78o(b)(4)(G).

33 See 15 U.S.C. 78o(b)(4)(B).

34 See 15 U.S.C. 78o(b)(4)(C).

35 The Commission has the same authority with respect to municipal securities dealers. See 15 U.S.C. 78o-4(c).

municipal advisor could be statutorily disqualified from acting as a municipal advisor.[36] In addition, the Commission wishes to make this important information available to municipal entities and obligated persons who engage municipal advisors and to investors who may purchase securities from offerings in which municipal advisors participated.

The disciplinary information to be disclosed is substantially similar to the information required to be disclosed in Form BD for broker-dealers.[37] Specifically, Form MA-T asks questions concerning the disciplinary history of the municipal advisor and of its associated municipal advisor professionals. The Commission defines the term "associated municipal advisor professional" in the glossary section of Form MA-T to mean: (A) any associated person of a municipal advisor primarily engaged in municipal advisory activities; (B) any associated person of a municipal advisor who is engaged in the solicitation of municipal entities or obligated persons; (C) any associated person who is a supervisor of any persons described in subparagraphs (A) or (B); (D) any associated person who is a supervisor of any person described in subparagraph (C) up through and including, the Chief Executive Officer or similarly situated official designated as responsible for the day-to-day conduct of the municipal advisor's municipal advisory activities; and (E) any associated person who is a member of the executive or management committee of the municipal advisor or a similarly situated official, if any; and excludes any associated person whose functions are solely clerical or ministerial. The definition of associated municipal finance professional is derived from the definition of "municipal finance professional" set forth in Rule G-37 of the Municipal Securities Rulemaking Board.

The Commission has chosen to limit this inquiry to a subgroup (associated municipal advisor professionals) for purposes of temporary registration in order to obtain information about

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36 See id.

37 17 CFR 249.501.

those associated persons[38] who are closely associated with an advisor's municipal advisory activities, i.e., those who are primarily engaged in an advisor's municipal advisory activities, have supervisory responsibilities over those primarily engaged in municipal advisory activities, are engaged in day-to-day management of the conduct of an advisor's municipal advisory activities, or are responsible for executive management of the advisor. The Commission believes this is an appropriate definition to use for purposes of temporary registration because it will allow the Commission to obtain, and municipal entities, obligated persons and investors to have access to, information about those persons who may be most relevant to an advisor's municipal advisory services, while excluding information about persons at a firm whose activities may have less bearing on the provision of such services.

The Commission seeks comment concerning whether this limitation is appropriate, whether it excludes persons whose disciplinary history may be relevant to a municipal advisor's activities, or whether it includes persons whose disciplinary history is not sufficiently relevant to a municipal advisor's activities to warrant disclosure. In addition, the Commission solicits specific suggestions as to how the disclosure regarding associated persons whose actions are covered by Item 3 of Form MA-T might be improved for purposes of a permanent registration program or whether the current limitation to associated municipal advisory professionals is suitable.

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38 Section 15B(e)(7) of the Exchange Act, added by Section 975(e) of the Dodd-Frank Act, defines "associated person of a municipal advisor" as any partner, officer, director, or branch manager of a municipal advisor (or any person occupying a similar status or performing similar functions); any other employee of a municipal advisor who is engaged in the management, direction, supervision, or performance of any activities relating to the provision of advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities; and any person directly or indirectly controlling, controlled by, or under common control with a municipal advisor, or an employee of a municipal advisor.

In addition, the Commission notes that the time-period limits for disclosure on Form MA-T are consistent with the disclosure reporting requirements on Form BD, adopted pursuant to Section 15(b)(4) of the Exchange Act. Specifically, with respect to felonies and misdemeanors involving investments or an investment-related business, Form MA-T requires disclosures of matters within the last ten years. With respect to whether the municipal advisor or any associated municipal advisor professional was enjoined by any domestic or foreign court in connection with any investment-related activity, Form MA-T similarly requires disclosures of matters within the last ten years. Disclosure is also required concerning any orders entered against the municipal advisor or any associated municipal advisor professional by any federal or state regulatory agency other than the SEC and Commodity Futures Trading Commission ("CFTC")[39] or by any foreign financial regulatory authority within the last ten years.

With respect to all other matters identified on Form MA-T (including federal, state, and foreign regulatory actions and actions taken by self-regulatory organizations), no time limit is placed on disclosure. The Commission believes that it is important to collect information about matters within these timeframes because, under the Exchange Act, the Commission could use such matters to form the basis for an action to suspend or revoke a municipal advisor's registration.[40]

The Commission seeks comment concerning these timeframes in connection with temporary registration of municipal advisors. Would the public and municipal entities find the full history of disciplinary information important and useful? Are these timeframes too long,

39 With regard to the orders entered by SEC and CFTC, no time limit is placed on disclosure. See infra Item 3(d).

40 See Section 15B(c)(2) of the Exchange Act.

such that they require disclosure of information that is no longer useful, or such that they impose an undue burden on applicants for temporary registration?

More specifically, Form MA-T asks the following, which are, in substance, the same as the disciplinary questions asked in Form BD:

1. Whether, in the past ten years, the municipal advisor or any associated municipal advisor professional has been convicted of or pled guilty or nolo contendere ("no contest") in a domestic, foreign, or military court to any felony or been charged[41] with any felony?
2. Whether in the past ten years, the municipal advisor or any associated municipal advisor professional has been convicted of or pled guilty or nolo contendere ("no contest") in a domestic, foreign, or military court to a misdemeanor involving: investments or an investment-related business, or any fraud, false statements, or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, extortion, or a conspiracy to commit any of these offenses or has been charged[42] with a misdemeanor involving such actions?
3. Whether the SEC or the CFTC has ever: (a) found the municipal advisor or any associated municipal advisor professional to have made a false statement or omission, (b) found the municipal advisor or any associated municipal advisor professional to have been involved in a violation of its regulations or statutes, (c) found the municipal advisor or any associated municipal advisor professional to have been a cause of an investment-related business having its authorization to do business

41 The Commission notes that a municipal advisor only needs to report charges that are currently pending.

42 The Commission notes that a municipal advisor only needs to report charges that are currently pending.

denied, suspended, revoked, or restricted, (d) entered an order against the municipal advisor or any associated municipal advisor professional in connection with investment-related activity, or (e) imposed a civil money penalty on the municipal advisor or any associated municipal advisor professional, or ordered the municipal advisor or any associated municipal advisor professional to cease and desist from any activity.

4. Whether any other federal regulatory agency, any state regulatory agency, or any foreign financial regulatory authority has (a) ever found the municipal advisor or any associated municipal advisor professional to have made a false statement or omission, or been dishonest, unfair, or unethical, (b) ever found the municipal advisor or any associated municipal advisor professional to have been involved in a violation of investment-related regulations or statutes, (c) ever found the municipal advisor or any associated municipal advisor professional to have been a cause of an investment-related business having its authorization to do business denied, suspended, revoked, or restricted, (d) in the past ten years, entered an order against the municipal advisor or any associated municipal advisor professional in connection with an investment-related activity, or (e) ever denied, suspended, or revoked the municipal advisor's or any associated municipal advisor professional's registration or license, or otherwise prevented the municipal advisor or any associated municipal advisor professional, by order, from associating with an investment-related business or restricted the municipal advisor's or any associated municipal advisor professional's activity.
5. Whether any self-regulatory organization or commodities exchange has ever (a) found the municipal advisor or any associated municipal advisor professional to have

made a false statement or omission, (b) found the municipal advisor or any associated municipal advisor professional to have been involved in a violation of its rules (other than a violation designated as a "minor rule violation" under a plan approved by the SEC), (c) found the municipal advisor or any associated municipal advisor professional to have been the cause of an investment-related business having its authorization to do business denied, suspended, revoked, or restricted, or (d) disciplined the municipal advisor or any associated municipal advisor professional by expelling or suspending it from membership, barring or suspending its association with other members, or otherwise restricting its activities.

6. Whether the municipal advisor's or any associated municipal advisor professional's authorization to act as an attorney, accountant, or federal contractor has ever been revoked or suspended.
7. Whether the municipal advisor or any associated municipal advisor professional is now the subject of any regulatory proceeding that could result in a "yes" answer to any part of the questions described in 3, 4 or 5 above.
8. Whether any domestic or foreign court has: (a) in the last ten years, enjoined the municipal advisor or any associated municipal advisor professional in connection with any investment-related activity, (b) ever found that the municipal advisor or any associated municipal advisor professional was involved in a violation of investment-related statutes or regulations, or (c) ever dismissed, pursuant to a settlement agreement, an investment-related civil action brought against the municipal advisor or any associated municipal advisor professional by a state or foreign financial regulatory authority?

9. Whether the municipal advisor or any associated municipal advisor professional is now the subject of any civil proceeding that could result in a "yes" answer to any part of question 8 above.

If a municipal advisor answers "yes" to any of these questions, a text box will require a brief narrative of the event or a cross-reference to disclosure of the event made through the broker-dealer or investment advisor public disclosure systems.

The Commission requests comments on all aspects of these disciplinary questions, including their appropriateness and adequacy, whether there are additional or other questions that should be included, and whether they will impose an excessive burden on municipal advisors to answer. In addition, the Commission requests comment concerning whether including the disciplinary questions in Form MA-T will impose undue hardship on, or have other consequences for, small municipal advisors. Furthermore, comment is solicited as to whether the ability to cross-reference to disciplinary disclosures on Form BD and Form ADV for investment advisers[43] will make it more difficult for municipal entities, obligated persons, investors and others to obtain this information than if it were included in Form MA-T itself. In addition, will the ability of municipal advisors to cross-reference such disclosures on Forms BD and ADV significantly reduce the burden on municipal advisors, and particularly small advisors, to complete Form MA-T?

Execution

With respect to execution of Form MA-T, the person who signs the form will be required to depose and say that he or she has executed the form on behalf of the municipal advisor and with its authority. With this execution, both the person who signs the form and the municipal

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[43] 17 CFR 279.1.

advisor must represent that the information and statements made in Form MA-T are current, true and complete. The municipal advisor also will be required to consent to service of any civil action or notice of any proceeding before the Commission or self-regulatory organization regarding its advisory services via registered or certified mail to its named contact person. This is consistent with the execution provisions of Forms BD and ADV, but deletes references to state registration, bonding requirements and other inapplicable components.

The individual who signs the Form MA-T depends upon the form of organization of the municipal advisor:

- For a sole proprietorship, the sole proprietor should sign.
- For a partnership, a general partner should sign.
- For a corporation, an authorized principal officer should sign.
- For all others, an authorized individual who participates in managing or directing the municipal advisor's affairs should sign.

The Commission requests comment concerning the representations required of a person who executes Form MA-T, such as whether there should be additional or alternative representations. In addition, the Commission solicits comment regarding the requirement that the municipal advisor submit to service of process in the manner described. Would there be alternative methods to obtain such consent or should such consent not be obtained?

Amendment, Withdrawal, and Rescission

Rule 15Ba2-6T requires that a municipal advisor promptly amend Sections 1 or 3 of Form MA-T if the information therein becomes inaccurate in any way and whenever a municipal advisor wishes to withdraw from registration. A municipal advisor can amend its Form MA-T on the Commission's website by accessing Form MA-T and checking the box in Item 1 for an amendment and providing updated information in the relevant sections of the form. Similarly, a municipal advisor can withdraw its registration by accessing Form MA-T on the Commission's website and by checking the box for withdrawal on the form. In addition, pursuant to Rule 15Ba2-6T, the Commission may rescind a municipal advisors' temporary registration following notice and hearing in accordance with the Commission's Rules of Practice.[44]

Instructions and Glossary

Form MA-T includes a set of instructions for its proper completion and submission, and a glossary of terms intended, in part, to help participants in the municipal securities industry in determining whether they are municipal advisors and thus required to register. These instructions and glossary are attached to this release, together with Form MA-T. The definitions in the glossary (except for the definition of associated municipal advisor professional discussed above[45]) are derived from Form ADV and the terms in the Exchange Act, including Section 975(e) of the Dodd-Frank Act.[46] The instructions are intended to answer basic questions

44 See supra note 23.

45 See supra text accompanying notes 37-38.

46 The following definitions in the glossary were taken from Form ADV (17 CFR 279.1): "Affiliate," "Charged," "Control," "Employee," "Enjoined," "Felony," "FINRA CRD or CRD," "Foreign Financial Regulatory Authority," "Found," "Investment-Related," "Involved," "Minor Rule Violation," "Misdemeanor," "Order," "Person," "Principal Place of Business or Principal Office and Place of Business," "Proceeding," "Related Person," and "Self-Regulatory Organization or SRO." The Commission believes that it is appropriate to conform the definitions for these terms in Form MA-T to the definitions used in Form ADV because the information sought will be used for similar purposes. In addition, inconsistency in the definitions could create unnecessary uncertainty and confusion for municipal advisors, some of whom also must file Form ADV. The following definitions in the glossary were taken from the Section 975(e) of the Dodd-Frank Act: "Associated Person of a Municipal Advisor," "Guaranteed Investment Contract," "Investment Strategies," "Municipal Advisor," "Municipal Entity," "Municipal Financial Product," "Obligated Person," and "Solicitation of a Municipal Entity or Obligated Person." "IARD" is a FINRA definition. See supra text accompanying notes 37-38 for the definition of "associated municipal advisor professional."

concerning completion of the form. Comments are requested on all aspects of the form, instructions and glossary. For example, comments are solicited concerning whether the definitions and instructions are clear and useful to a submitter and how they might be improved. In addition, comments are solicited concerning whether additional instructions or definitions would be useful.

Timing Issues

As noted above, current municipal advisors are required by statute to register with the Commission by October 1, 2010. Municipal advisors are advised to allow ample time to establish an account and obtain access credentials (username and password) and complete the on-line version of Form MA-T by the statutory deadline.

In order to establish an account and obtain access credentials to the temporary registration system for filing Form MA-T on the Commission's secure website, a submitter will need to fill out general user information fields such as name, address, phone number, e-mail address, organization name and employer identification number, and user account information (i.e., username and password), and to select and answer a security question. Once accepted by the temporary registration system, the submitter will receive an e-mail notification that the account has been established and the submitter will be able to access and complete Form MA-T. The Commission anticipates that submitters will ordinarily obtain access credentials the same day that they are requested. To avoid the possibility of delay, municipal advisors are encouraged to allow ample time to establish an account and obtain access credentials and submit Form MA-T before October 1, 2010.

Form MA-T will be accessible through a link located on the Commission's website, www.sec.gov, beginning on or about September 1, 2010, at which time municipal advisors will be able to submit forms for temporary registration and to amend and withdraw such registrations through the Commission's website. Each Form MA-T, including each amendment to a temporary registration or withdrawal from temporary registration, is considered filed with the Commission upon its completion on the Commission web page established for that purpose and the Commission has sent confirmation that the form was filed to the municipal advisor.

A municipal advisor that completes the temporary registration form and receives confirmation from the Commission that the form was filed will be temporarily registered for purposes of Section 15B[47] until the earlier of: (1) the date that the municipal advisor's registration is approved or disapproved by the Commission pursuant to a final rule adopted by the Commission establishing another manner of registration of municipal advisors and prescribing a form for such purpose;[48] (2) the date on which the municipal advisor's temporary registration is rescinded by the Commission; or (3) the expiration of the interim final temporary rule on December 31, 2011. Comment is requested concerning the December 31, 2011 expiration date; would an earlier or later date be more appropriate?

III. Other Matters

The Administrative Procedure Act generally requires an agency to publish notice of a proposed rulemaking in the Federal Register.[49] This requirement does not apply, however, if the agency "for good cause finds . . . that notice and public procedure are impracticable, unnecessary, or contrary to the public interest."[50] Further, the Administrative Procedure Act also generally requires that an agency publish an adopted rule in the Federal Register 30 days before

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47 See supra note 9.

48 Approval of a municipal advisor's registration under the final permanent rule will replace and supersede a temporary registration.

49 See 5 U.S.C. 553(b).

50 See id.

it becomes effective.[51] This requirement does not apply, however, if the agency finds good cause for making the rule effective sooner.[52] The Commission finds, for good cause, that notice and solicitation of comment before adopting the new rules are impracticable, unnecessary, or contrary to the public interest.

For the reasons discussed throughout this release, the Commission finds good cause to act immediately to adopt these rules on an interim final temporary basis. The Dodd-Frank Act amended Section 15B(a)(2) of the Exchange Act to provide that, effective on October 1, 2010, "[i]t shall be unlawful for a municipal advisor to provide advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, or to undertake a solicitation of a municipal entity or obligated person, unless the municipal advisor is registered…" with the Commission.[53] The Commission is adopting an interim final temporary rule in order to allow municipal advisors temporarily to satisfy the registration requirement in order that they may continue to act as municipal advisors on and after October 1, 2010. Absent such means to register, municipal advisors would likely have to cease providing all municipal advisory services, which may have a significant adverse impact on their businesses and on municipal entities and obligated persons engaged in issuing municipal securities or other activities for which they obtain the advice of a municipal advisor. Some municipal entities and obligated persons do not access the capital markets frequently and depend heavily on their municipal advisors in connection with offerings of municipal securities. In addition, some municipal entities and obligated persons, such as large or frequent issuers, often have complex financial plans and large borrowing needs and use municipal advisors to

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51 See 5 U.S.C. 553(d).

52 See id.

53 See Section 975(a) of the Dodd-Frank Act.

supply independent, expert advice concerning long term financial planning and the use of swaps and other sophisticated financial products. The interim final temporary rule is designed to provide a method by which municipal advisors may continue to provide municipal advisory services to municipal entities and obligated persons without violating Section 15B(a)(2) of the Exchange Act.

The Commission is requesting comments on the interim final temporary rule and will carefully consider any comments received and respond to them as necessary or appropriate. The interim final temporary rule will expire on December 31, 2011. Setting a termination date for the interim final temporary rule will necessitate further Commission action no later than the end of that period. The Commission finds that there is good cause to have the rule effective as an interim final temporary rule on October 1, 2010, and that notice and public procedure in advance of effectiveness of the interim final temporary rule are impracticable, unnecessary and contrary to the public interest.[54]

IV. Paperwork Reduction Act

A. Background

Rule 15Ba2-6T and Form MA-T contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("Paperwork Reduction Act" or "PRA").[55] The title for the collection of information is "Temporary Registration of Municipal Advisors – Form MA-T" and the OMB control number for the collection of information is 3235-0659.

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[54] This finding also satisfies the requirements of 5 U.S.C. 808(2), allowing the rule and form to become effective notwithstanding the requirement of 5 U.S.C. 801 (if a federal agency finds that the notice and public comment are "impracticable, unnecessary or contrary to the public interest," a rule "shall take effect at such time as the federal agency promulgating the rule determines").

[55] 44 U.S.C. 3501 et seq.

The Commission has submitted these requirements to the Office of Management and Budget ("OMB") for review and approval in accordance with 44 U.S.C. 3507(j) and 5 CFR 1320.13. Separately, the Commission has submitted the collection of information to OMB for review and approval in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. OMB has approved the collection of information related to Form MA-T on an emergency basis with an expiration date of March 31, 2011.

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. As discussed above, Section 15B of the Exchange Act, as amended by the Dodd-Frank Act, requires municipal advisors (as defined in Section 975 of the Dodd-Frank Act) to register with the Commission by October 1, 2010.[56] As a transitional step to the implementation of a final permanent registration program, the Commission is today adopting, on an interim final basis, new Rule 15Ba2-6T, which will permit municipal advisors to temporarily satisfy the registration requirement.

Rule 15Ba2-6T and Form MA-T will require a municipal advisor to:

- Provide, in Item 1 of Form MA-T, basic identifying information, including name; address; telephone number; e-mail address; fax number and website address, if any; and Employer Identification Number (but not Social Security Number, in the case, for example, of a sole proprietor). If the municipal advisor is also registered with the Commission as an investment adviser, broker, dealer, or municipal securities dealer, it will be required to provide its Commission file number(s), and will be required to provide its CRD number under FINRA's CRD system or under IARD, if it has one;

56 See paragraphs (a) and (i) of Section 975 of the Dodd-Frank Act.

- Indicate, in Item 2 of Form MA-T, what type of municipal advisory services it provides by checking one or more of seven activities listed on Form MA-T and/or by describing any other activities; and
- Answer "Yes" or "No" in Item 3 of Form MA-T to approximately 24 questions concerning any convictions of – or any guilty or nolo contendere pleas by – the municipal advisor or any of its associated municipal advisor professionals in a felony case over the last ten years, and any pending felony charges. It will also ask for information regarding the municipal advisor or any of its associated municipal advisor professionals concerning any convictions, guilty or nolo contendere pleas, or pending charges with respect to a misdemeanor or conspiracy to commit an offense involving investments or investment-related business, fraud, false statements, omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, or extortion during the last ten years. Form MA-T will similarly require disclosure of disciplinary sanctions imposed by the Commission, the Commodity Futures Trading Commission, and other federal, state, or foreign regulatory authorities, or by self-regulatory agencies, organizations and commodity exchanges. In addition, it will inquire about injunctions issued by domestic or foreign courts in connection with investment-related activities, adverse findings by such courts concerning investment-related statutes or regulations and pending civil proceedings that could result in an injunction or finding.

On the execution page of Form MA-T, the municipal advisor will be required to consent to service of any civil action brought by, or notice of proceeding before the Commission or SRO in connection with its municipal advisory services via registered or certified mail or confirm telegram to its contact person. The signatory of Form MA-T on behalf of, and with the authority of, the municipal advisor will be required to represent that the information and statements contained in Form MA-T are current, true, and complete.

Completion of Item 1 of Form MA-T involves supplying basic identifying information that should be readily available to municipal advisors. Item 2 of Form MA-T describes seven types of services that may be provided by a municipal advisor, and an applicant is asked to check one or more boxes to identify any type that applies to it. If the municipal advisor provides other municipal advisory services that are not listed in the check-box list, the municipal advisor must provide a narrative description of the services. The Commission estimates that the paperwork burden of Items 1 and 2 will be approximately one-half hour.

Providing answers to the questions on Item 3 of Form MA-T entails gathering the accurate disciplinary history information regarding the municipal advisor and its associated municipal advisor professionals. Form MA-T will permit disciplinary actions previously reported in connection with other filings (such as Form BD, Form ADV, or Form U4) to be provided by referencing such other filings. The Commission notes, however, that, while an "associated person of a municipal advisor," as defined under the Dodd-Frank Act, includes a broad category of control persons and employees,[57] the information that must be provided in Item 3 of Form MA-T concerns a smaller subset of persons of this category, namely "municipal advisor professionals." A municipal advisor professional for these purposes is defined to include only persons who are directly engaged in municipal advisory activities, persons in the

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57 See Section 975(e) of the Dodd-Frank Act.

supervisory chain overseeing these activities, and members of the executive or management committees of the municipal advisor.[58]

The Commission believes that the size of municipal advisors will likely range from sole proprietorships to large firms, and will include firms that provide municipal advisory services as part of a broader array of financial services serving many types of clients, and may have many associated municipal advisor professionals. Thus the paperwork burden will vary from applicant to applicant, depending on its size.

The Commission has previously estimated that, in the case of Form ADV – a similar, but far more comprehensive form than Form MA-T, which must be completed for the registration of investment advisers – the average time necessary to complete the form is approximately 4.32 hours, and that estimate has been subject to notice and comment. The Commission believes that the paperwork burden of completing Form MA-T will be less than this amount of time because this form is less comprehensive than Form ADV and will thus require less time to complete. The Commission estimates that the average amount of time for a municipal advisor to complete Form MA-T is approximately 2.5 hours. This estimate includes all of the time necessary to research, evaluate, and gather all of the information that is requested in the form and all of the time necessary to complete and submit the form.[59]

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58 See supra text accompanying notes 37-38.

59 The Commission notes that some municipal advisors that are required to register under Rule 15Ba2-6T will also be registered with the Commission as broker-dealers and/or investment advisers. The Commission believes that these persons could require less time to research and complete this temporary registration process to the extent information contained in those other registration(s) can be cross-referenced, avoiding the need to repeat information on Form MA-T.

Based on discussions with the MSRB, the Commission estimates that approximately 1,000 municipal advisors will be required to complete Form MA-T.[60] Thus, the total burden hours will be approximately 2,500 hours.

Once a municipal advisor temporarily satisfies the registration requirement, the municipal advisor must promptly amend Form MA-T when information concerning Items 1 or 3 on Form MA-T becomes inaccurate or to withdraw from registration. The Commission estimates that the average time necessary to complete an amended form would be approximately 30 minutes because only certain parts of the form will be completed for amendments. For the purposes of this PRA analysis, the Commission assumes that all 1,000 municipal advisors would have to amend their forms once during the period September 1, 2010 and December 31, 2011. The estimate of the number of municipal advisors that will submit amendments is likely to be lower than all 1,000 as some municipal advisors will not have any changes to their forms during this period. It is also likely that some of these 1,000 municipal advisors will have to submit more than one amendment. However, given the short transition period, the Commission believes that on balance its estimate of one amendment for each municipal advisors is conservative. Therefore, the total burden for these amendments during this period would be 500 hours,[61] and the total estimated paperwork burden for Form MA-T and keeping it properly updated is 3,000 hours.[62]

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60 Telephone call between Martha Mahan Haines, Commission, and Ernesto Lanza, General Counsel, MSRB on August 17, 2010 (estimating the number of persons required to complete Form MA-T). The MSRB is the self-regulatory organization created by Congress to oversee the municipal securities market.

61 500 hours = 1,000 (persons required to amend Form MA-T) x 0.5 (30 minutes) (estimated time to complete amended Form MA-T).

62 3,000 = 2,500 hours (total estimated burden to complete Form MA-T for all municipal advisors) + 500 hours (total estimated burden to complete amendments to Form MA-T for all municipal advisors).

In addition, the Commission believes that some municipal advisors will seek outside counsel to help them comply with the requirements of Rule 15Ba2-6T and Form MA-T. For PRA purposes, the Commission assumes that all 1,000 municipal advisors will on average consult outside counsel for one hour to help them comply with the requirements. The Commission believes that the estimate of the number of municipal advisors that will consult outside counsel is likely to be lower than 1,000 as some municipal advisors will choose not to seek outside counsel or will rely entirely on in-house counsel. The Commission also recognizes that some municipal advisors will hire outside counsel for more than one hour and others may hire counsel for less than one hour. On balance, the Commission believes that its estimate that on average each municipal advisor will hire outside counsel for one hour is conservative. The Commission estimates that the total cost for all municipal advisors to hire outside counsel to review their compliance with the requirements of Rule 15Ba2-6T and Form MA-T to be approximately $400,000.[63]

B. Collection of Information is Mandatory

Any collection of information pursuant to Rule 15Ba2-6T and Form MA-T is a mandatory collection of information.

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[63] $400,000 = 1,000 (estimated number municipal advisors that hire outside attorney) x 1 hour (estimated time spent by outside attorney to help municipal advisor comply with rule) x $400 (hourly rate for an attorney). The $400 per hour figure for an attorney is from the Securities Industry and Financial Markets Association's publication titled Management & Professional Earnings in the Securities Industry 2009, as modified by Commission staff to account for an 1,800 hour work year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

C. Responses to Collection of Information Will Not Be Kept Confidential

The collection of information made pursuant to Rule 15Ba2-6T will not be confidential and will be made publicly available. The collection of information that will be provided pursuant to the Form MA-T will be publicly available via the Internet.

V. Cost-Benefit Analysis

A. Introduction

The Commission is sensitive to the costs and benefits of its rules. The Commission has identified certain costs and benefits of Rule 15Ba2-6T and Form MA-T and request comment on all aspects of this cost-benefit analysis. Where possible, the Commission requests that commenters provide empirical data to support any positions advanced.

The Commission is adopting, as an interim final temporary rule, Rule 15Ba2-6T and Form MA-T for the temporary registration of municipal advisors. The Commission is adopting this rule and Form MA-T in response to the changes implemented by the Dodd-Frank Act, which prohibits municipal advisors from providing municipal advisory services to a municipal entity or obligated person, unless the municipal advisor is registered.

B. Benefits

Section 975 of the Dodd-Frank Act generally is intended to strengthen oversight of municipal securities and broaden current municipal securities market protections to cover, among other things, previously unregulated market participants. Rule 15Ba2-6T and Form MA-T are designed to meet this objective temporarily by requiring each municipal advisor to provide basic identifying information about itself, a description of its activities, and facts regarding its disciplinary history, if any, and that of any of its associated municipal advisor professionals. This transitional registration process will allow municipal advisors to temporarily satisfy the registration requirement in order that they may continue to act as municipal advisors on and after October 1, 2010. Absent such a means to register, municipal advisors would have to cease providing municipal advisory services, which may have a significant adverse impact on their businesses and on municipal entities and obligated persons engaged in issuing municipal securities or other activities for which they obtain the advice of a municipal advisor. The interim final temporary rule is designed to provide a method by which municipal advisors may continue to provide municipal advisory services to municipal entities and obligated persons without violating Section 15B(a)(2) of the Exchange Act.

In addition, disclosure of the disciplinary history of every municipal advisor – sole proprietor or large firm – and every municipal advisor professional will become available, not only to regulators, but also to all members of the investing community, benefitting investors, municipal entities and the general public in the area of municipal investments. Municipal entities issuing securities and obligated persons will have access to this information and thus will be more fully informed when choosing those who would guide them and issue and support quality investment vehicles. Also, the standardization of the required disclosure format would lower the costs for municipal entities in comparing municipal advisors. Lower costs generally make the market more competitive. The Commission believes that this will benefit the municipal market, and ultimately could benefit state and local governments that raise funds for the good and welfare of their citizens, including roads, bridges, energy and other necessary utility infrastructures, as well as education, health, safety, and the wide range of other benefits and social support that these governments provide.

C. Costs

In promulgating the provisions of Section 975 of the Dodd-Frank Act, Congress established a mandatory registration regime for municipal advisors. The establishment of this Congressionally-mandated regulatory regime for municipal advisors will impose burdens on municipal advisors to register with the Commission and to comply with Commission rules. In order to temporarily satisfy the registration requirement, municipal advisors must complete Form MA-T on the Commission's public website. The Commission believes that municipal advisors will principally incur these costs when the rule and the form take effect on October 1, 2010. As noted in the PRA section above, the Commission estimated that the total one-time reporting burden for all municipal advisors to complete Form MA-T would be approximately 2,500 hours. Based on this estimate, the Commission believes the total labor cost for all municipal advisors to complete the Form MA-T will be approximately $735,000.[64] Municipal advisors will also incur costs when they need to amend or withdraw the registration. As noted in the PRA section above, the Commission estimated that the total hourly burden for all municipal advisors to complete an amended Form MA-T would be approximately 500 hours. Based on this estimate, the Commission believes the total annual labor cost for all municipal advisors to complete an amended Form MA-T will be approximately $147,000.[65] In addition to the costs associated with

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64 2,500 hours (total estimated hourly burden under the rule for all municipal advisors to complete a Form MA-T) x $294 (hourly rate for a Compliance Manager) = $735,000. The $294 per hour figure for a Compliance Manager is from the Securities Industry and Financial Markets Association's publication titled Management & Professional Earnings in the Securities Industry 2009, as modified by Commission staff to account for an 1,800 hour work year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

65 500 hours (total estimated hourly burden under the rule for all municipal advisors to complete an amended Form MA-T) x $294 (hourly rate for a Compliance Manager) = $147,000. The $294 per hour figure for a Compliance Manager is from the Securities

completing and amending Form MA-T, the Commission also believes that some persons will incur costs associated with hiring outside counsel to help them determine whether they must file and to comply with the requirements of Rule 15Ba2-6T and Form MA-T. As noted in the PRA section above, the Commission estimated that the total cost for all municipal advisors to hire outside counsel to review their compliance with the requirements of Rule 15Ba2-6T and Form MA-T to be approximately $400,000.[66]

The Commission does not believe that the process of temporary registration through Form MA-T will be particularly burdensome – given the brevity of the form, its convenient availability online, and the automated manner of submitting the information. However, costs will be incurred in completing the disciplinary information sections of Form MA-T, which will demand care in compiling legally accurate statements of disciplinary history of a municipal advisor and its associated municipal advisor professionals. The Commission has reflected these estimated costs discussed above. The Commission also recognizes the possibility that the cost of registering could be passed on to the municipal entity customers of municipal advisors in the form of higher fees. Given the relatively small magnitude of these costs and the large number of municipal entity issuers (nearly 51,000 issuers as of 2009),[67] the Commission expects any increase in municipal advisory fees attributable to registration would be minimal.

Industry and Financial Markets Association's publication titled Management & Professional Earnings in the Securities Industry 2009, as modified by Commission staff to account for an 1,800 hour work year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

66 See supra Section IV.A.

67 See Securities Exchange Act Release No. 62184A (May 26, 2010), 75 FR at 33101 (June 10, 2010).

D. Request for Comment

The Commission requests comment on all aspects of this cost-benefit analysis. Commenters should address in particular whether Rule 15Ba2-6T and Form MA-T will generate the anticipated benefits or impose any other costs in municipal advisors. The Commission also requests comment as to any costs or benefits associated with Rule 15Ba2-6T and Form MA-T that may not have been considered here, including whether the costs associated with the rule will have a disproportionate impact on certain municipal advisors.

VI. 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, in addition to the protection of investors, whether the action would promote efficiency, competition and capital formation.[68] In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact such rules would have on competition.[69] 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 believes that Rule 15Ba2-6T may promote efficiency and competition, and is likely to have no impact on capital formation.

A. Efficiency

In adopting Rule 15Ba2-6T, the Commission has considered its effect on efficiency, competition and capital formation. Rule 15Ba2-6T and Form MA-T are designed to improve the

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68 15 U.S.C. 78c(f).

69 15 U.S.C. 78w(a)(2).

efficiency of the Commission's oversight of municipal advisors, by requiring the registration and identification to the Commission, for the first time, of people engaged in providing municipal advisory services. The temporary registration of municipal advisors will facilitate the Congressional mandate to register municipal advisors and establish an efficient system to provide information to the Commission, the public, and municipal entities.

B. Competition

The Commission also believes that adoption of Rule 15Ba2-6T may promote competition of municipal advisory service providers by allowing municipal advisors to temporarily satisfy the registration requirement that is mandated by October 1, 2010 under the Dodd-Frank Act and thus be permitted to continue to provide advice to, or on behalf of, a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, or to undertake a solicitation of a municipal entity or obligated person on October 1, 2010. In addition, it may promote competition by making uniform information, especially disciplinary information, for all municipal advisors available to consumers of the services of municipal advisors on which to base a selection. Furthermore, because all municipal advisors must register, none would be placed at a competitive advantage or disadvantage over others. The Commission believes that Rule 15Ba2-6T will not result in a burden on competition that is not necessary or appropriate in furtherance of the Exchange Act.

C. Capital Formation

The Commission has also considered the effect of Rule 15Ba2-6T on capital formation. Rule 15Ba2-6T allows municipal entities and obligated persons issuing securities to better choose their advisors based on the information required to be disclosed by Rule 15Ba2-6T; however, this benefit would most likely only affect the way in which municipal entities and obligated persons choose municipal advisors, but would likely have no impact on capital formation because it does not affect the borrowing needs of municipal entities or obligated persons. Therefore, the Commission believes that the rule is not likely to have an effect on capital formation.

The Commission requests comment on this analysis of whether the adoption of Rule 15Ba2-6T will promote efficiency, competition, and capital formation or have an impact or burden on competition. The Commission seeks comments on whether Rule 15Ba2-6T would promote capital formation. Specifically, the Commission requests comments on the extent to which the ability of municipal entities and obligated persons to obtain information concerning registered municipal advisors from Form MA-T before hiring a municipal advisor would promote capital formation. In addition, the Commission seeks comments on the manner and extent to which Rule 15Ba2-6T would assist municipal entities and obligated persons to raise additional capital. The Commission requests commenters to provide empirical data and other factual support for their views, if possible.

VII. Final Regulatory Flexibility Analysis

The Commission has prepared this Final Regulatory Flexibility Analysis (FRFA) in accordance with Section 604(a) of the Regulatory Flexibility Act (RFA).[70] This FRFA relates to new Rule 15Ba2-6T under the Exchange Act, which will permit municipal advisors to temporarily satisfy the registration requirement set forth in the Dodd-Frank Act until such time as the Commission promulgates a final permanent regulatory program.[71]

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70 See 5 U.S.C. 604(a).

71 Although the requirements of the RFA are not applicable to Rules adopted under the Administrative Procedures Act's "good cause" exception, see 5 U.S.C. 601(2) (defining "rule" and notice requirement under the Administrative Procedures Act), the Commission nevertheless prepared this Final Regulatory Flexibility Act Analysis.

Section 975 of the Dodd-Frank Act generally is intended to strengthen oversight of municipal securities and broaden current municipal securities market protections to cover, among other things, previously unregulated market participants. Rule 15Ba2-6T and Form MA-T are designed to meet this mandate by requiring each municipal advisor to provide basic identifying information about itself, a description of its activities, and facts regarding its disciplinary history, if any, and that of any of its associated persons who are municipal advisor professionals.

A. Need for and Objectives of the Rule and Form MA-T

Sections I – III of this Release describe the reasons for and objectives of interim final temporary Rule 15Ba2-6T and Form MA-T. As discussed above, the Commission is adopting an interim final temporary rule that establishes a means for municipal advisors, as defined in the Dodd-Frank Act, to satisfy temporarily the requirement that they register with the Commission by October 1, 2010. This rule and form are necessary so that municipal advisors can meet this Congressional mandate and continue to function as municipal advisors.

B. Small Entities Subject to the Rule

In developing Rule 15Ba2-6T and Form MA-T, the Commission has considered their potential impact on small entities that will be subject to the rule. All municipal advisors must register with the Commission, including small entities, and will be subject to the rule. Because "municipal advisor" is a new term under the Dodd-Frank Act, the Commission has not promulgated a rule to define which municipal advisors should be identified as a "small business" or "small organization" for purposes of the RFA. However, the Commission has referred to its definitions of small entities in the Exchange Act and Investment Advisers Act to inform this FRFA.

Paragraph (c)(1) of Rule 0-10 under the Exchange Act[72] states that the terms "small business" or "small organization," when referring to a broker-dealer, means a broker or dealer that has total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Section 240.17a-5(d); and is not affiliated with any person (other than a natural person) that is not a small business or small organization. As discussed above, based on industry sources, the Commission estimates that approximately 1,000 municipal advisors must complete Form MA-T on the Commission's public website.[73] Industry sources were unable to provide an estimate, based on the definitions discussed above, of how many of these advisors would be a small business or small organization. However, for the purpose of this FRFA, the Commission believes that the proportion of small municipal advisors subject to the rule to all registered municipal advisors subject to the rule may be similar to the proportion of small registered broker-dealers to all registered broker-dealers. The Commission has previously estimated that approximately 17% of all broker-dealers are "small" for the purposes of the RFA.[74] Therefore, the Commission estimates that 170 municipal advisors will be small entities subject to the rule.[75]

The Commission requests comment on its estimate of how many municipal advisors would be small entities for purposes of the RFA. Specifically, the Commission seeks comment on whether there are alternative ways to estimate the number of municipal advisors that are small entities. Is the proportion of small registered municipal advisors to all registered municipal

72 17 CFR 240.0-10(c)(1).

73 See supra Section IV.A.

74 See Securities Exchange Act Release No. 34-61908 (April 14, 2010), 75 FR 21456, 21483 (April 23, 2010).

75 170 = 1,000 (estimated number of municipal advisors subject to the Rule) x .17 (estimated percentage of municipal advisors that are small entities).

advisors for purposes of the RFA similar to the proportion of small registered broker-dealers to all registered broker-dealers?

As noted above, the Commission has defined in Rule 0-10 small entity under the Exchange Act for purposes of the RFA. Should the Commission consider including in that rule criteria specifically related to municipal advisors? For example, should it depend on the number of municipalities the municipal advisor advises? On the number of issuances with respect to which the municipal advisor provides advice? On the total amount of issuances outstanding for the municipalities the advisor advises? On other factors or a combination of factors?

C. Projected Reporting, Recordkeeping, and Other Compliance Requirements

Rule 15Ba2-6T and Form MA-T impose certain reporting and compliance requirements on small municipal advisors, requiring them to provide basic identifying information about themselves, a description of their activities, and facts regarding their disciplinary history, if any, and that of any of their associated persons who are municipal advisor professionals.[76] The rule does not impose any recordkeeping requirements.

As discussed above, current municipal advisors are required by statute to register with the Commission by October 1, 2010 by completing Form MA-T. Form MA-T will be accessible through a link located on the Commission's website, www.sec.gov, beginning on or about September 1, 2010, at which time municipal advisors will be able to submit forms for temporary registration and to amend and withdraw such registrations through the Commission's website.

As noted above, the Commission estimated that the total initial reporting burden for all municipal advisors to complete Form MA-T would be approximately 2,500 hours and the total

[76] Sections I – III of this Release describe these requirements in more detail.

associated cost to complete the Form is approximately $735,000.[77] Municipal advisors will also incur costs when they need to amend or withdraw the registration. As noted above, the Commission estimated that the total hourly burden for all municipal advisors to complete an amended Form MA-T would be approximately 500 hours.[78] The Commission estimates that the total annual labor cost for all municipal advisors to complete an amended Form MA-T will be approximately $147,000.[79] In addition to the costs associated with completing and amending Form MA-T, the Commission also believes that some municipal advisors will incur costs associated with hiring outside counsel to determine the need to file and to comply with the requirements of Rule 15Ba2-6T and Form MA-T. As noted above, the Commission estimates that the total costs for all municipal advisors to hire outside counsel to be approximately $400,000.[80]

D. Agency Action to Minimize Effect on Small Entities

As required by the RFA, the Commission has considered alternatives that would accomplish the stated objectives, while minimizing any significant adverse impact on small entities. Rule 15Ba2-6T should not adversely affect small entities because it imposes minimal new reporting requirements to complete Form MA-T and submit it electronically on the Commission's website. The Commission does not believe that it is appropriate to develop separate requirements for small entities because all municipal advisors should be subject to the same temporary registration process. In developing Rule 15Ba2-6T and Form MA-T, the Commission considered requiring additional information from municipal advisors and using

77 See supra Sections IV.A. and V.C.

78 See supra Section IV.A.

79 See supra Section V.C.

80 See supra Section IV.A.

different electronic delivery mechanisms. After taking into account the short time frame for municipal advisors to comply with the Congressional mandate to register with the Commission, the Commission determined that the Rule 15Ba2-6T and Form MA-T strikes the appropriate balance of minimizing the burden on small municipal advisors while allowing the Commission to meet its mandate under the Dodd-Frank Act.

Counteracting these relatively minor costs is the benefit that small advisors in particular would obtain under the new regime. The registration of municipal advisors (large or small) would improve the availability of information and thus reduce information research costs of investors and issuers in the municipal bond market. These information research costs are generally higher with respect to smaller entities, about which it is often more difficult to obtain information than for large entities. The increased availability of information about smaller entities may have the result that more investors and issuers will locate those entities and be willing to engage their services. Thus, smaller advisors are likely to benefit proportionally more from the improved and relatively standardized disclosure than the larger, more established entities, which might already be disclosing information for other purposes (for example, if they are broker-dealers, or underwriters).

E. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate, overlap, or conflict with Rule 15Ba2-6T.

F. Significant Alternatives

The RFA directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities.[81] In connection with the interim final temporary rule, the Commission considered the following alternatives: (1) establishing different compliance or reporting standards that take into account the resources available to small entities; (2) clarifying, consolidating, or simplifying compliance requirements under the rule; (3) using performance rather than design standards; and (4) exempting small municipal advisers from coverage of all or part of the Rule 15Ba2-6T and Form MA-T.

The Commission believes that the interim final temporary rule strikes the appropriate balance between minimizing the burden on small municipal advisors and allowing the Commission to meet its mandate under the Dodd-Frank Act to provide an appropriate and meaningful process for registering municipal advisors. The Commission does not believe that establishing different compliance or reporting standards is necessary because the information requested in Form MA-T is basic and minimally necessary to meet the statutory goals of the Dodd-Frank Act. Moreover, the Commission believes that completing and submitting Form MA-T on the Commission's website should not be unduly burdensome or costly for municipal advisors, including small municipal advisors. In developing Rule 15Ba2-6T and Form MA-T, the Commission considered requiring additional information from municipal advisors and using different electronic delivery mechanisms. In light of the relatively short time frame for compliance and the resources available to small municipal issuers, the Commission decided that the information in the Form MA-T and the electronic submission requirements are simple, straightforward, and taken into account the resources available to all municipal advisors, including small municipal advisors. The Commission believes that it is inconsistent with the goals of a uniform registration system to use performance standards rather than design standards.

[81] See 5 U.S.C. 603(c).

Further, the Commission believes that it would be inconsistent with the purposes of the Dodd-Frank Act to exempt small entities entirely from having to comply with the interim final temporary rule.

G. General Request for Comment

The Commission is soliciting comments regarding the analysis. The Commission requests comment on the number of small entities that will be subjected to the rule and whether the interim final temporary rule will have any effects that have not been discussed. The Commission requests that commenters describe the nature of any effects on small entities subject to the rule and provide empirical data to support the nature and extent of the effect.

IX. Statutory Authority

Pursuant to the Exchange Act, and particularly Sections 15B (15 U.S.C. 78o-4) and 36 (15 U.S.C. 78mm), the Commission is adopting § 240.15Ba2-6T and 249.1300T of Title 17 of the Code of Federal Regulations in the manner set forth below.

Text of Rule

List of Subjects in 17 CFR Part 240 and Part 249

Reporting and recordkeeping requirements, Municipal advisors, temporary registration requirements.

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

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

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

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78o-4, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; 18 U.S.C. 1350; and 12 U.S.C. 5221(e)(3), unless otherwise noted.

* * * * *

2. Section 240.15Ba2-6T is added to read as follows.

§ 240.15Ba2-6T Temporary Registration as a Municipal Advisor; Required Amendments; and Withdrawal from Temporary Registration.

(a) A municipal advisor (as defined in Section 15B(e)(4) of the Securities Exchange Act of 1934 (the "Act") (15 U.S.C. 78o-4(e)(4)) shall file with the Commission, pursuant to Section 15B(a) (15 U.S.C. 78o-4(a)) of the Act, the information set forth on Form MA-T (17 CFR 249.1300T) electronically through the Commission's Internet website (www.sec.gov) to temporarily register or to withdraw from temporary registration.

(b) A temporary registration must promptly be amended:

(1) Whenever any information concerning Items 1 or 3 of Form MA-T (17 CFR 249.1300T) have become inaccurate in any way; and

(2) Whenever a municipal advisor wishes to withdraw from registration.

(c) Every initial registration and each amendment to a registration or withdrawal from registration filed pursuant to this rule shall constitute a "report" within the meaning of Sections 15B(c) (15 U.S.C. 78o-4(c)), 17(a) (15 U.S.C. 78q(a)), 18(a) (15 U.S.C. 78r(a)) and 32(a) (15 U.S.C. 78ff(a)) and other applicable provisions of the Act.

(d) Each Form MA-T (17 CFR 249.1300T), including each amendment to a registration or withdrawal from registration, is considered filed with the Commission upon its completion on the Commission web page established for that purpose and the Commission has sent confirmation that the form was filed to the municipal advisor.

(e) All temporary registrations submitted pursuant to this section will expire on the earlier of:

(1) the date that the municipal advisor's registration is approved or disapproved by the Commission pursuant to a final rule adopted by the Commission establishing another manner of registration of municipal advisors and prescribing a form for such purpose;

(2) the date on which the municipal advisor's temporary registration is rescinded by the Commission; or

(3) on December 31, 2011.

(f) This section will expire on December 31, 2011.

PART 249 -- FORMS, SECURITIES EXCHANGE ACT OF 1934

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

* * * * *

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

4. Subpart N and § 249.1300T are added to read as follows.

Subpart N – Forms for Registration of Municipal Advisors

§249.1300T Form MA-T -- For temporary registration as a municipal advisor, and for amendments to, and withdrawals from, temporary registration.

[Note: The text of Form MA-T does not, and the amendments will not, appear in the Code of Federal Regulations.]

The form shall be used for temporary registration as a municipal advisor, and for amendments to, and withdrawals from, temporary registration pursuant to Section 15B of the Exchange Act, (15 U.S.C. 78o).

OMB APPROVAL
OMB Number: 3235-0659
Expires: March 31, 2011
Estimated average
Burden hours per form: 2.5
Per amendment: 0.5

Note: Form MA-T is an electronic form accessible through a link located on the website of the U.S. Securities and Exchange Commission at www.sec.gov. It may not be filed in paper form.

FORM MA-T

MUNICIPAL ADVISOR TEMPORARY REGISTRATION FORM

ITEM 1 - IDENTIFYING INFORMATION

A. This is:
- ☐ An initial temporary registration as a municipal advisor
- ☐ An amendment of temporary registration as a municipal advisor
  Municipal Advisor Registration Number: ___ -_______
- ☐ A withdrawal of temporary registration as a municipal advisor
  Municipal Advisor Registration Number: ___ -_______

B. Full Legal Name of municipal advisor:

____
(firm name or name of sole proprietor)

C. Name under which the municipal advisor conducts business, if different:

____

D. IRS Employer Identification Number of the municipal advisor: ________________
(Note: If you are a sole proprietor, leave this space blank. Do NOT fill in your social security number.)

E. If the municipal advisor is also registered with the SEC as an investment adviser, its SEC file number: 801-__________

F. If the municipal advisor is also registered with the SEC as a broker, dealer, or municipal securities dealer, its SEC file number: ________________________

G. If the municipal advisor has a number ("CRD Number") assigned by the FINRA's CRD system or by the IARD system, its CRD number (*Do not provide the CRD number of the municipal advisor's officers, employees, or affiliates)*: ________________________

H. Municipal advisor's principal office and place of business:

(1) Address *(do not use a P.O. Box)*:

____
(number and street)

____
(city) (state/country) (zip+4/postal code)

(2) Telephone number at this location: ______________________
(area code) (telephone number)

(3) Facsimile number at this location, if any:

____
(area code) (telephone number)

(4) General e-mail address for the municipal advisor, if any:
_____________@_____________

(5) Website, if any, of the municipal advisor

www.____________________ . ________

I. Mailing address, if different from the municipal advisor's principal office and place of business address:

____
(number and street)

____
(city) (state/country) (zip+4/postal code)

J. Contact person: *[The contact person should be a person whom the municipal advisor has authorized to receive information and respond to questions about this registration.]*

____
(name)

____
(title)

______________________ ______________________
(telephone number, including area code) (facsimile number, if any, including area code)

____
(number and street)

____
(city) (state/country) (zip+4/postal code)

____________________@____________________
(e-mail address, if any, of contact person)

ITEM 2 - MUNICIPAL ADVISORY ACTIVITIES

What type(s) of municipal advisory services does the municipal advisor provide? *Check all that apply.*

- ☐ (1) Advice concerning the issuance of municipal securities
- ☐ (2) Advice concerning the investment of the proceeds of municipal securities
- ☐ (3) Advice concerning guaranteed investment contracts
- ☐ (4) Recommendation and/or brokerage of municipal escrow investments
- ☐ (5) Advice concerning the use of municipal derivatives (e.g., swaps)
- ☐ (6) Solicitation of business from a municipal entity or obligated person for an unaffiliated person or firm (e.g., third party marketers, placement agents, solicitors and finders)
- ☐ (7) Preparation of feasibility studies, tax or revenue projections, or similar products in connection with offerings or potential offerings of municipal securities
- ☐ (8) Other (specify):____________________________

ITEM 3 - DISCIPLINARY INFORMATION

In this Item, we ask for information about the municipal advisor's disciplinary history and the disciplinary history of all associated municipal advisor professionals (as defined in the Glossary accompanying this form). For any question to which you answer "yes," a drop-down box will appear for you to supply relevant information. *Note: If you have submitted a Criminal Disclosure Report Page or Pages, a Regulatory Action Disclosure Page or Pages, or a Civil Judicial Action Disclosure Reporting Page or Pages to FINRA or the SEC in connection with other filings, you may provide such information by referencing the public disclosure system (BrokerCheck or Investment Adviser Public Disclosure) that currently contains the disclosure, the CRD number of the entity under which the disclosure is listed, and whether the entity under which the disclosure is listed is a firm or individual. (Example: Please reference BrokerCheck, CRD 123456, for the individual Mr. X for reportable disclosures; Example: Please reference IAPD, CRD 987654, for the firm X's reportable disclosures.)*

One event may result in "yes" answers to more than one of the questions below.

A. In the past ten years, has the municipal advisor or any associated municipal advisor professional:

(1) been convicted of or pled guilty or nolo contendere ("no contest") in a domestic, foreign, or military court to any felony? YES/NO

(2) been charged with any felony? YES/NO

You may limit your response to Item 3.A(2) to charges that are currently pending.

B. In the past ten years, has the municipal advisor or any associated municipal advisor professional:

(1) been convicted of or pled guilty or nolo contendere ("no contest") in a domestic, foreign, or military court to a misdemeanor involving: investments or an investment-related business, or any fraud, false statements, or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, extortion, or a conspiracy to commit any of these offenses? YES/NO

(2) been charged with a misdemeanor listed in Item 3.B(1)? YES/NO
You may limit your response to Item 3.B(2) to charges that are currently pending.

C. Has the SEC or the Commodity Futures Trading Commission (CFTC) ever:

(1) found the municipal advisor or any associated municipal advisor professional to have made a false statement or omission? YES/NO

(2) found the municipal advisor or any associated municipal advisor professional to have been involved in a violation of its regulations or statutes? YES/NO

(3) found the municipal advisor or any associated municipal advisor professional to have been a cause of an investment-related business having its authorization to do business denied, suspended, revoked, or restricted? YES/NO

(4) entered an order against the municipal advisor or any associated municipal advisor professional in connection with investment-related activity? YES/NO

(5) imposed a civil money penalty on the municipal advisor or any associated municipal advisor professional, or ordered the municipal advisor or any associated municipal advisor professional to cease and desist from any activity? YES/NO

D. Has any other federal regulatory agency, any state regulatory agency, or any foreign financial regulatory authority:

(1) ever found the municipal advisor or any associated municipal advisor professional to have made a false statement or omission, or been dishonest, unfair, or unethical? YES/NO

(2) ever found the municipal advisor or any associated municipal advisor professional to have been involved in a violation of investment-related regulations or statutes? YES/NO

(3) ever found the municipal advisor or any associated municipal advisor professional to have been a cause of an investment-related business having its authorization to do business denied, suspended, revoked, or restricted? YES/NO

(4) in the past ten years, entered an order against the municipal advisor or any associated municipal advisor professional in connection with an investment-related activity? YES/NO

(5) ever denied, suspended, or revoked the municipal advisor's or any associated municipal advisor professional's registration or license, or otherwise prevented the municipal advisor or any associated municipal advisor professional, by order, from associating with an investment-related business or restricted the municipal advisor's or any associated municipal advisor professional's activity? YES/NO

E. Has any self-regulatory organization or commodities exchange:

(1) ever found the municipal advisor or any associated municipal advisor professional to have made a false statement or omission? YES/NO

(2) ever found the municipal advisor or any associated municipal advisor professional to have been involved in a violation of its rules (other than a violation designated as a "minor rule violation" under a plan approved by the SEC)? YES/NO

(3) ever found the municipal advisor or any associated municipal advisor professional to have been the cause of an investment-related business having its authorization to do business denied, suspended, revoked, or restricted? YES/NO

(4) ever disciplined the municipal advisor or any associated municipal advisor professional by expelling or suspending it from membership, barring or suspending its association with other members, or otherwise restricting its activities? YES/NO

F. Has the municipal advisor's or any associated municipal advisor professional's authorization to act as an attorney, accountant, or federal contractor ever been revoked or suspended? YES/NO

G. Is the municipal advisor or any associated municipal advisor professional the subject of any regulatory proceeding that could result in a "yes" answer to any part of Item 3.C., 3.D., or 3.E.? YES/NO

H. (1) Has any domestic or foreign court:

(a) in the past ten years, enjoined the municipal advisor or any associated municipal advisor professional in connection with any investment-related activity? YES/NO

(b) ever found that the municipal advisor or any associated municipal advisor professional was involved in a violation of investment-related statutes or regulations? YES/NO

(c) ever dismissed, pursuant to a settlement agreement, an investment-related civil action brought against the municipal advisor or any associated municipal advisor professional by a state or foreign financial regulatory authority? YES/NO

(2) Is the municipal advisor or any associated municipal advisor professional now the subject of any civil proceeding that could result in a "yes" answer to any part of Item 3.H(1)? YES/NO

ITEM 4 – EXECUTION

The municipal advisor consents that service of any civil action brought by or notice of any proceeding before the Securities and Exchange Commission or any self-regulatory organization in connection with the municipal advisor's municipal advisory activities may be given by registered or certified mail or confirmed telegram to the municipal advisor's contact person at the main address, or mailing address, if different, given in Items 1.H, 1.I., and 1.J.

The undersigned deposes and says that he/she has executed this form on behalf of, and with the authority of, the municipal advisor. The undersigned and the municipal advisor represent that the information and statements contained herein and other information filed herewith, all of which are made a part hereof, are current, true and complete. The undersigned and the municipal advisor further represent that, if this is an amendment, to the extent that any information previously submitted is not amended such information is currently accurate and complete.

Date: ____________________

Full Legal Name of Municipal Advisor: ______________________________

By. ____
(signature)

Title: ______________________________

Warning: Intentional misstatements or omissions of fact constitute Federal criminal violations. See, 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

FORM MA-T
MUNICIPAL ADVISOR TEMPORARY REGISTRATION FORM

General Instructions

Note: Beginning on October 1, 2010, Section 15B(a)(1)(B) of the Securities Exchange Act of 1934 makes it unlawful for a municipal advisor to provide advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, or to undertake a solicitation of a municipal entity or obligated person, unless the municipal advisor is registered with the Securities and Exchange Commission. *See Glossary for definitions of terms used in Form MA-T and in these instructions.*

Read these instructions carefully before filing Form MA-T. Failure to follow these instructions or properly complete the form may result in temporary registration as a municipal advisor being delayed or rejected.

1. What is From MA-T?

Form MA-T provides for temporary registration by municipal advisors.

2. Where can I get Form MA-T?

Form MA-T is available on the SEC's website: www.sec.gov/info/municipal/form_MA-T.htm.

3. When must Form MA-T be used?

Municipal advisors use Form MA-T to:

- File initial temporary registration as a municipal advisor with the Securities and Exchange Commission
- Amend those temporary registrations
- Withdraw from temporary registration

4. What is the deadline for filing Form MA-T for temporary registration?

Current municipal advisors must file Form MA-T by October 1, 2010. These municipal advisors should allow enough time to establish an account and obtain access credentials (username and password) and complete the on-line version of the Form by that date. Any person who desires to become a municipal advisor after October 1, 2010 should file Form MA-T before providing advice to a municipal entity or obligated person.

5. When is a municipal advisor required to update its Form MA-T?

A municipal advisor must amend the Form MA-T <u>promptly</u> if information provided in response to Items 1 or 3 becomes inaccurate in any way. Failure to update Form MA-T, as required by this instruction, is a violation of SEC rule 15Ba2-6T and could lead to revocation of a municipal advisor's temporary registration.

6. Where and how do I sign Form MA-T?

Form MA-T must be signed with the typed name of the municipal advisor and of the name and title of the signer on the appropriate lines in Item 4.

7. Who must sign Form MA-T?

The individual who signs the form depends upon the form of organization of the municipal advisor:

- For a sole proprietorship, the sole proprietor should sign.
- For a partnership, a general partner should sign.
- For a corporation, an authorized principal officer should sign.
- For all others, an authorized individual who participates in managing or directing the municipal advisor's affairs should sign.

8. How do I file Form MA-T?

Complete Form MA-T using the Commission's public website (<www.sec.gov/info/municipal/form_MA-T.htm>). Follow the detailed instructions available on the website.

In order to begin filling out Form MA-T, it will be necessary to establish an account and obtain access credentials (username and password) with the SEC's temporary registration system. A submitter will need to fill out general user information fields such as name, address, phone number, e-mail address, organization name and employer identification number, and user account information (i.e., select a username and password), and to select and answer a security question. Once accepted by the temporary registration system, the submitter will receive an e-mail notification that the account has been established and the submitter will be able to access and complete Form MA-T. The Commission anticipates that submitters will ordinarily obtain access credentials the same day that they are requested. *However, to avoid the possibility of delay, the Commission encourages submitters to file Form MA-T prior to the initial October 1, 2010 submission deadline.*

9. Are there filing fees?

No.

10. Whom may I contact with questions about filing Form MA-T?

You may call the SEC Division of Trading and Markets' Office of Interpretation and Guidance at (202) 551-5777 or e-mail tradingandmarkets@sec.gov.

Federal Information Law and Requirements

Section 15B(a) the Securities Exchange Act [15 U.S.C. § 78o-4(a)] authorizes the SEC to collect the information required by Form MA-T. The SEC collects the information for regulatory purposes. Filing Form MA-T is mandatory for municipal advisors who are required to register with the SEC. The SEC maintains the information submitted on this form and makes it publicly available. The SEC will not accept forms that do not include required information.

SEC's Collection of Information

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The Securities Exchange Act authorizes the SEC to collect the information on Form MA-T from applicants. See 15 U.S.C. § 78o-4. Filing the form is mandatory.

The main purpose of this form is to enable the SEC to provide for the temporary registration of municipal advisors. Every applicant for temporary registration with the SEC as a municipal advisor must file the form. See 17 C.F.R. § 240.15Ba2-6T. By accepting Form MA-T, however, the SEC does not make a finding that it has been completed or submitted correctly. The form is filed initially by every municipal advisor, no later than October 1, 2010. It is also filed promptly during the year to reflect changes to the information in Items 1 or 3 and when a municipal advisor wishes to withdraw from temporary registration. See 17 C.F.R. § 240.15Ba2-6T. The SEC maintains the information on the form and makes it publicly available through the SEC's public website.

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

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

Intentional misstatements or omissions of facts constitute Federal Criminal Violations.

See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

GLOSSARY OF TERMS

1. **Affiliate**: (1) all officers, partners, or directors (or any person performing similar functions) of a municipal advisor; (2) all persons directly or indirectly controlling or controlled by a municipal advisor; and (3) all of a municipal advisor's current employees (other than employees performing only clerical, administrative, support or similar functions).

2. **Associated municipal advisor professional** includes: (1) any associated person of a municipal advisor primarily engaged in municipal advisory activities; (2) any associated person of a municipal advisor who is engaged in the solicitation of municipal entities or obligated persons (as defined in this Glossary); (3) any associated person of a municipal advisor who is a supervisor of any person described in (1) or (2) above; (4) any associated person of a municipal advisor who is a supervisor of any person described in (3) above up through and including, the Chief Executive Officer or similarly situated official designated as responsible for the day-to-day conduct of the municipal advisor's municipal advisory activities; and (5) any associated person of a municipal advisor who is a member of the executive or management committee of the municipal advisor or a similarly situated official, if any; and excludes any associated person of a municipal advisor whose functions are solely clerical or ministerial.

3. **Associated person of a municipal advisor**: any partner, officer, director, or branch manager of a municipal advisor (or any person occupying a similar status or performing similar functions); any other employee of a municipal advisor who is engaged in the management, direction, supervision, or performance of any activities relating to the provision of advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities; and any person directly or indirectly controlling, controlled by, or under common control with such municipal advisor, or any employee of such municipal advisor.

4. **Charged**: Being accused of a crime in a formal complaint, information, or indictment (or equivalent formal charge).

5. **Control**: Control means the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise.
   - Each of a municipal advisor's officers, partners, or directors exercising executive responsibility (or persons having similar status or functions) is presumed to control the municipal advisor.
   - A person is presumed to control a corporation if the person: (i) directly or indirectly has the right to vote 25 percent or more of a class of the corporation's voting securities; or (ii) has the power to sell or direct the sale of 25 percent or more of a class of the corporation's voting securities.
   - A person is presumed to control a partnership if the person has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the partnership.
   - A person is presumed to control a limited liability company ("LLC") if the person: (i) directly or indirectly has the right to vote 25 percent or more of a class of the interests of

the LLC; (ii) has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the LLC; or (iii) is an elected manager of the LLC.

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

6. **Employee**: This term includes an independent contractor who performs advisory functions on behalf of a municipal advisor.

7. **Enjoined**: This term includes being subject to a mandatory injunction, prohibitory injunction, preliminary injunction, or a temporary restraining order.

8. **Felony**: For jurisdictions that do not differentiate between a felony and a misdemeanor, a felony is an offense punishable by a sentence of at least one year imprisonment and/or a fine of at least $1,000. The term also includes a general court martial.

9. **FINRA CRD or CRD**: The Web Central Registration Depository ("CRD") system operated by FINRA for the registration of broker-dealers and broker-dealer representatives.

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

11. **Found**: This term includes adverse final actions, including consent decrees in which the respondent has neither admitted nor denied the findings, but does not include agreements, deficiency letters, examination reports, memoranda of understanding, letters of caution, admonishments, and similar informal resolutions of matters.

12. **Guaranteed Investment Contract:** any investment that has specified withdrawal or reinvestment provisions and a specifically negotiated or bid interest rate, and also includes any agreement to supply investments on 2 or more future dates, such as a forward supply contract.

13. **IARD**: the Investment Adviser Registration Depository operated by FINRA.

14. **Investment-Related**: Activities that pertain to securities, commodities, banking, insurance, or real estate (including, but not limited to, acting as or being associated with an investment adviser, broker-dealer, municipal securities dealer, government securities broker or dealer, issuer, investment company, futures sponsor, bank, or savings association).

15. **Investment Strategies**: plans or programs for the investment of the proceeds of municipal securities that are not municipal derivatives, guaranteed investment contracts, and the recommendation of and brokerage of municipal escrow investments.

16. **Involved**: Engaging in any act or omission, aiding, abetting, counseling, commanding, inducing, conspiring with or failing reasonably to supervise another in doing an act.

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

18. **Misdemeanor**: For jurisdictions that do not differentiate between a felony and a misdemeanor, a misdemeanor is an offense punishable by a sentence of less than one year imprisonment and/or a fine of less than $1,000. The term also includes a special court martial.

19. **Municipal Advisor:**
    - a person (who is not a municipal entity or an employee of a municipal entity) that (i) provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues; or (ii) undertakes a solicitation of a municipal entity;
    - includes financial advisors, guaranteed investment contract brokers, third-party marketers, placement agents, solicitors, finders, and swap advisors, if such persons are described in any of clauses (i) through (ii) above; and
    - does *not* include a broker, dealer, or municipal securities dealer serving as an underwriter (as defined in section 2(a)(11) of the Securities Act of 1933) (15 U.S.C. 77b(a)(11)), any investment adviser registered under the Investment Advisers Act of 1940, or persons associated with such investment advisers who are providing investment advice, any commodity trading advisor registered under the Commodity Exchange Act or persons associated with a commodity trading advisor who are providing advice related to swaps, attorneys offering legal advice or providing services that are of a traditional legal nature, or engineers providing engineering advice.

20. **Municipal Entity:** any State, political subdivision of a State, or municipal corporate instrumentality of a State, including—
    - any agency, authority, or instrumentality of the State, political subdivision, or municipal corporate instrumentality;
    - any plan, program, or pool of assets sponsored or established by the State, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof; and
    - any other issuer of municipal securities;

21. **Municipal Financial Product**: municipal derivatives, guaranteed investment contracts, and investment strategies.

22. **Obligated person:** any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person, committed by contract or

other arrangement to support the payment of all or part of the obligations on the municipal securities to be sold in an offering of municipal securities."

23. **Order**: A written directive issued pursuant to statutory authority and procedures, including an order of denial, exemption, suspension, or revocation. Unless included in an order, this term does not include special stipulations, undertakings, or agreements relating to payments, limitations on activity or other restrictions.

24. **Person**: A natural person (an individual) or a company. A company includes any partnership, corporation, trust, limited liability company ("LLC"), limited liability partnership ("LLP"), sole proprietorship, or other organization.

25. **Principal Place of Business or Principal Office and Place of Business**: A municipal advisor's executive office from which its officers, partners, or managers direct, control, and coordinate the activities of the municipal advisor.

26. **Proceeding**: This term includes a formal administrative or civil action initiated by a governmental agency, self-regulatory organization or foreign financial regulatory authority; a felony criminal indictment or information (or equivalent formal charge); or a misdemeanor criminal information (or equivalent formal charge). This term does not include other civil litigation, investigations, or arrests or similar charges effected in the absence of a formal criminal indictment or information (or equivalent formal charge).

27. **Related Person**: Any affiliate and any person that is under common control with the municipal advisor.

28. **Self-Regulatory Organization or SRO**: Any national securities or commodities exchange, registered securities association, or registered clearing agency. For example, the Chicago Board of Trade ("CBOT"), FINRA, New York Stock Exchange ("NYSE") and Municipal Securities Rulemaking Board ("MSRB") are self-regulatory organizations.

29. **Solicitation of a Municipal Entity or Obligated Person**: means a direct or indirect communication with a municipal entity or obligated person made by a person, for direct or indirect compensation, on behalf of a broker, dealer, municipal securities dealer, municipal advisor, or investment adviser (as defined in section 202 of the Investment Advisers Act of 1940) that does not control, is not controlled by, or is not under common control with the person undertaking such solicitation for the purpose of obtaining or retaining an engagement by a municipal entity or obligated person of a broker, dealer, municipal securities dealer, or municipal advisor for or in connection with municipal financial products, the issuance of municipal securities, or of an investment adviser to provide investment advisory services to or on behalf of a municipal entity.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: September 1, 2010

Chairman Schapiro and Commissioner Casey not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

Securities Exchange Act of 1934
Release No. 62837 / September 2, 2010

Administrative Proceeding
File No. 3-13675

In the Matter of **Value Line, Inc.,** **Value Line Securities, Inc.,** **Jean Bernhard Buttner, and** **David Henigson,** **Respondents.**	**ORDER APPOINTING A FUND ADMINISTRATOR AND WAIVING BOND**

On November 4, 2009, the Commission instituted settled public administrative and cease-and-desist proceedings against Value Line, Inc. ("Value Line"), Value Line Securities, Inc., Jean Bernhard Buttner, and David Henigson in connection with the misappropriation of assets from the Value Line Family of Mutual Funds. See 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, Sections 15(b)(4), 15(b)(6) and 21C of the Securities Exchange Act of 1934, Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, and Sections 9(b) and 9(f) of the Investment Company Act of 1940, Securities Act Release No. 9081 (November 4, 2009). Among other things, the Commission ordered Value Line to pay a total of $43,705,765 in disgorgement, prejudgment interest and civil penalty, for establishment of a Fair Fund.

The Division of Enforcement ("Division") seeks approval of the appointment of A.B. Data, Ltd. ("A.B. Data") as Fund Administrator, and that the Fund Administrator not be required to post a bond generally required under Fair Fund Rule 1105(c). The Division proposes that the Commission waive the bond requirement of the Fund Administrator for good cause. In lieu of bond, any proposed plan of distribution for the Fair Fund will incorporate several layers of protection for the Fair Fund. Among other things, under any distribution plan: (1) the fund administrator will have no custody, and only limited control, of the Fair Fund; (2) the Fair Fund will be held by the U.S. Treasury Department's Bureau of the Public Debt until immediately before transmittal of checks or electronic transfers to eligible investors; (3) upon transfer from the U.S. Treasury, funds will be held in an escrow account, separate from the assets of the Escrow Bank, until presentation of a check or electronic transfer, at which time funds will be transferred to a controlled distribution account; (4) presented checks or electronic transfers will be subject to "positive pay" controls before being honored by the Escrow Bank; and (5) both the Escrow Bank and the fund administrator will maintain, throughout this process, insurance and/or a financial institution bond that covers errors and omissions, misfeasance and fraud.

Accordingly, pursuant to Rules 1105(a) and (c) of the Commission's Rules on Fair Fund and Disgorgement Plans, 17 C.F.R. § 201.1105, IT IS HEREBY ORDERED that A.B. Data is appointed as Fund Administrator and that waiver of the bond requirement is granted for good cause shown.

By the Commission.

Elizabeth M. Murphy
Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62834 / September 2, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14028

In the Matter of **LACE FINANCIAL CORP. and BARRON PUTNAM,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTIONS 15E(d) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND CEASE-AND-DESIST ORDERS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate, necessary for the protection of investors, and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant Sections 15E(d) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against LACE Financial Corp. ("LACE" or the "Company") and pursuant to Section 21C of the Exchange Act against Barron Putnam ("Putnam") (collectively, "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15E(d) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and Cease-and-Desist Orders ("Order"), as set forth below.

III.

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

Summary

These proceedings arise out of misrepresentations made by LACE in its application to the Commission to become registered as a Nationally Recognized Statistical Rating Organization ("NRSRO") and its accompanying request for an exemption from a conflict-of-interest provision. Exchange Act 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 ten percent of the total net revenue of the NRSRO for the fiscal year. In its request for an exemption from this rule, LACE materially misstated the amount of revenue it received from its largest customer during 2007.

In addition, LACE also violated certain other Commission rules governing NRSROs. LACE violated Exchange Act Rule 17g-1(a) by making the misstatements described above and by failing to disclose in its registration application that it performed an extra layer of review for the credit ratings of issuers whose securities made up the pools for asset-backed securities managed by LACE's largest customer. LACE violated Rule 17g-2(a)(6) by failing to document the process of this extra layer of review in its written policies and procedures. LACE violated Rule 17g-2(b)(7) by failing to maintain all emails relating to its credit ratings and violated Rule 17g-3(a)(1) by furnishing inaccurate audited financials to the Commission for 2008. In addition, LACE violated Rule 17g-5(c)(2) because LACE's founder and majority owner, Putnam, participated in determining a credit rating for an entity whose stock he owned. Putnam was a cause of LACE's violations.

Respondents

1. LACE is a credit rating agency located in Frederick, Maryland. During 2008, LACE had total revenues of $918,714 and net income of $98,837. LACE was formed in 1984, and derives most of its revenue from subscription fees. On February 11, 2008, the Commission granted LACE's application to register as an NRSRO for all five classes of credit ratings described in clauses (i) through (v) of Section 3(a)(62)(B) of the Exchange Act. On the same day, the Commission also granted LACE's request for an exemption from Exchange Act Rule 17g-5(c)(1) until January 1, 2009, provided that LACE disclosed that the firm received more than ten percent of its net revenue in fiscal year 2007 from a client that paid it to rate asset-backed securities. Since its founding, LACE has specialized in issuing credit ratings for financial institutions. At the time of its NRSRO application, LACE provided quarterly credit ratings on approximately 7,900 commercial and savings banks, 1,000 bank holding companies, 850 savings and loans, 1,500 to 8,700 credit unions (depending on the quarter), 250 foreign banks, and 95 title insurance companies.

2. Putnam is the founder of LACE and during the relevant period was LACE's 90 percent owner. He was president of LACE until April of 2007, when LACE hired a new

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

president. At that time, Putnam took on the role of part-time adviser to LACE, in which role he advised the Company on major decisions and continued to be involved in the ratings process. He also served as LACE's compliance officer. At the end of 2008, LACE terminated its president ("LACE's former President") and Putnam resumed that position in January 2009.

The Credit Rating Agency Reform Act and Commission Rules Governing NRSROs

3. The Credit Rating Agency Reform Act of 2006 ("Rating Agency Act"),[2] enacted on September 29, 2006, defined the term "nationally recognized statistical rating organization" and provided authority for the Commission to implement registration, recordkeeping, financial reporting, and oversight rules with respect to registered credit rating agencies. The final Commission implementing rule (Exchange Act Rule 17g-1) and form (Form NRSRO) prescribing the process for a credit rating agency to apply for registration became effective on June 18, 2007. Exchange Act Rule 17g-1 requires a credit rating agency applying for registration as an NRSRO to use Form NRSRO to furnish the Commission with the initial application. The Rule requires a firm, after becoming registered as an NRSRO, to update its registration application if any of the information becomes materially inaccurate and to provide an annual certification on Form NRSRO. Exchange Act Rules 17g-2 through 17g-6 became effective on June 26, 2007. Among other things, Exchange Act Section 15E and these rules (a) require an NRSRO to make and retain certain records (Rule 17g-2); (b) require NRSROs to furnish the Commission with periodic financial reports (Rule 17g-3); and (c) prohibit NRSROs from having certain conflicts of interest and require NRSROs to establish, maintain, and enforce written policies and procedures reasonably designed to address and manage certain other conflicts of interest related to the issuance of credit ratings by the NRSRO (Rule 17g-5).

4. To register with the Commission as an NRSRO, a credit rating agency must have been in business as a credit rating agency for at least three consecutive years immediately preceding the date of its application, and it must issue credit ratings with respect to one or more of the following categories of obligors: (a) financial institutions, (b) insurance companies, (c) corporate issuers, (d) issuers of asset-backed securities, and (e) issuers of government securities, municipal securities, or securities issued by a foreign government. The credit rating agency also must submit an application that contains certain information including, among other things, the procedures and methodologies that the applicant uses to determine credit ratings, policies and procedures to prevent the misuse of material, nonpublic information, any conflict of interest relating to the issuance of credit ratings, whether it has a code of ethics in effect, and certain financial information.

5. The Commission's rules were designed to further the goals of the Rating Agency Act to "improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry."[3] To meet these goals, it is critical that firms provide accurate information to the Commission and the public in their Form NRSROs and financial reports, that they do not have prohibited conflicts, and that they establish, maintain, and enforce policies and procedures to address conflicts of interest. Compliance with the recordkeeping requirements is critical to the Commission's NRSRO examination and oversight programs.

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2 Pub. L. No. 109-291 (2006).

3 Preamble to the Rating Agency Act.

Facts

A. LACE's Misstatements in its NRSRO Application

6. The Commission received a complete application from LACE to register as an NRSRO on October 31, 2007.

7. In a letter dated October 30, 2007, LACE requested that the Commission issue an order exempting LACE from Rule 17g-5(c)(1), which 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 ten percent of the total net revenue of the NRSRO for the fiscal year (the "Ten Percent Rule").

8. LACE requested an exemption from the Ten Percent Rule because, for the fiscal year ending December 31, 2007, LACE maintained credit ratings on asset-backed securities solicited by LACE's largest client ("Firm A"), which had provided LACE with more than ten percent of LACE's total revenue during fiscal year 2007. Firm A, among other things, manages Collateralized Debt Obligation ("CDO") investment vehicles constructed from pools of assets comprised largely of trust-preferred securities issued by banks and thrifts, and hired LACE to prepare initial and semi-annual reports regarding the issuing entities that Firm A distributed to investors in these CDOs.

9. LACE prepared the investor reports for Firm A twice a year for each of Firm A's five (and beginning in 2007, six) CDO pools. The reports included, among other things, a report on the financial condition of the particular CDO pool, summaries of all issuers whose LACE ratings had been upgraded or downgraded from the previous quarter, a description of any issuers that had undergone a merger or acquisition in the past quarter, and a banking industry analysis. The reports also included charts showing selected financial ratios and other financial data.

10. The reports also contained LACE's credit rating for each issuer whose securities were in the CDO pools, as well as a rating of the overall credit worthiness of each CDO pool, based on the par weighted average of LACE's ratings on each issuer of securities in the pool. LACE did not rate the various tranches of securities issued by the CDOs.

11. In its October 30, 2007 letter requesting an exemption from the Ten Percent Rule, LACE stated that its estimated annual revenues from Firm A for 2007 would be $119,000 when calculated on a cash basis and $179,000 when calculated on an accrual basis. The letter further stated that the account represented 18.6 percent of LACE's revenues and that LACE expected this percentage to decrease by the end of 2007 and further decrease in 2008. Putnam signed the letter.

12. Subsequently, in an attempt to keep the 2007 revenue from Firm A as close as possible to ten percent of its total revenues for the year, LACE postponed billing Firm A for reports completed during December 2007 until January 2008. The total value of the work for which billing was deferred totaled $115,450, which LACE recognized as 2008 revenue. However, because the reports were completed in December 2007, under generally accepted accounting principles ("GAAP"), LACE should have recorded this as 2007 revenue.[4]

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[4] GAAP provides that revenue should generally be recognized when it is earned, as opposed to when it is billed or received. See SEC Staff Accounting Bulletin No. 104, Revenue Recognition (December 17, 2003) (Corrected Copy).

13. In a letter dated January 10, 2008 to the staff of the Commission's Division of Trading and Markets, LACE stated that its 2007 revenues from Firm A were $119,393, which accounted for 14.2 percent of LACE's 2007 revenue. The letter, signed by LACE's former President and copied to Putnam, stated that although the numbers provided in the letter were unaudited, LACE did not anticipate that there would be any material changes. The amount of revenue attributed to Firm A in the letter was the amount that LACE had been paid by Firm A during 2007, and, inconsistent with GAAP, did not include the $115,450 for work that LACE had completed for Firm A in December 2007, but had not billed until January 2008. The letter signed by LACE's former President did not describe the basis for the stated revenue amount or disclose that LACE had deferred its recognition of revenue from Firm A into 2008. The total value of work performed for Firm A by LACE during 2007 was in fact $233,268.28, approximately 28 percent of LACE's revenues for the year when properly calculated on an accrual basis as required by GAAP.[5]

14. On February 11, 2008, the Commission granted LACE's application to be registered as an NRSRO in all five classes of credit ratings. On the same day, the Commission issued an order exempting LACE from the Ten Percent Rule until January 1, 2009, provided that LACE disclosed in its Form NRSRO that it received more than ten percent of its net revenue from a client that paid it to rate asset-backed securities. In granting the exemption, the Commission recognized 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." The Commission's order also specifically noted that LACE had "stated that it expects the percentage of total revenue provided by the client will decrease."

15. On February 27, 2008, LACE's auditor sent an email to LACE's former President stating, "I did notice that there was a billing to [Firm A] early in January 2008 . . . that appeared to be for services provided in December 2007. We'll have to talk about this when I come out, as I need to make sure that revenues are recorded in the correct accounting period." In response, LACE's former President represented to the auditor that the work in question for Firm A had not been completed until January 2008, thus making them 2008 revenues, even though he knew or should have known that the work in question had been completed during December 2007.

16. LACE thus continued to improperly record the deferred billing of $115,450 to Firm A as 2008 revenue. Because LACE did not properly record the revenues it earned from Firm A, LACE's audited financial statements for 2007, which were provided to the Commission and purportedly prepared in accordance with GAAP, were inaccurate.[6] Because LACE also improperly deferred $127,500 of 2008 revenue from Firm A into 2009, LACE's 2008 audited financials that it furnished to the Commission also were inaccurate. In October 2009, LACE submitted corrected audited financial statements to the Commission for 2007 and 2008.

17. Putnam and LACE's former President were responsible for ensuring the accuracy of the information provided to the Commission in connection with LACE's NRSRO application and its request for an exemption from the Ten Percent Rule.

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5 There is a discrepancy of $1,574.72 between the revenue LACE reported from Firm A in the January 10, 2008 letter ($119,393) and the amounts reflected on the invoices sent by LACE to Firm A and paid during 2007 ($117,819.28).

6 Because its registration became effective in 2008, LACE was first required to furnish audited financial statements to the Commission for the fiscal year ended December 31, 2008. LACE voluntarily provided the Commission with its fiscal year 2007 audited financial statements upon request by the Commission's staff.

18. Putnam knew or should have known that LACE was required to recognize all of the revenue it earned from Firm A for work completed during 2007 as 2007 revenue, and that as a result, the financial information that LACE provided to the Commission in connection with its NRSRO application, its request for an exemption from the Ten Percent Rule, and its 2008 audited financials was inaccurate. Putnam failed to consult with LACE's outside auditor about whether the deferral of revenue from Firm A was appropriate under GAAP. Furthermore, despite LACE's ongoing communications with the Division of Trading and Markets staff regarding LACE's NRSRO application and exemption request, Putnam failed to ensure that the Commission was informed about LACE's deferral of revenue from Firm A.

B. LACE's Undisclosed, Additional Internal Review for Credit Ratings on Certain Entities

19. During 2007 and 2008, LACE's process for rating banks, thrifts, and credit unions began with the retrieval of publicly-available financial data on the rated institutions. After this data was uploaded to LACE's computer system, the computer ratings model developed and maintained by Putnam was applied to the data.

20. Using ratings guidelines established by LACE, analysts then reviewed the ratings generated by the computer model. First, the ratings were reviewed by a junior analyst, who marked any computer-generated ratings that he or she thought should be changed. Those changes were then reviewed by a senior analyst, and the two analysts discussed any discrepancies. If the analysts could not reach agreement, they consulted a third analyst or a supervisor, including Putnam or LACE's former President.

21. After the ratings were finalized, they were entered into the LACE system and issued on the LACE Monitoring System, which allowed subscribers to view LACE's credit ratings online.

22. However, LACE performed an extra layer of review of its credit ratings for the banks whose securities were part of the CDO pools managed by Firm A. After completing its normal ratings procedures, but before the ratings were entered into LACE's system and published online, the ratings for these banks were printed as a separate document and were reviewed a third time. During 2007 and 2008, LACE's former President was primarily responsible for performing this extra review.

23. LACE's former President made a significant number of changes to the ratings produced by the firm's normal ratings procedures when performing this extra layer of review on the issuers whose securities were in the CDO pools managed by Firm A. In December 2007, March 2008, and June 2008, for example, there were over 50 changes in each quarter, out of a total of approximately 220 institutions whose securities were in Firm A's CDO pools. Approximately 85 percent of these changes were upgrades from the rating that had been generated by LACE's normal quarterly credit ratings process. These revised ratings were then published online and used in the investor reports that LACE prepared regarding Firm A's CDO pools.[7]

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[7] An analysis showed that, for the December 2008 reports, LACE's rating on the overall creditworthiness of two of Firm A's CDO pools would have been BBB- instead of BBB, had it not been for the ratings changes made during the extra level of review. For the June 2008 reports, one pool that would have received a BBB+ rating without the changes instead received an A rating, and another pool received a BBB+ rating instead of a BBB rating. LACE's

24. Although LACE was required to disclose in its NRSRO application the procedures and methodologies that it used to determine credit ratings, LACE failed to disclose its practice of conducting an extra layer of review for the issuers whose securities were in the CDO pools managed by Firm A. Furthermore, LACE had no written policies and procedures in place governing this extra layer of review.

C. LACE's Failure to Retain Emails

25. During 2008 to mid-2009, LACE had no systems in place to ensure that email messages relating to initiating, determining, maintaining, changing, or withdrawing a credit rating were retained, and, as a result, LACE failed to retain all relevant email messages for that period.

D. Putnam's Participation in Rating an Entity in Which He Owned Stock

26. Although the policy and practice at LACE was for Putnam to recuse himself from discussions regarding the credit ratings for entities in which he owned stock, internal meeting minutes show that in January 2009 Putnam participated in discussing the rating of an entity in the financial services sector whose securities he owned.

E. Violations

27. Section 15E(d) of the Exchange Act provides that the Commission shall, by order, censure, place limitations on, suspend, or revoke the registration of any NRSRO if the Commission finds that such action is necessary for the protection of investors and in the public interest and that the NRSRO or any person associated with the NRSRO has, among other things, committed any act specified in Sections 15(b)(4)(A) or (D) of the Exchange Act. Section 15(b)(4)(A) authorizes such sanctions for willful misstatements[8] of material fact in any application for registration or proceeding before the Commission with respect to registration. Section 15(b)(4)(D) authorizes such sanctions for willful violations of the Exchange Act and the rules thereunder. As described above, LACE willfully made misstatements concerning the amount of revenue it received from Firm A in its NRSRO application and its request for an exemption from the Ten Percent Rule.

28. Pursuant to Section 15E(a)(1) of the Exchange Act, a credit rating agency that elects to be treated as an NRSRO:

> shall furnish to the Commission an application for registration . . . containing . . . the procedures and methodologies that the applicant uses in determining credit ratings . . . and . . . any other information and documents concerning the applicant . . as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.

29. Rule 17g-1(a) requires a credit rating agency applying for registration as an NRSRO to furnish the Commission with an initial application on Form NRSRO that follows the Form's instructions. By willfully making misstatements concerning the amount of revenue it

ratings of the creditworthiness of the four remaining pools were not affected by the ratings changes made during the extra layer of review conducted during these quarters.

[8] 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)).

received from Firm A in its NRSRO application and its request for an exemption from the Ten Percent Rule, LACE violated Section 15E(a)(1) and Rule 17g-1(a). Additionally, the instructions to Exhibit 2 of Form NRSRO require that an applicant or NRSRO provide "a general description of the procedures and methodologies used by the Applicant/NRSRO to determine credit ratings . . . within the classes of credit ratings for which the Applicant/NRSRO is seeking registration . . . 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 . . ." LACE violated Section 15E(a)(1) and Rule 17g-1(a) and the instructions to Exhibit 2 of Form NRSRO by failing to disclose in its application that it performed an extra layer of review when determining credit ratings for banks whose securities were part of Firm A's CDO pools, after those entities already had been rated through LACE's standard ratings process, which LACE had described in its initial application.

30. The Rating Agency Act amended Section 17(a)(1) of the Exchange Act to add NRSROs to the list of entities required 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. The Commission implemented Rule 17g-2 under this authority. Rule 17g-2(a)(6) requires an NRSRO to make and retain a current and complete record documenting the established procedures and methodologies it uses to determine credit ratings. LACE violated Section 17(a) of the Exchange Act and this rule by failing to maintain records regarding the policies and procedures that governed the extra layer of review performed on the credit ratings issued on the banks whose securities were part of Firm A's CDO pools.

31. Rule 17g-2(b)(7) requires an NRSRO to retain internal and external communications, including electronic communications, received and sent by the NRSRO and its employees that relate to initiating, determining, maintaining, changing, or withdrawing a credit rating. LACE violated Section 17(a) of the Exchange Act and this rule because it did not retain all emails sent or received by the firm and its employees relating to initiating, determining, maintaining, changing, or withdrawing credit ratings.

32. Exchange Act Section 15E(k) requires an NRSRO to furnish to 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. Rule 17g-3(a)(1) requires an NRSRO to furnish the Commission with annual audited financial reports. LACE violated Section 15E(k) and Rule 17g-3(a)(1) because its 2008 audited financial statements provided to the Commission were inaccurate due to LACE's improper recording of revenue from Firm A.

33. Exchange Act Section 15E(h)(1) requires an NRSRO to establish, maintain, and enforce written policies and procedures reasonably designed to address and manage conflicts of interest. Rule 17g-5(c)(2) prohibits an NRSRO from having certain conflicts of interest relating to the issuance or maintenance of a credit rating, including issuing or maintaining a credit rating where the NRSRO, an analyst that participated in determining the credit rating, or a person responsible for approving the credit rating owns securities of the entity subject to the credit rating. LACE violated Section 15E(h)(1) and Rule 17g-5(c)(2) because Putnam participated in rating an entity whose stock he owned.

34. As a result of the conduct described above, LACE willfully violated Sections 15E(a)(1), 15E(h)(1), 15E(k), and 17(a) of the Exchange Act and Rules 17g-1(a), 17g-2(a)(6), 17g-2(b)(7), 17g-3(a)(1), and 17g-5(c)(2) thereunder.

35. Putnam, as the majority owner of LACE and a person responsible for LACE's policies, procedures, disclosures in its NRSRO application, and statements made to the Commission staff in connection with LACE's request for an exemption from the Ten Percent Rule, was a cause of LACE's violations.

36. In determining to accept the Offers, the Commission considered the remedial efforts undertaken by LACE and Putnam and cooperation afforded to the Commission staff during its investigation.

IV.

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

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

A. Respondent LACE is censured.

B. Respondents LACE and Putnam cease and desist from committing or causing any violations and any future violations of Sections 15E(a)(1), 15E(h)(1), 15E(k), and 17(a) of the Exchange Act and Rules 17g-1, 17g-2, 17g-3, and 17g-5 thereunder.

C. Respondent LACE shall pay a civil money penalty in the amount of $20,000 to the United States Treasury. Payment shall be made in the following installments: (a) LACE shall pay $10,000 within 10 days of the entry of this Order; and (b) LACE shall pay $10,000 within 180 days of the entry of this Order ("Second Installment"), with post-judgment interest due on the Second Installment. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. § 3717, shall be due and payable immediately, without further application. Payments shall be: (A) made by 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 LACE as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Antonia Chion, Division of Enforcement, Securities and Exchange Commission, 100 F St., N.E., Washington, D.C. 20549.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62835 / September 2, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14029

In the Matter of **DAMYON MOUZON,** **Respondent.**	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

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

II.

After an investigation, the Division of Enforcement alleges that:

A. Respondent

1. From April 2007 until January 2009, Mouzon was the President of LACE Financial Corp. ("LACE"), a credit rating agency that has been registered with the Commission as a Nationally Recognized Statistical Rating Organization ("NRSRO") since February 2008. As the President, Mouzon was responsible for managing the operations of LACE, including overseeing LACE's staff of analysts and the ratings process, maintaining client relationships, and managing sales and marketing. In his capacity as President of LACE, he communicated frequently with the Commission staff regarding LACE's application to register with the Commission as an NRSRO. Mouzon was notified in October 2008 that he would be terminated by LACE due to his job performance, and his final day at LACE was January 16, 2009.

B. Other Relevant Entity

2. LACE is a credit rating agency located in Frederick, Maryland. During 2008, LACE had total revenues of $918,714 and net income of $98,837. LACE was formed in 1984, and derives most of its revenue from subscription fees. On February 11, 2008, the Commission granted LACE's application to register as an NRSRO for all five classes of credit ratings described in clauses (i) through (v) of Section 3(a)(62)(B) of the Exchange Act. On the same day, the

Commission also granted LACE's request for an exemption from Exchange Act Rule 17g-5(c)(1) until January 1, 2009. Exchange Act Rule 17g-5(c)(1) (the "Ten Percent Rule") 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 ten percent of the total net revenue of the NRSRO for the fiscal year. The Commission's order required that LACE disclose that the firm received more than ten percent of its net revenue in fiscal year 2007 from a client that paid it to rate asset-backed securities. Since its founding, LACE has specialized in issuing credit ratings for financial institutions. At the time that LACE became registered as an NRSRO, LACE provided quarterly credit ratings on approximately 7,900 commercial and savings banks, 1,000 bank holding companies, 850 savings and loans, 1,500 to 8,700 credit unions (depending on the quarter), 250 foreign banks, and 95 title insurance companies.

C. Summary

3. These proceedings arise out of misrepresentations made by LACE in its application to the Commission to become registered as an NRSRO and in connection with its accompanying request for an exemption from the Ten Percent Rule. In its application and request for an exemption from this rule, LACE materially misstated the amount of revenue it received from its largest customer during 2007.

4. LACE also violated certain other Commission rules governing NRSROs. LACE violated Section 15E(a)(1) of the Exchange Act and Exchange Act Rule 17g-1(a) by making the misstatements described above and by failing to disclose in its registration application that it performed an extra layer of review for the credit ratings of issuers whose securities made up the pools for asset-backed securities managed by LACE's largest customer. LACE violated Section 17(a) of the Exchange Act and Exchange Act Rule 17g-2(a)(6) by failing to document the process of this extra layer of review in its written policies and procedures. LACE also violated Section 17(a) of the Exchange Act and Exchange Act Rule 17g-2(b)(7) by failing to maintain all emails relating to its credit ratings. Mouzon, as President of LACE beginning in April 2007 and the person responsible for the day-to-day operations of the company until his departure in January 2009, was a cause of LACE's violations.

D. The Credit Rating Agency Reform Act and Commission Rules Governing NRSROs

5. 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" and provided authority for the Commission to implement registration, recordkeeping, financial reporting, and oversight rules with respect to registered credit rating agencies. The final Commission implementing rule (Exchange Act Rule 17g-1) and form (Form NRSRO) prescribing the process for a credit rating agency to apply for registration became effective on June 18, 2007. Exchange Act Rule 17g-1 requires a credit rating agency applying for registration as an NRSRO to use Form NRSRO to furnish the Commission with the initial application. The Rule requires a firm, after becoming registered as an NRSRO, to update its registration application if any of the information becomes materially inaccurate and to provide an annual certification on Form NRSRO. Exchange Act Rules 17g-2 through 17g-6 became effective on June 26, 2007. Among other things, these rules (a) require an NRSRO to make and retain certain records (Rule 17g-2); and (b) prohibit NRSROs from having certain conflicts of interest and require NRSROs to

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[1] Pub. L. No. 109-291 (2006).

establish, maintain, and enforce written policies and procedures reasonably designed to address and manage certain other conflicts of interest related to the issuance of credit ratings by the NRSRO (Rule 17g-5).

6. To register with the Commission as an NRSRO, a credit rating agency must have been in business as a credit rating agency for at least three consecutive years immediately preceding the date of its application, and it must issue credit ratings with respect to one or more of the following categories of obligors: (a) financial institutions, (b) insurance companies, (c) corporate issuers, (d) issuers of asset-backed securities, and (e) issuers of government securities, municipal securities, or securities issued by a foreign government. The credit rating agency also must submit an application that contains certain information including, among other things, the procedures and methodologies that the applicant uses to determine credit ratings, policies and procedures to prevent the misuse of material, nonpublic information, any conflict of interest relating to the issuance of credit ratings, whether it has a code of ethics in effect, and certain financial information.

7. The Commission's rules were designed to further the goals of the Rating Agency Act to "improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry."[2] To meet these goals, it is critical that firms provide accurate information to the Commission and the public in their Form NRSROs and financial reports, that they do not have prohibited conflicts, and that they establish, maintain, and enforce policies and procedures to address conflicts of interest. Compliance with the recordkeeping requirements is critical to the Commission's NRSRO examination and oversight programs.

E. LACE's Misstatements in its NRSRO Application

8. The Commission received a completed application from LACE to register as an NRSRO on October 31, 2007.

9. In a letter dated October 30, 2007, LACE requested that the Commission issue an order exempting LACE from the Ten Percent Rule, Rule 17g-5(c)(1).

10. LACE requested an exemption from the Ten Percent Rule because, for the fiscal year ending December 31, 2007, LACE maintained credit ratings on asset-backed securities solicited by LACE's largest client ("Firm A"), which had provided LACE with more than ten percent of LACE's total revenue during fiscal year 2007. Firm A, among other things, manages Collateralized Debt Obligation ("CDO") investment vehicles constructed from pools of assets comprised largely of trust-preferred securities issued by banks and thrifts, and hired LACE to prepare initial and semi-annual reports regarding the issuing entities that Firm A distributed to investors in these CDOs.

11. LACE prepared the investor reports for Firm A twice a year for each of Firm A's five (and beginning in 2007, six) CDO pools. The reports included, among other things, a report on the financial condition of the particular CDO pool, summaries of all issuers whose LACE ratings had been upgraded or downgraded from the previous quarter, a description of any issuers that had undergone a merger or acquisition in the past quarter, and a banking industry analysis. The reports also included charts showing selected financial ratios and other financial data.

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[2] Preamble to the Rating Agency Act.

12. The reports also contained LACE's credit rating for each issuer whose securities were in the CDO pools, as well as a rating of the overall credit worthiness of each CDO pool, based on the par weighted average of LACE's ratings on each issuer of securities in the pool. LACE did not rate the various tranches of securities issued by the CDOs.

13. Mouzon was involved in the editing and production of these reports. He supervised the analysts who created the initial drafts, edited their drafts, and oversaw the production process.

14. In its October 30, 2007 letter requesting an exemption from the Ten Percent Rule, LACE stated that its estimated annual revenues from Firm A for 2007 would be $119,000 when calculated on a cash basis and $179,000 when calculated on an accrual basis. The letter further stated that the account represented 18.6 percent of LACE's revenues and that LACE expected this percentage to decrease by the end of 2007 and further decrease in 2008.

15. Subsequently, in an attempt to keep its 2007 revenue from Firm A as close as possible to ten percent of its total revenues for the year, LACE postponed until January 2008 billing Firm A for reports completed during December 2007. The deferred billings totaled $115,450, which LACE recognized as 2008 revenue. However, because the reports had been completed in December 2007, under generally accepted accounting principles ("GAAP"), LACE should have recorded the $115,450 as 2007 revenue.[3]

16. In a letter dated January 10, 2008 to the staff of the Commission's Division of Trading and Markets, LACE stated that its 2007 revenues from Firm A were $119,393, which accounted for 14.2 percent of LACE's 2007 revenue. The letter, signed by Mouzon and copied to LACE's majority owner, stated that although the numbers provided in the letter were unaudited, LACE did not anticipate that there would be any material changes. The amount of revenue attributed to Firm A in the letter was the amount that LACE actually had been paid by Firm A during 2007, but did not include the $115,450 that LACE had deferred billing for until January 2008. The letter signed by Mouzon did not describe the basis for the stated revenue amount or disclose that, inconsistent with GAAP, LACE had deferred its recognition of revenue from Firm A into 2008. The total value of work performed for Firm A by LACE during 2007 was in fact $233,268.28, comprising approximately 28 percent of LACE's revenues for the year when properly calculated on an accrual basis as required by GAAP.[4]

17. On February 11, 2008, the Commission granted LACE's application to be registered as an NRSRO in all five classes of credit ratings. On the same day, the Commission issued an order exempting LACE from the Ten Percent Rule until January 1, 2009, provided that LACE disclosed in its Form NRSRO that it received more than ten percent of its net revenue from a client that paid it to rate asset-backed securities. In granting the exemption, the Commission recognized 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

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3 GAAP provides that revenue should generally be recognized when it is earned, as opposed to when it is billed or received. See SEC Staff Accounting Bulletin No. 104, Revenue Recognition (December 17, 2003) (Corrected Copy).

4 There is a discrepancy of $1,574.72 between the revenue LACE reported from Firm A in the January 10, 2008 letter ($119,393) and the amounts reflected on the invoices sent by LACE to Firm A and paid during 2007 ($117,819.28).

agency's impartiality." The Commission's order also specifically noted that LACE had "stated that it expects the percentage of total revenue provided by the client will decrease."

18. On February 27, 2008, LACE's auditor sent an email to Mouzon stating, "I did notice that there was a billing to [Firm A] early in January 2008 . . . that appeared to be for services provided in December 2007. We'll have to talk about this when I come out, as I need to make sure that revenues are recorded in the correct accounting period." In response, Mouzon represented to the auditor that the work in question for Firm A had not been completed until January 2008, thus making them 2008 revenues, even though he knew or should have known that the work in question had been completed during December 2007.

19. Mouzon directed the auditor to entries on the Firm A invoices indicating that "rework" had been performed, and told the auditor that this work had carried over into 2008, when in fact LACE had completed its work on the Firm A reports before the end of 2007. The "rework" noted in the invoices referred to Firm A adding additional issuers to the CDO pools during November 2007. Mouzon knew or should have known that this work had been completed in 2007, because he was heavily involved in editing the reports for Firm A and overseeing their completion. Furthermore, Mouzon sent and received emails indicating that the reports were to be amended and delivered in November or December of 2007.

20. LACE thus continued to improperly record as 2008 revenue the $115,450 for which it had deferred billing to Firm A. Because LACE did not properly record the revenues that it earned from Firm A, LACE's audited financial statements for 2007, which were provided to the Commission and purportedly prepared in accordance with GAAP, were inaccurate.

21. As president of LACE, Mouzon, together with LACE's founder and majority owner, was responsible for ensuring the accuracy of the information provided to the Commission in connection with LACE's NRSRO application and its request for an exemption from the Ten Percent Rule.

22. Mouzon knew or should have known that LACE was required to recognize all of the revenue it earned from Firm A for work completed during 2007 as 2007 revenue, and that as a result, the financial information that LACE provided to the Commission in connection with its NRSRO application and its request for an exemption from the Ten Percent Rule was inaccurate. Furthermore, despite LACE's frequent communications with the Division of Trading and Markets staff regarding LACE's NRSRO application and exemption request, Mouzon failed to ensure that the Commission was informed about LACE's deferral of revenue from Firm A at the time the application and exemption request were pending. In January 2009, three months after he had been notified that he would be terminated and shortly before his departure from LACE, Mouzon contacted the Commission staff and informed them of LACE's deferral of revenue from Firm A.

F. LACE's Undisclosed, Additional Internal Review for Credit Ratings on Certain Entities

23. During 2007 and 2008, LACE's process for rating banks, thrifts, and credit unions began with the retrieval of publicly-available financial data on the rated institutions. After the data was loaded into LACE's computer system, LACE's proprietary computer ratings model was applied to the data.

24. Using ratings guidelines established by LACE, analysts then reviewed the ratings generated by the computer model. Initially, the ratings were reviewed by a junior analyst, who

marked any computer-generated ratings that he or she thought should be changed. Those changes were then reviewed by a senior analyst, and the two analysts discussed any discrepancies. If the analysts could not reach agreement, they consulted a third analyst or a supervisor, including Mouzon or LACE's majority owner.

25. After the ratings were finalized, they were entered into the LACE computer system and issued on the LACE Monitoring System, which allowed subscribers to view LACE's credit ratings online.

26. LACE, however, performed an extra review of its credit ratings for the banks whose securities were part of the CDO pools managed by Firm A. After completing its normal ratings procedures, but before the ratings were entered into LACE's system and published online, the ratings for these banks were reviewed a third time. During 2007 and 2008, Mouzon was primarily responsible for performing this extra review.

27. Mouzon made a significant number of changes to the ratings produced by the firm's normal ratings procedures when performing this extra layer of review on the issuers whose securities were in the CDO pools managed by Firm A. In December 2007, March 2008, and June 2008, for example, there were over 50 changes in each quarter, out of a total of approximately 220 institutions whose securities were in Firm A's CDO pools. Approximately 85 percent of these changes were upgrades from the ratings that had resulted from LACE's normal quarterly credit ratings process. These revised ratings were then published online and incorporated into the investor reports that LACE prepared regarding Firm A's CDO pools.

28. LACE was required to disclose in its NRSRO application the procedures and methodologies that it used to determine credit ratings. LACE failed to disclose its practice of conducting an extra review for the issuers whose securities were in the CDO pools managed by Firm A. Furthermore, LACE had no written policies and procedures in place governing this extra layer of review. Mouzon knew or should have known that LACE was required to disclose this extra review, and have written policies and procedures in place that described and governed the extra review, yet he failed to ensure that LACE did so.

G. LACE's Failure to Retain Emails

29. During 2008 to mid-2009, after LACE became registered as an NRSRO, LACE had no systems in place to ensure that email messages relating to initiating, determining, maintaining, changing, or withdrawing a credit rating were retained, and, as a result, LACE failed to retain all relevant email messages for that period. As LACE's President from April 2007 to January 2009, Mouzon knew or should have known that, as an NRSRO, LACE was required to retain such email messages. Mouzon failed to ensure that the required emails were retained.

H. Violations

30. Pursuant to Section 15E(a)(1) of the Exchange Act, a credit rating agency that elects to be treated as an NRSRO:

> shall furnish to the Commission an application for registration . . . containing . . . the procedures and methodologies that the applicant uses in determining credit ratings . . . and . . . any other information and documents concerning the applicant . . . as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.

31. Rule 17g-1(a) requires a credit rating agency applying for registration as an NRSRO to furnish the Commission with an initial application on Form NRSRO that follows the Form's instructions. By willfully making misstatements concerning the amount of revenue it received from Firm A in its NRSRO application and its request for an exemption from the Ten Percent Rule, LACE violated Section 15E(a)(1) of the Exchange Act and Rule 17g-1(a). Additionally, the instructions to Exhibit 2 of Form NRSRO require that an applicant or NRSRO provide "a general description of the procedures and methodologies used by the Applicant/NRSRO to determine credit ratings . . . within the classes of credit ratings for which the Applicant/NRSRO is seeking registration . . . . 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 . . ." LACE violated Section 15E(a)(1) and Rule 17g-1(a) and the instructions to Exhibit 2 of Form NRSRO by failing to disclose in its application that it performed an extra layer of review when determining credit ratings for banks whose securities were part of Firm A's CDO pools, after those entities already had been rated through LACE's standard ratings process, which LACE had described in its initial application.

32. The Rating Agency Act amended Section 17(a)(1) of the Exchange Act to add NRSROs to the list of entities required 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. The Commission implemented Rule 17g-2 under this authority. Rule 17g-2(a)(6) requires an NRSRO to make and retain a current and complete record documenting the established procedures and methodologies it uses to determine credit ratings. LACE violated Section 17(a) of the Exchange Act and Rule 17g-2(a)(6) by failing to maintain records regarding the policies and procedures that governed the extra layer of review performed on the credit ratings issued on the banks whose securities were part of Firm A's CDO pools.

33. Rule 17g-2(b)(7) requires an NRSRO to retain internal and external communications, including electronic communications, received and sent by the NRSRO and its employees that relate to initiating, determining, maintaining, changing, or withdrawing a credit rating. LACE violated Section 17(a) of the Exchange Act and Rule 17g-2(b)(7) because it did not retain all emails sent or received by the firm and its employees relating to initiating, determining, maintaining, changing, or withdrawing credit ratings.

34. As a result of the conduct described above, LACE willfully violated Sections 15E(a)(1) and 17(a) of the Exchange Act and Rules 17g-1(a), 17g-2(a)(6), and 17g-2(b)(7) thereunder.

35. Mouzon, as the President of LACE and a person responsible for LACE's policies and procedures, the disclosures in LACE's NRSRO application, and the statements made to the Commission staff in connection with LACE's request for an exemption from the Ten Percent Rule, was a cause of LACE's violations.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it appropriate that 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; and

B. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 21C 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.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62844 / September 3, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14031

In the Matter of

EDWARD M. DENIGRIS,

Respondent.

ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

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

II.

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

III.

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

1. At the time of the relevant conduct, Denigris, 59 years old, resided in Fort Lauderdale, Florida. He is currently a resident of Costa Rica. From May 2008 through October 2009, Denigris, the president and sole director of Amante Corporation, solicited investors to purchase Amante Corporation's securities. Denigris received transaction-based compensation in connection with sales of Amante Corporation's securities. When Denigris solicited investors to purchase Amante Corporation's securities, Denigris was neither registered as a broker or dealer nor associated with a registered broker or dealer.

2. On August 11, 2010, a final judgment was entered by consent against Denigris, permanently enjoining him from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933 ("Securities Act"), Sections 10(b) and 15(a) of the Exchange Act, and Exchange Act Rule 10b-5, in the civil action entitled Securities and Exchange Commission v. Amante Corporation, et al., Civil Action Number 09-CV-61716-JIC, in the United States District Court for the Southern District of Florida.

3. The Commission's complaint alleged that Denigris fraudulently offered and sold the stock of Amante Corporation in unregistered transactions without being associated with a broker or dealer registered with the Commission. The complaint further alleged Denigris's offers and sales of Amante Corporation's securities were fraudulent because Denigris misrepresented to investors that an initial public offering of Amante Corporation's stock was imminent and that the stock's price would increase materially.

IV.

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

Accordingly, it is hereby ORDERED:

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

Elizabeth M. Murphy
Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

September 3, 2010

In the Matter of **PROSPERO GROUP,** **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 Prospero Group ("Prospero") because: a) it has failed to file any periodic reports since an overdue filing of its Form 10-K for the fiscal year ended March 31, 2009; b) its filings for the fiscal years ended March 31, 2008 and March 31, 2009 fail to include all of the Items requested by Form 10-K; and c) certain of its periodic filings and subsequent disclosures on Form 8-K appear to contain information that is misleading, internally inconsistent, and/or lacking in sufficient detail. Prospero is quoted on the Pink Sheets operated by Pink OTC Markets, Inc. under the ticker symbol "PRPG."

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

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed company is suspended for the period from 9:30 a.m. EDT on September 3, 2010, through 11:59 p.m. EDT on September 17, 2010.

By the Commission.

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Chapter II [Release Nos. 33-9138, 34-62841, 39-2470, IA-3078, IC-29408; File No. S7-20-10]

List of Rules to be Reviewed Pursuant to the Regulatory Flexibility Act

AGENCY: Securities and Exchange Commission.

ACTION: Publication of list of rules scheduled for review.

SUMMARY: The Securities and Exchange Commission is today publishing a list of rules to be reviewed pursuant to Section 610 of the Regulatory Flexibility Act. The list is published to provide the public with notice that these rules are scheduled for review by the agency and to invite public comment on them.

DATES: Comments should be submitted by December 15, 2010.

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

Electronic comments:

- Use the Commission's Internet comment form(http://www.sec.gov/rules/other.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-20-10 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090. All submissions should refer to File No. S7-20-10. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet web site (http://www.sec.gov/rules/other.shtml). Comments also are available for website viewing and printing in the Commission's Public Reference Room, 100 F Street NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Anne Sullivan, Office of the General Counsel, 202-551-5019.

SUPPLEMENTARY INFORMATION: The Regulatory Flexibility Act ("RFA"), codified at 5 U.S.C. 600-611, requires an agency to review its rules that have a significant economic impact upon a substantial number of small entities within ten years of the publication of such rules as final rules. 5 U.S.C. 610(a). The purpose of the review is "to determine whether such rules should be continued without change, or should be amended or rescinded . . . to minimize any significant economic impact of the rules upon a substantial number of such small entities." 5 U.S.C. 610(a).

The RFA sets forth specific considerations that must be addressed in the review of each rule:

- the continued need for the rule;
- the nature of complaints or comments received concerning the rule from the public;
- the complexity of the rule;
- the extent to which the rule overlaps, duplicates or conflicts with other federal rules, and, to the extent feasible, with state and local governmental rules; and

- the length of time since the rule has been evaluated or the degree to which technology, economic conditions, or other factors have changed in the area affected by the rule. 5 U.S.C. 610(c).

The Securities and Exchange Commission, as a matter of policy, reviews all final rules that it published for notice and comment to assess not only their continued compliance with the RFA, but also to assess generally their continued utility. The list below is therefore broader than that required by the RFA, and may include rules that do not have a significant economic impact on a substantial number of small entities. Where the Commission has previously made a determination of a rule's impact on small businesses, the determination is noted on the list. The Commission particularly solicits public comment on whether the rules listed below affect small businesses in new or different ways than when they were first adopted.

The rules and forms listed below are scheduled for review by staff of the Commission during the next twelve months. The list includes rules from 1999. When the Commission implemented the Act in 1980, it stated that it "intend[ed] to conduct a broader review [than that required by the RFA], with a view to identifying those rules in need of modification or even rescission." Securities Act Release No. 6302 (Mar. 20, 1981), 46 FR 19251 (Mar. 30, 1981). The rules are grouped according to which Division or Office of the Commission recommended their adoption.

<u>Rules and Forms Division of Corporation Finance</u>

<u>Title:</u>	Regulation of Takeovers and Security Holder Communications.
<u>Citation:</u>	17 CFR 229.1000 – 1016, 17 CFR 230.162, 17 CFR 230.165, 17 CFR 230.166, 17 CFR 230.425, 17 CFR 240.13e-4, 17 CFR 240.13e-100, 17 CFR 240.14d-11, 17 CFR 240.14e-5, 17 CFR 240.14e-8.
<u>Authority:</u>	15 U.S.C. 77a *et seq.*, 15 U.S.C. 78a *et seq.*
<u>Description:</u>	These rules and regulations apply to takeover transactions (including tender offers, mergers, acquisitions and similar extraordinary transactions). They also permit increased communications with security holders and the markets, balance the treatment of cash and stock tender offers, simplify and centralize disclosure requirements, and eliminate regulatory inconsistencies in mergers and tender offers.
<u>Prior Commission Determination Under 5 U.S.C. 601:</u>	A Final Regulatory Flexibility Analysis was prepared in accordance with 5 U.S.C. 604 in conjunction with the adoption of Release No. 33–7760, approved by the Commission on October 22, 1999, which adopted Regulation M-A and the related rules and revisions. Comments to the proposing release were considered at that time. The Commission received no comments on the Initial Regulatory Flexibility Analysis.

* * * * *

<u>Title:</u>	Cross-Border Tender and Exchange Offers, Business Combinations and Rights Offerings.
<u>Citation:</u>	17 CFR 230.800 – 802, 17 CFR 260.4d-10.
<u>Authority:</u>	15 U.S.C. 77a *et seq.*, 15 U.S.C. 78a *et seq.*
<u>Description:</u>	These rules provide tender offer and Securities Act registration exemptions for cross-border tender and exchange offers, business combinations and rights offerings relating to the securities of foreign companies.

Prior Commission Determination Under 5 U.S.C. 601: A Final Regulatory Flexibility Analysis was prepared in accordance with 5 U.S.C. 604 in conjunction with the adoption of Release No. 33–7759, approved by the Commission on October 22, 1999, which adopted Securities Act Rules 800 through 802 and Trust Indenture Act Rule 4d-10. Comments to the proposing release were considered at that time. The Commission received no comments on the Initial Regulatory Flexibility Analysis.

* * * * *

Title: International Disclosure Standards.

Citation: 17 CFR 210.3-01, 17 CFR 210.3-20, 239.36.

Authority: 15 U.S.C. 77a *et seq.*, 15 U.S.C. 78a *et seq.*

Description: These rules revise disclosure requirements to conform to the international disclosure standards endorsed by the International Organization of Securities Commissions in September 1998.

Prior Commission Determination Under 5 U.S.C. 601: Pursuant to the Regulatory Flexibility Act (15 U.S.C. § 605(b)), the Chairman of the Commission certified at the proposal stage on February 2, 1999 that the revisions to rules and forms would not have a significant economic impact on a substantial number of small entities. The Commission received no comments specifically addressing the certification.

* * * * *

Title: Audit Committee Disclosure.

Citation: 17 CFR 210.10-01.

Authority: 15 U.S.C. 77a *et seq.*, 15 U.S.C. 78a *et seq.*

Description: This rule requires that companies' independent auditors review the companies' financial information included in the companies' quarterly reports prior to the filing of these reports.

Prior Commission Determination Under 5 U.S.C. 601: A Final Regulatory Flexibility Analysis was prepared in accordance with 5 U.S.C. 604 in conjunction with the adoption of Release No. 34–42266, approved by the Commission on December 22, 1999, which adopted Rule 10-01 of Regulation S-X under the Securities Act of 1933 and the Securities Exchange Act of 1934. Comments to the proposing release and Initial Regulatory Flexibility Analysis were considered at that time.

* * * * *

Rules and Forms Administered by the Division of Investment Management

Title: Rule 17j-1

Citation: 17 CFR 270.17j-1

Authority: 15 U.S.C. 80a-1 et seq., 80a-17(j), 80a-37(a)

Description: Rule 17j-1 under the Investment Company Act of 1940 ("Act") prohibits fraudulent, deceptive or manipulative acts by persons affiliated with a registered investment company ("fund") or with the fund's investment adviser or principal underwriter in connection with their personal securities transactions in securities held or to be acquired by the fund. The rule requires 17j-1 organizations to adopt codes of ethics reasonably designed to prevent fraud and requires fund personnel to report their personal securities transactions to their 17j-1 organization.

Prior Commission Determination Under 5 U.S.C. 601: A Final Regulatory Flexibility Analysis was prepared in accordance with 5 U.S.C. 604 in conjunction with the adoption of Release No. IC-23958, which was approved by the Commission on Aug. 20, 1999. Comments to the proposing release and any comments to the Initial Regulatory Flexibility Analysis were considered at that time.

* * * * *

Title: Rule 154

Citation: 17 CFR 230.154

Authority: 15 U.S.C. 77a et seq.

Description: Rule 154 under the Securities Act of 1933 permits an issuer or broker-dealer that has an obligation to deliver a prospectus to multiple persons at a single address to satisfy that obligation by delivering a single prospectus, subject to certain conditions.

Prior Commission Determination Under 5 U.S.C. 601: A Final Regulatory Flexibility Analysis was prepared in accordance with 5 U.S.C. 604 in conjunction with the adoption of Release No. IC-24123, which was approved by the Commission on November 4, 1999. Comments to the proposing release and any comments to the Initial Regulatory Flexibility Analysis were considered at that time.

* * * * *

Rules and Forms Administered by the Division of Trading and Markets

Title: Rule 10b-18

Citation: 17 CFR 240.10b-18

Authority: 15 U.S.C. 78b, 78c, 78i(a)(6), 78j(b), 78m(e), 78*o*(c) and 78w(a)

Description: Rule 10b-18 under the Securities Exchange Act of 1934 Rule 10b-18 provides a "safe harbor" from liability for manipulation under Sections 9(a)(2) and 10(b) of the Exchange Act, and Rule 10b-5 thereunder, when an issuer or affiliated purchaser of the issuer bids for or buys shares of its common stock in compliance with the Rule's conditions.

Prior Commission Determination Under 5 U.S.C. 601: A Final Regulatory Flexibility Analysis was prepared in accordance with 5 U.S.C. 604 in conjunction with the adoption of Release No. 34-41905, which was approved by the Commission on Sept. 23, 1999. Comments to the proposing release and any comments to the Initial Regulatory Flexibility Analysis were considered at that time.

* * * * *

Title: Rules 15b3-1, 15Ba2-2, and 15Ca2-1

Citation: 17 CFR 240.15b3-1, 240.15Ba2-2, and 240.15Ca2-1

Authority: 15 U.S.C. §§ 78o(a), 78o(b), 78o-4(a)(2), 78o-5(a)(2), and 78w(a).

Description: Rule 15b3-1 under the Securities Exchange Act of 1934 governs amendments to applications for registration as a broker or a dealer. Rule 15Ba2-2 under the Securities Exchange Act of 1934 governs applications for registration of non-bank municipal securities dealers whose business is exclusively intrastate. Rule 15Ca2-1 under the Securities Exchange Act of 1934 governs applications for registrations as a government securities broker or government securities dealer.

Prior Commission Determination Under 5 U.S.C. 601: A Final Regulatory Flexibility Analysis was prepared in accordance with 5 U.S.C. 604 in conjunction with the adoption of Release No. 34-41594, which was approved by the Commission on July 2, 1999. Comments to the proposing release and any comments to the Initial Regulatory Flexibility Analysis were considered at that time.

By the Commission

Elizabeth M. Murphy

Elizabeth M Murphy
Secretary

September 3, 2010

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62852 / September 7, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14032

In the Matter of **America First Associates Corp.,** **American Eco Corp.,** **American Income 2 LP,** **American Income 3 LP,** **American International Assets, Inc.,** **American Leasing Investors V-C,** **American Sensors, Inc., and** **Americana Hotels & Realty Corp.** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents America First Associates Corp., American Eco Corp., American Income 2 LP, American Income 3 LP, American International Assets, Inc., American Leasing Investors V-C, American Sensors, Inc., and Americana Hotels & Realty Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. America First Associates Corp. (CIK No. 1084203) is a void Delaware corporation located in Stewart Manor, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). America First is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB/A for the period ended June 30, 2004, which reported a net loss of $169,921 for the prior three months.

2. American Eco Corp. (CIK No. 868076) is an Ontario corporation located in Houston, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Eco 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 February 29, 2000, which reported a net loss of over $4.2 million for the prior three months. American Eco is also delinquent in its filings with the Ontario Securities Commission. On August 4, 2000, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Delaware, which was converted to Chapter 7 and terminated on September 13, 2007. As of August 30, 2010, the company's stock (symbol "ECGOQ") was traded on the over-the-counter markets.

3. American Income 2 LP (CIK No. 742102) is a canceled Massachusetts limited partnership located in Boston, Massachusetts with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Income 2 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, 1995.

4. American Income 3 LP (CIK No. 742103) is a canceled Massachusetts limited partnership located in Boston, Massachusetts with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Income 3 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, 1995, which reported a net loss of $150,737 for the prior twelve months.

5. American International Assets, Inc. (CIK No. 862024) is an expired Utah corporation located in Flushing, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American International is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2003, which reported a net loss of $157,412 for the prior nine months.

6. American Leasing Investors V-C (CIK No. 710155) is a canceled California limited partnership located in Greenwich, Connecticut with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Leasing is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 1995.

7. American Sensors, Inc. (CIK No. 912090) is an Ontario corporation located in Toronto, Ontario, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Sensors 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 June 30, 1996, which reported a net loss of $11,052 for the prior twelve months.

8. Americana Hotels & Realty Corp. (CIK No. 356959) is a dissolved Maryland corporation located in Boston, Massachusetts with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Americana is delinquent in its

periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended March 31, 1998.

B. DELINQUENT PERIODIC FILINGS

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

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

11. 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 registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9139 / September 7, 2010

SECURITIES EXCHANGE ACT OF 1934
Release No. 62855 / September 7, 2010

INVESTMENT ADVISERS ACT OF 1940
Release No. 3079 / September 7, 2010

INVESTMENT COMPANY ACT OF 1940
Release No. 29411 / September 7, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14033

In the Matter of **NEAL R. GREENBERG,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(f) AND (k) 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 Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(f), and (k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Neal R. Greenberg ("Greenberg" or "Respondent").

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. Greenberg, age 54 and a resident of Boulder, Colorado, was at all relevant times the CEO of an investment adviser registered with the Commission, Tactical Allocation Services ("TAS") and the head portfolio manager for another investment adviser registered with the Commission, Agile Group, LLC ("Agile Group"). Agile Group is wholly-owned by TAS, and Greenberg is the majority owner of TAS. TAS provided investment advice to individual clients. Agile Group served as the general partner and investment adviser to at least eight affiliated Agile hedge funds. Greenberg controlled and had ultimate decision-making authority for TAS and Agile Group. In October 2009 Agile Group and TAS withdrew their registrations as investment advisers with the Commission and Greenberg ended his association with the firms. At all relevant times Greenberg held Series 1, 4, 7, 24, 63, and 65 licenses. He was the principal of an affiliated registered broker-dealer, Agile Securities, Inc., starting in 1996 until that firm withdrew its registration with the Commission in November 2008.

B. SUMMARY

2. This case involves fraud and breach of fiduciary duty by Greenberg through his recommendation and sale of the Agile hedge funds, acting individually and through TAS and Agile Group, to TAS clients and other investors. Due to Greenberg, a large majority of TAS clients invested in Agile hedge funds, and these clients were generally conservative, older investors near or in retirement who wanted low-risk investments offering significant capital protection. In the offer and sale of the Agile hedge funds, as well as in advising clients to remain invested in the funds, Greenberg made material misrepresentations and omissions, including misrepresentations materially overstating the diversification and liquidity of the funds, and materially understating the risks of investing in the funds. Further, numerous TAS clients invested in the hedge funds based upon unsuitable recommendations for which Greenberg was responsible.

3. In September 2008, Agile Group suspended redemptions in its hedge funds. The Agile hedge funds remain frozen today, and investors likely have lost most, and possibly all, of their investment.

C. BACKGROUND

4. Agile Group served as an investment adviser to affiliated hedge funds, including the Agile Safety Fund ("The Safety Fund"), the Agile Performance Fund ("The Performance Fund"), the Agile Safety Master Fund ("The Master Fund"), the Agile Safety Fund International ("The International Fund"), and the Agile Safety Variable Fund ("The Variable Fund").

5. The Safety Fund and the Performance Fund were formed in 2002. The Safety Fund was a fund-of-funds and the Performance Fund was a multi-strategy fund. Virtually the only investors in the Safety Fund were pre-existing TAS advisory clients who transferred their assets from unaffiliated investments into the Safety Fund. The primary investor in the Performance Fund initially was the Safety Fund.

6. The Master Fund and the International Fund were formed in 2004. The Safety Fund and the International Fund became feeder funds for the Master Fund, and fully invested all of their assets in the Master Fund. The Master Fund in turn invested almost all of its assets (except for some limited cash holdings) in a single call-option contract with BNP Paribas ("BNP"), which was designed to track a basket of underlying hedge funds selected by Agile Group. BNP provided leverage to the Master Fund through the call-option contract. The Master Fund did not make any direct investments in hedge funds. However, in practice, any hedge fund selected for the hedge fund basket by Agile Group was purchased by BNP. Agile Group selected the Performance Fund as one of the funds for its hedge fund basket, and BNP subsequently made investments in the Performance Fund to match the amount selected for the basket by Agile Group.

7. The Variable Fund was also formed in 2004. The Variable Fund was a fund of funds that invested in largely the same basket of funds as the Master Fund. The Variable Fund had only one limited partner, AGL Life Assurance Company, and the Variable Fund was an investment option within the AGL Life variable annuity. Clients purchasing an annuity from AGL Life were advised to allocate their premium payments entirely to the Variable Fund. Once again, virtually the only investors in the Variable Fund were pre-existing TAS advisory clients who transferred their assets from unaffiliated investments into the Variable Fund.

8. The vast majority of the Performance Fund's investor capital came directly or indirectly from the Safety Fund, the Variable Fund, and the International Fund.

9. Greenberg, individually and through TAS, recommended to many clients that they invest in these affiliated Agile hedge funds. At least 140 TAS clients (roughly 75% of the total TAS client base) were invested in Agile hedge funds as of December 2007.

10. Many TAS clients were conservative, older investors near or in retirement who wanted low-risk investments offering significant capital protection. Many TAS clients also needed money from their investment portfolio to fund their annual living expenses.

11. In mid-September 2008, the Safety Fund, the Variable Fund, and the International Fund decided to limit redemptions because the funds were anticipating that they would not have sufficient liquidity to meet redemption requests as of September 30, 2008. In late September 2008, investors were told that the Safety Fund, the Variable Fund, and the International Fund were suspending redemptions because the funds had suffered substantial losses due to investments the funds had made, either directly or indirectly, with the Lancelot Investors Fund, L.P. and Lancelot Investors Fund II, LP. (collectively "Lancelot"), and the Palm Beach Finance Partners L.P. and Palm Beach Finance Partners II, L.P. (collectively "Palm Beach"). Lancelot and Palm Beach had suffered very significant losses due to a fraudulent scheme by Tom Petters ("Petters"). At this

point, approximately $174 million of investor capital was invested in the Safety Fund, the Variable Fund, and the International Fund.

12. In December 2008, investors were told that the Safety Fund, the Variable Fund, and the International Fund had suffered additional losses due to investments made, either directly or indirectly, in the Rye Select Broad Market Fund, L.P. and Rye Select Broad Market Prime Fund, L.P. (collectively "Rye Select") which had suffered very significant losses due to a fraudulent scheme by Bernard Madoff ("Madoff").

13. To date, no redemptions have been allowed by the Safety Fund, the Variable Fund, and International Fund, and investors likely have lost most, and possibly all, of their investments in these funds. Some investors have lost most or all of their retirement savings.

D. MISREPRESENTATIONS AND OMISSIONS TO INVESTORS AND PROSPECTIVE INVESTORS IN THE AGILE HEDGE FUNDS

14. Between at least 2006 and 2008, Greenberg made material misrepresentations and omissions to clients and investors in the offer and sale of the Agile hedge funds as well as in advising clients to remain invested in the funds. For each of the specific allegations made in Paragraphs 14-22, these misrepresentations and omissions were made by Greenberg, acting individually and/or through TAS and Agile Group.

15. First, Greenberg made false and/or misleading oral and written representations that the Safety Fund, the International Fund, and the Variable Fund were "immensely" diversified including, but not limited to, representations about the high number of managers or funds, the high number and variety of different underlying investments held by those funds, and the high number of non-correlated strategies employed by those funds. Greenberg stated that investors should invest most or all of their investment monies in Agile hedge funds because the tremendous diversification in the funds made them low-risk, safe investments.

16. For example, in a September 25, 2007 conference call with investors, Greenberg stated:

> "One of the exciting things we do with [the Safety Fund] is we emphasize diversification immensely so that the—if we're sitting in 50 or substantially more managers each of those managers might be sitting on 15,000 different investments so there are some of our managers that have multiple strategies and thousands and thousands and thousands of different investments. Some of them much fewer might be a single strategy with 100 or 200 different investments but in aggregate, we're constructing for our clients such a high level of diversification by using so many managers, each of whom uses different strategies and different investments that this particular portfolio has so much what's called non-correlation. When I say non-correlation I mean that Investment A zigs while Investment B zags. That's the whole benefit of diversification. So that's what we want to do in the past, that's what we've done in the past and that's what we intend to do in the future so we can

continue to provide good returns with minimal risk....We think it's the best way of managing the bulk of client's wealth going into the future."

17. Similarly, a March 2006 Monthly Newsletter to Safety Fund investors stated the following:

> "We at Agile Group believe in hyper- or ultra- diversification. This means we believe it is important for a client to have many different asset classes, investment managers and funds...Instead of owning 4 or 5 different asset classes in a traditional pie chart diversification model, a client can have over 10 different asset classes in one package. Instead of owning 5 to 10 mutual funds, a client can own 50 different managers and know they are being monitored monthly and replaced automatically when they underperform. Lastly, instead of a false sense of diversification, a client can effectively own over 11,000 stocks, bonds, and other instruments in over 10 different assets classes with over 50 different managers but all in one easy to digest package that is professionally managed and accountable to investors."

18. The representations that the Safety Fund, the International Fund, and the Variable Fund were highly diversified were false and/or misleading because, for example, as of September 30, 2008, 48% of the investor capital (not including leverage) in those funds had been invested indirectly with Petters through the Lancelot and Palm Beach funds. Similarly, 14% of the investor capital (not including leverage) in those funds had been invested indirectly with Madoff through Rye Select. Together, these investments equaled 62% of investor capital in the funds. As of December 31, 2007, the investments in Lancelot, Palm Beach, and Rye Select equaled 56% of investor capital (not including leverage) in these funds. This was not the level of diversification touted by Greenberg, and was inconsistent with representations that the Agile hedge funds would disperse assets among a multitude of underlying hedge fund managers, investments, and strategies.

19. Greenberg also falsely stated that the tremendous diversification of the Safety Fund, the International Fund, and the Variable Fund would insulate the funds from significant losses if one or two investments made by the funds lost most of their value. Given the large percentage of investor capital invested in a few funds, Greenberg knew or was reckless in not knowing that the Agile hedge funds were not insulated from losses in funds in which they were heavily invested.

20. Greenberg also failed to disclose to investors that the Safety Fund, the International Fund, and the Variable Fund had a practice of placing a large proportion of investor capital in a few hedge funds. This was misleading given the representations made to investors about diversification, the large number of managers, and the significant number of non-correlated investments and strategies. Investors reasonably understood that the funds would not be concentrating a large amount of investor capital in only a few funds. Beyond the Lancelot, Palm Beach, and Rye Select investments, the Safety Fund, the International Fund, and the Variable Fund also made concentrated investments in several other funds and had a high concentration in certain strategies including asset-based lending strategies. The concentration of the Safety Fund, the

International Fund, and the Variable Fund in certain core investments and strategies increased the undisclosed risks created by the funds' lack of diversification.

21. Greenberg also made false oral and written representations concerning the risks of the hedge fund investments. Greenberg falsely stated that the Safety Fund, the Variable Fund, and the International Fund: (a) involved a minimal degree of risk; (b) had an investment objective of conservative growth with significant principal protection; (c) were suitable for retirees who needed liquidity in their investment to pay for living expenses; (d) could each safely represent an investor's entire investment program; and (e) used leverage in a way that did not significantly increase the risk profile of the funds.

22. The risk disclosures in the 2007 and later private placement memoranda ("PPMs") for the funds directly contradicted Greenberg's oral and written representations and showed that the representations were false and/or misleading. For example, the 2007 PPM for the Safety Fund stated that it: (a) involved a "high degree of risk"; (b) had a primary objective of "capital appreciation"; (c) was suitable only for persons "who have no need for liquidity in the investment"; (d) should be considered only "as a supplement to an overall investment program"; and (e) used leverage in a way that could "substantially increase the exposure to loss" with a "relatively small movement in the market." Due to Greenberg's continuing oral and written misrepresentations, many Agile hedge fund investors were never adequately informed of the risks. For example, with regard to leverage, not only did the Safety Fund, the Variable Fund, and the International Fund use leverage, but many of the hedge funds invested in by those funds also used leverage. Many investors were never adequately informed about the risks of leverage in the Agile hedge funds.

E. <u>THE AGILE HEDGE FUND INVESTMENTS WERE UNSUITABLE FOR MANY TAS ADVISORY CLIENTS</u>

23. TAS marketed itself as an investment adviser dedicated to preserving wealth for conservative investors. Clients were told in marketing materials that TAS formulated investment advice with a "risk minimization first, return second" mindset designed to deliver the "peace of mind you need to sleep well at night." Clients were also told in those materials that TAS created "an individualized portfolio tailored to [their] needs and objectives." As a result of positioning itself in this manner, TAS attracted mainly investors that were in retirement or near retirement, and that generally had relatively conservative investment objectives and low risk tolerances. Many clients needed money from their investment portfolio to fund their annual living expenses, were financially unsophisticated, and had no understanding of complex financial investments such as hedge funds. Greenberg was fully aware of the general profile of the average TAS client.

24. In 2002, when Greenberg began creating the Agile hedge funds, TAS clients were encouraged to invest in them. The name "safety" in all the funds to convey the notion that the funds were intended as relatively safe investment vehicles designed for conservative investors. Greenberg, acting individually and through TAS and Agile Group, repeatedly stated that the Agile hedge funds achieved much better returns with less risk than traditional mutual fund and bond investments.

25. At of end of 2006, 83% of the assets under management by TAS were invested in Agile hedge funds. As of June 2008, at least 75 clients over age 60 had more than 80% of their assets under management at TAS invested in Agile hedge funds, and of those 75 clients, at least 40 were over age 70.

26. The Safety Fund, the International Fund, and the Variable Fund were unsuitable as the primary investment for numerous TAS clients. In some instances, it was unsuitable for a client to have invested any of his assets into Agile hedge funds given his investment objectives, age, liquidity needs, financial sophistication, and/or risk tolerance; in other instances, it may have been suitable for a portion of a client's portfolio to have been invested in Agile hedge funds, but it was unsuitable to have invested such a high percentage of the client's portfolio in Agile hedge funds.

27. Greenberg knew or was reckless in not knowing that the Agile hedge funds were not suitable investments for many TAS clients. The risk disclosures in the later PPMs establish that the funds were not suitable. In addition to the risk disclosures outlined above in Paragraph 22, the PPMs made other risk disclosures, including disclosures relating to high fees, very broad discretion in investment management, significant counterparty risk, conflicts of interest, and broad indemnification provisions. Greenberg, acting individually and through TAS, largely ignored these disclosures when recommending investments in the Agile hedge funds. Greenberg also knew or was reckless in not knowing that the Agile hedge funds were not suitable because:

a. Greenberg was aware of the concentrated positions the Safety Fund, the Variable Fund, and the International Fund were taking in certain hedge funds, managers, and strategies as described in Paragraphs 18-20 above. In early 2008, some members of the portfolio team (including two recent hires with substantial outside experience) raised concerns about concentrations in certain strategies and funds and suggested placing limits on those concentrations, but Greenberg refused to implement any such limits.

b. Greenberg knew, or was reckless in not knowing, that the Agile hedge funds had significant transparency risks because they could not generally examine the specific holdings of any hedge fund in which the Agile hedge funds invested. Greenberg also knew, or was reckless in not knowing, that the Agile hedge funds had significant liquidity risks because they could not move quickly in and out of particular funds due to various redemption restrictions in those funds. Greenberg also knew, or was reckless in not knowing, of significant leverage risks because the Agile hedge funds were using leverage, and the hedge funds those funds were investing in also often used leverage.

c. Greenberg was aware of numerous general risks relating to hedge fund investing. For example, he knew that particular hedge fund strategies had unexpectedly failed in the past when used by other hedge funds. He was also aware that in certain down market situations in the past, hedge funds and banks had been forced to sell assets at distressed prices. He testified that, by 2008, he was aware of the "tremendous risk embedded in individual hedge funds."

d. Finally, Greenberg knew that the Safety Fund had suffered the largest monthly loss in its history in August 2007. That loss was significantly worse than clients were led to believe could happen in any one month and it increased the measurement of volatility in the fund. In addition, an employee left the firm in 2008 after Greenberg strongly disagreed with the employee's request that a particular client diversify by investing in other unaffiliated funds.

F. MATERIALLY MISLEADING DISCLOSURE CONCERNING ADVISORY FEES TO BE CHARGED ON INVESTMENTS IN AN AFFILIATED FUND

28. From inception, the PPMs for the Safety Fund, the International Fund, and the Variable Fund generally provided that no additional fees would be charged if capital was allocated to an affiliated fund. Consistent with that disclosure, Agile Group did not charge such additional management and performance fees on investors' original capital. Agile Group did, however, charge additional management and performance fees on the leveraged portion of the Safety Fund, the International Fund, and the Variable Fund's investment in the Performance Fund. Greenberg approved the payment of fees to Agile Group on the leverage. The PPMs failed to adequately disclose the additional management and performance fees that would be charged on leverage, that significant layering of fees could occur, and the conflicts of interest from having these funds invest in the Performance Fund. Although Agile Group increased its disclosure in December 2006 after a compliance examination conducted by SEC examiners in 2006, the firm earned at least $2 million in additional revenue from the improperly disclosed fee arrangement between 2003 and 2006, and Greenberg (as majority owner of Agile Group) directly benefitted from those fees.

G. INADEQUATE COMPLIANCE POLICIES AND PROCEDURES, AND NONCOMPLIANCE WITH THE CUSTODY RULE

29. Between 2003 and 2008, TAS and Agile Group, aided and abetted and caused by Greenberg, failed to adopt and implement adequate compliance policies and procedures reasonably designed to prevent violation of the Advisers Act, including failing to adopt and implement adequate policies and procedures relating to conflicts of interest, suitability, and Agile Group's role as a hedge fund manager. For example, Greenberg failed to ensure that adequate policies and procedures were developed and/or implemented for determining when it would be suitable for clients to invest in complex hedge fund products, particularly for those clients that were unsophisticated, elderly, on limited incomes, and/or risk-averse, and he failed to ensure that adequate supervisory procedures were developed and/or implemented relating to those determinations.

30. Between 2005 and 2009, Agile Group had custody of client funds, and aided and abetted and caused by Greenberg, it repeatedly failed to comply with the custody rule because account statements were not provided by a qualified custodian to investors on a quarterly basis for the various Agile hedge funds nor were audited financial statements distributed to investors within 180 days after the end of the hedge fund's fiscal years.

H. OTHER FEE AND EXPENSE ISSUES BY WHICH GREENBERG BREACHED HIS FIDUCIARY DUTY TO CLIENTS

31. Greenberg, through Agile Group, improperly caused the Safety Fund to pay approximately one-third of the rent for Greenberg's personal New York apartment despite objections by other employees. After the SEC compliance examination, these charges were refunded to the Safety Fund in 2007.

32. Greenberg, through Agile Group, failed to properly refund a performance fee overcharge to their present and former clients. Agile Group discovered that it overcharged certain affiliated hedge funds by $233,000 in 2005 because it made mistakes in calculating the performance fee. About 40 investors who had withdrawn their investments from the funds received no reimbursement of the overcharges to their accounts, and Agile Group wrongfully retained those funds. For current investors in the funds, Greenberg decided to refund the overcharges by a means of a credit against future fees over a 24-month period instead of refunding the overcharge immediately. After the SEC compliance examination, Agile Group provided refunds to all present and former investors in 2007.

I. VIOLATIONS

33. As a result of the conduct described above, Greenberg willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer and sale of securities and in connection with the purchase or sale of securities.

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

35. As a result of the conduct described above, Greenberg willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-8 promulgated thereunder, which prohibit fraudulent conduct by an investment adviser to a pooled investment vehicle.

36. As a result of the conduct described above, Agile Group, willfully aided and abetted and caused by Greenberg, willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-2 promulgated thereunder, which require that investment advisers who maintain custody or possession of client assets either provide clients with account statements from a qualified custodian at least quarterly or distribute audited financial statements to investors within 180 days of the end of the fiscal year.

37. As a result of the conduct described above, Agile Group and TAS, willfully aided and abetted and caused by Greenberg, willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder, which require that all investment advisers adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act.

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 actions are appropriate in the public interest against Respondent pursuant to Section 15(b) of the Exchange Act including, but not limited to, civil penalties pursuant to Section 21B of the Exchange Act;

C. What, if any, remedial actions are appropriate in the public interest against Respondent pursuant to Section 9(b) of the Investment Company Act including, but not limited to, civil penalties pursuant to Section 9(d) of the Investment Company Act;

D. What, if any, remedial actions are appropriate in the public interest against Respondent pursuant to Section 203(f) of the Advisers Act including, but not limited to, civil penalties pursuant to 203(i) of the Advisers Act;

E. Whether, pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, and Section 203(k) of the Advisers Act, Respondent should be ordered to cease and desist from committing or causing violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rules 204-2, 206(4)-2, 206(4)-7, and 206(4)-8 thereunder, and whether Respondent should be ordered to pay disgorgement plus prejudgment interest thereon and provide an accounting pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, and Section 203(k) of the Advisers Act.

F. Whether, pursuant to Section 308 of the Sarbanes-Oxley Act, a Fair Fund should be established for the benefit of defrauded investors to distribute to affected investors any disgorgement, prejudgment interest, and civil penalty payments that may be made.

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, 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.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62859 / September 7, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14034

In the Matter of **Microwave Laboratories, Inc., Millionaire.com, Inc., Mirador Diversified Services, Inc., ML Direct, Inc., MLH Properties Ltd. Partnership, Modena 4, Inc., Motor Cars Auto Group, Inc., and Multi Solutions, Inc.,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Microwave Laboratories, Inc., Millionaire.com, Inc., Mirador Diversified Services, Inc., ML Direct, Inc., MLH Properties Ltd. Partnership, Modena 4, Inc., Motor Cars Auto Group, Inc., and Multi Solutions, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Microwave Laboratories, Inc. (CIK No. 798289) is a void Delaware corporation located in Raleigh, North Carolina with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Microwave Laboratories 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 January 31, 1994, which reported a net loss of $699,016 for the prior nine months. On May 17, 1994, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Eastern District of North Carolina, and the case was terminated on March 19, 1999.

2. Millionaire.com, Inc. (CIK No. 1079916) is a revoked Nevada corporation located in Bluffton, South Carolina with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Millionaire.com 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 $207,136 for the prior three months. As of August 30, 2010, the company's stock (symbol "MLRE") was traded on the over-the-counter markets.

3. Mirador Diversified Services, Inc. (CIK No. 1096649) is a dissolved Nevada corporation located in Virginia Beach, Virginia with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Mirador Diversified Services 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 January 31, 2001, which reported a net loss of $4,693,000 for the prior twelve months.

4. ML Direct, Inc. (CIK No. 1011775) is a void Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ML Direct 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 August 31, 1997, which reported a net loss of $2,453,205 for the prior nine months.

5. MLH Properties Ltd. Partnership (CIK No. 310990) is an inactive New York corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). MLH Properties is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended March 31, 1995.

6. Modena 4, Inc. (CIK No. 1271078) is a void Delaware corporation located in Largo, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Modena 4 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 July 31, 2004, which reported a net loss of $1,100 for the prior nine months.

7. Motor Cars Auto Group, Inc. (CIK No. 1059024) is an inactive Florida corporation located in Miami, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Motor Cars Auto Group is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2003, which reported a net loss of $1,510,604 for the prior nine months. As of February 19, 2010, the company's stock (symbol "MAGI") was traded on the over-the-counter markets.

8. Multi Solutions, Inc. (CIK No. 723733) is a New Jersey corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Multi Solutions 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 January 31, 2008, which reported a net loss of $19,541 for the prior nine months. As of August 30, 2010, the company's stock (symbol "MULT") was traded on the over-the-counter markets.

B. DELINQUENT PERIODIC FILINGS

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

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

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

III.

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

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

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62860 / September 7, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14035

In the Matter of

Team America, Inc.,
Teldar Financial, Inc. (n/k/a Harlem Business Development Corp.),
Telecomm Industries, Inc.,
TeleHubLink Corp.,
Terra Firma Technologies, Inc.,
Texon Energy Corp.,
Thatlook.com, Inc., and
THC Communications, Inc.

Respondents.

ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Team America, Inc., Teldar Financial, Inc. (n/k/a Harlem Business Development Corp.), Telecomm Industries, Inc., TeleHubLink Corp., Terra Firma Technologies, Inc., Texon Energy Corp., Thatlook.com, Inc., and THC Communications, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Team America, Inc. (CIK No. 860235) is a cancelled Ohio corporation located in Columbus, Ohio with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Team America 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 28, 2003, which reported a net loss of over $4.25 million for the prior six months. On September 26, 2003, the company filed a Chapter 11 petition in the U.S.

Bankruptcy Court for the Southern District of Ohio, which was dismissed on November 7, 2008. As of August 31, 2010, the company's stock (symbol "TMOSQ") was traded on the over-the-counter markets.

2. Teldar Financial, Inc. (n/k/a Harlem Business Development Corp.) (CIK No. 1137262) is a void Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Teldar 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 $500 since the company's April 9, 2001 inception.

3. Telecomm Industries, Inc. (CIK No. 87888) is a void Delaware corporation located in Twinsburg, Ohio with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Telecomm Industries 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. On June 5, 2001, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Northern District of Ohio, which was terminated on March 13, 2002. As of August 31, 2010, the company's stock (symbol "TCMM") was traded on the over-the-counter markets.

4. TeleHubLink Corp. (CIK No. 931073) is a forfeited Delaware corporation located in Andover, Massachusetts with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Telehublink 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 July 28, 2001. As of August 31, 2010, the company's stock (symbol "THLC") was traded on the over-the-counter markets.

5. Terra Firma Technologies, Inc. (CIK No. 1302647) is a void Delaware corporation located in Chicago, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Terra Firma is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2006, which reported no assets, revenues, or net income for the prior three months.

6. Texon Energy Corp. (CIK No. 312827) is a Texas corporation located in Stamford, Connecticut with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Texon 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 January 31, 1994, which reported a net loss of over $6.3 million for the prior nine months. On July 8, 2002, the U.S. District Court for the Central District of California permanently enjoined Texon from violations of the antifraud and registration provisions of the federal securities laws.

7. Thatlook.com, Inc. (CIK No. 1057653) is a permanently revoked Nevada corporation located in Stroudsburg, Pennsylvania with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Thatlook.com is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it

filed a Form 10-QSB for the period ended June 30, 2001, which reported a net loss of over $1.1 million for the prior three months.

8. THC Communications, Inc. (CIK No. 1098307) is a void Delaware corporation located in Yonkers, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). THC 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 $341,977 for the prior three months. As of August 31, 2010, the company's stock (symbol "THCR") was traded on the over-the-counter markets.

B. DELINQUENT PERIODIC FILINGS

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

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

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

III.

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

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

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62861 / September 7, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14036

In the Matter of

The Tag Group, Inc.,
T.C.B. Enterprises, Inc.,
Technology International, Ltd.,
Telelink International Corp.,
Teletimer International, Inc.,
Telmed, Inc.,
Texas American Resources, Inc., and
Texas Equipment Corp.,

Respondents.

ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents The Tag Group, Inc., T.C.B. Enterprises, Inc., Technology International, Ltd., Telelink International Corp., Teletimer International, Inc., Telmed, Inc., Texas American Resources, Inc., and Texas Equipment Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. The Tag Group, Inc. (CIK No. 835400) is a void Delaware corporation located in Charlotte, North Carolina with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). The Tag Group is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB/A for the period ended December 31, 2004, which reported a net loss of $21,274 for the prior twelve months. As of August 31, 2010, the company's stock (symbol "TGGP") was traded on the over-the-counter markets.

2. T.C.B. Enterprises, Inc. (CIK No. 1109235) is a revoked Nevada corporation located in Winston-Salem, North Carolina with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). T.C.B. is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-SB registration statement on March 22, 2000, which reported a net loss of $1,019 from the company's June 14, 1996 inception to August 31, 1999.

3. Technology International, Ltd. (CIK No. 201040) is a revoked New Mexico corporation located in Fort Lauderdale, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Technology International 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, which reported a net loss of $356,604 for the prior three months.

4. Telelink International Corp. (CIK No. 861051) is a Nevada corporation located in Miami, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Telelink is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the period ended March 31, 1995, which reported a net loss of $495,487 for the prior twelve months.

5. Teletimer International, Inc. (CIK No. 790238) is a void Delaware corporation located in Palm Beach Gardens, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Teletimer 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 January 31, 1993, which reported a net loss of $148,133 for the prior three months.

6. Telmed, Inc. (CIK No. 883719) is a void Delaware corporation located in Miami, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Telmed 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, 1997, which reported a net loss of $150,387 for the prior nine months.

7. Texas American Resources, Inc. (CIK No. 2825) is a Texas corporation located in New Orleans, Louisiana with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Texas American is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q/A for the period ended September 30, 1994.

8. Texas Equipment Corp. (CIK No. 887996) is a permanently revoked Nevada corporation located in Seminole, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Texas Equipment is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended March 31, 2001, which reported a net loss of $806,280 for the prior three months.

B. DELINQUENT PERIODIC FILINGS

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

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

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

III.

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

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

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-62853; File No. 4-610]

State of the Municipal Securities Market Field Hearings

AGENCY: Securities and Exchange Commission.

ACTION: Notice of field hearings.

SUMMARY: On May 7, 2010, the Chairman of the Securities and Exchange Commission Mary L. Schapiro, announced that Commissioner Elisse B. Walter would lead an effort to gather facts, opinions and analyses about the municipal securities market by holding a series of field hearings across the country. A broad array of municipal market participants representing diverse viewpoints will be invited to participate in the field hearings by sharing their perspectives on important topics relating to the municipal securities market.

DATES: The initial field hearing will be held on September 21, 2010 in San Francisco, California and will be open to the public. The field hearing will begin at 9 a.m. Over the next several months, the Commission will hold four additional public field hearings in cities across the country. Information regarding the dates and times of future field hearings will be available on the Commission's website at http://www.sec.gov.

ADDRESSES: The September 21, 2010 field hearing will be held at the Port of San Francisco, Pier 1, The Embarcadero, San Francisco, CA 94111. Information regarding the locations of future field hearings will be available on the Commission's website at http://www.sec.gov. Comments relating to the state of the municipal securities market field hearings may be filed electronically by e-mail to munifieldhearings@sec.gov or through the comment form available at: http://www.sec.gov/rules/other.shtml. Transcripts of the field hearings and all submitted comments will also be available on the Commission's website at http://www.sec.gov. 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: Alicia F. Goldin, Office of Commissioner Elisse B. Walter, at (202)551-5618, Lesli Sheppard, Office of Commissioner Elisse B. Walter, at (202)551-2806 or Kayla Gillan, Office of the Chairman, at (202)551-2600.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: September 7, 2010

COMMODITY FUTURES TRADING COMMISSION

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-62863, File No. 4-611]

Joint Public Roundtable to Discuss Data for Swaps and Security-Based Swaps, Swap Data Repositories, Security-Based Swap Data Repositories, and Real-Time Public Reporting

AGENCIES: Commodity Futures Trading Commission ("CFTC") and Securities and Exchange Commission ("SEC") (each, an "Agency," and collectively, the "Agencies").

ACTION: Notice of roundtable discussion; request for comment.

SUMMARY: On September 14, 2010, commencing at 8:45 a.m. and ending at 5:30 p.m., staff of the Agencies will hold a public roundtable discussion at which invited participants will discuss data for swaps and security-based swaps, swap data repositories, security-based swap data repositories, and real-time public reporting in the context of certain authority that Sections 727, 728, and 763 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") granted to the Agencies respectively. The discussion will be open to the public with seating on a first-come, first-served basis. Members of the public may also listen by telephone. Call-in participants should be prepared to provide their first name, last name, and affiliation. The information for the conference call is set forth below.

- US/Canada Toll-Free: (866) 312-4390
- International Toll: (404) 537-3379
- Conference ID: 98801653
- A transcript of the public roundtable discussion will be published on the following CFTC pages: Swap Data Repositories Registration Standards and Core Principle Rulemaking,

Interpretation & Guidance; Data Recordkeeping & Reporting Requirements; and Real Time Reporting, available at www.cftc.gov/LawRegulation/OTCderivatives/otc_rules.html.

The roundtable discussion will take place in Lobby Level Hearing Room (Room 1000) at the CFTC's headquarters at Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581.

FOR FURTHER INFORMATION CONTACT: The CFTC's Office of Public Affairs at (202) 418-5080, or the SEC's Office of Public Affairs at (202) 551-4120.

SUPPLEMENTARY INFORMATION: The roundtable discussion will take place on Tuesday, September 14, 2010, commencing at 8:45 a.m. and ending at 5:30 p.m. Commenters are encouraged to submit views on data for swaps and security-based swaps, swap data repositories, security-based swap data repositories, and real-time public reporting that would help inform the discussion at the roundtable. Members of the public who wish to submit their views on these topics may do so via:

- paper submission to David Stawick, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, DC 20581, or Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090; or
- electronic submission to the e-mail address provided on the CFTC's Swap Data Repositories Registration Standards and Core Principle Rulemaking, Interpretation & Guidance page, Data Recordkeeping & Reporting Requirements page, and Real Time Reporting page, and/or by e-mail to rule-comments@sec.gov or through the comment form available at http://www.sec.gov/rules/other.shtml. All submissions will be reviewed jointly by the Agencies. All comments must be in English or be accompanied by an English translation. All submissions provided to either Agency in any electronic form or on paper will be

published on the website of the respective Agency, without review and without removal of personally identifying information. Please submit only information that you wish to make publicly available.

By the Securities and Exchange Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

September 8, 2010

By the Commodity Futures Trading Commission.

David A. Stawick

David A. Stawick
Secretary

September 8, 2010

COMMODITY FUTURES TRADING COMMISSION

SECURITIES AND EXCHANGE COMMISSION

Release No. 34-34-62864; File No. 4-612

Joint Public Roundtable on Swap Execution Facilities and Security-Based Swap Execution Facilities

AGENCIES: Commodity Futures Trading Commission ("CFTC") and Securities and Exchange Commission ("SEC") (each, an "Agency," and collectively, the "Agencies").

ACTION: Notice of roundtable discussion; request for comment.

SUMMARY: On September 15, 2010, commencing at 9:00 a.m. and ending at 12:30 p.m., staff of the Agencies will hold a public roundtable discussion at which invited participants will discuss swap execution facilities and security-based swap execution facilities in the context of certain authority that Sections 733 and 763 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") granted to the Agencies respectively. The discussion will be open to the public with seating on a first-come, first-served basis. Members of the public may also listen by telephone. Call-in participants should be prepared to provide their first name, last name, and affiliation. The information for the conference call is set forth below.

- US/Canada Toll-Free: 877-732-6422
- Conference ID: 7772

A transcript of the public roundtable discussion will be published on the SEC's mandatory exchange trading and swap execution facilities rulemaking page at http://www.sec.gov/spotlight/regreformcomments.shtml. The transcript also will be available by a link on the CFTC's SEF Registration Requirements and Core Principle Rulemaking, Interpretation & Guidance web page at

http://www.cftc.gov/LawRegulation/OTCDerivatives/otc_rules.html. The roundtable discussion will take place in the Auditorium (Room L-002) at the SEC Headquarters located at 100 F Street NE, Washington, DC.

FOR FURTHER INFORMATION CONTACT: the CFTC's Office of Public Affairs at (202) 418-5080 or the SEC's Office of Public Affairs at (202) 551-4120.

SUPPLEMENTARY INFORMATION: The roundtable discussion will take place on Wednesday, September 15, 2010, commencing at 9:00 a.m. and ending at 12:30 p.m. Commenters are also encouraged to submit views on swap execution facilities and security-based swap execution facilities that would help inform the discussion at the roundtable. Members of the public who wish to submit comments may do so via:

- paper submission to David Stawick, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, DC 20581, or Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090; or
- by e-mail to SEFRules@CFTC.gov; and/or by email to rule-comments@sec.gov or through the comment form available at: http://www.sec.gov/rules/other.shtml.

All submissions will be reviewed jointly by the Agencies. All comments must be in English or be accompanied by an English translation. All submissions provided to either Agency in any electronic form or on paper will be published on the website of the respective Agency, without review and without removal of personally identifying information. Please submit only information that you wish to make publicly available.

By the Securities and Exchange Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

September 8, 2010

By the Commodity Futures Trading Commission.

David A. Stawick

David A. Stawick
Secretary

September 8, 2010

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62865 / September 8, 2010

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3181 / September 8, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14037

In the Matter of **KEVIN J. SCHOTT, 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 Kevin J. Schott ("Respondent" or "Schott") pursuant to Section Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

II.

In anticipation of the institution of these proceedings, Respondent Schott has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these

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[1] Rule 102(e)(3)(i) provides, in relevant part, that:

> The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . suspend from appearing or practicing before it any . . . 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.

proceedings, and the findings contained in Section III.3 below, which are admitted, Respondent Schott 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 Schott's Offer, the Commission finds that:

1. Schott, age 44, was licensed as a CPA in Missouri until he allowed his license to lapse in May 1990. He served as Chief Financial Officer of Zoltek Companies, Inc. ("Zoltek") from May 2004 until his resignation in May 2008.

2. Zoltek was, at all relevant times, a Missouri corporation with its principal place of business in Bridgeton, Missouri. Zoltek has operations in several countries and is engaged in the manufacture of carbon fibers used in brake pads and wind turbine blades. At all relevant times, Zoltek's stock has been registered pursuant to Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act"), and traded on the NASDAQ.

3. On August 16, 2010, a final judgment was entered against Schott, permanently enjoining him from future violations of Section 13(b)(5) of the Exchange Act and Rules 13a-14, 13b2-1 and 13b2-2 thereunder, in the civil action entitled U.S. Securities and Exchange Commission v. Kevin J. Schott, Civil Action Number 4:10-cv-01500-AGF, in the United States District Court for the Eastern District of Missouri. Schott was ordered to pay a $20,000 civil penalty.

4. The Commission's complaint alleged, among other things, that Schott circumvented Zoltek's internal accounting controls and caused Zoltek to make two payments totaling $250,000 to an outside consultant who had raised funds for Zoltek in the past, despite Zoltek's CEO's explicit instruction not to make the payments. Instead of following Zoltek's internal controls which required the CEO to approve all wire transfers originated in the United States for over $5,000, Schott emailed the controller of Zoltek's Hungarian subsidiary on two occasions and instructed him to wire $175,000 and $75,000, respectively, to the consultant. According to the complaint, Schott told the Hungarian controller in both emails that the payments were for another purpose. Schott further concealed the payments to the outside consultant by creating a false document which he gave to Zoltek's CEO. By characterizing the payments he made to the consultant as relating to another purpose, Schott caused Zoltek to make false entries into its books and records. According to the complaint, Schott also made false and misleading representations to the public and to Zoltek's external auditors when he certified Zoltek's financial statements for the fiscal year ended on September 30, 2007 and for the first quarter of 2008 ended on December 31, 2007.

IV.

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

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

A. Respondent Schott is suspended from appearing or practicing before the Commission as an accountant.

B. After one year from the date of this order, Respondent Schott 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 Schott'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 Schott, 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 Schott, 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 Schott 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 Schott 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.

Elizabeth M. Murphy
Secretary

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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3080 / September 8, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14039

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

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Gregory Vincent Cronin ("Cronin" or "Respondent").

II.

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

III.

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

1. Cronin, an investment adviser, was the founder, principal, and sole employee of Innovative Investment Advisors, Inc. ("IIA"), an investment adviser formerly registered with the Commonwealth of Virginia. Cronin, 49 years old, is a resident of Lovettsville, Virginia.

2. On May 7, 2010, Cronin pled guilty to one count of mail fraud in violation of Title 18 United States Code, Section 1341 and one count of securities fraud in violation of Title 18 United States Code, Section 1348 before the United States District Court for the Eastern District of Virginia, in *United States v. Gregory Vincent Cronin*, Crim. Information No. 1:10 CR 154 (LOG) (May 7, 2010).

3. The counts of the criminal information to which Cronin pled guilty alleged, *inter alia,* that from approximately 2002 through September 2009, Cronin sought clients by falsely claiming that he would establish individual accounts for them at IIA and would invest their funds in well-known publicly traded companies and stock index options. In exchange for managing their funds, Cronin would receive management fees of up to 1.5% of assets under management. Cronin sent clients fictitious periodic reports which purported to show that each client had an individual account; IIA had purchased and/or sold shares of stock of well-known public companies on their behalf; IIA was actively trading in stock index options on their behalf; and IIA's trading was successful. In reality, Cronin did not purchase shares of stock of well-known companies or generate positive returns trading in options as represented. Instead, he lost a majority of the clients' funds trading in options and repaying earlier clients. In addition, Cronin did not establish individual accounts for clients but instead pooled funds in one account in the name of IIA which he controlled. In total, Cronin raised approximately $10 million and caused losses of approximately $6.7 million. As part of his plea, Cronin agreed to pay restitution for the full amount of the victims' losses.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 203(f) of the Advisers Act, that Respondent Cronin be, and hereby is barred from association with any investment adviser.

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 232

[Release Nos. 33-9140; 34-62873; 39-2471; IC-29413]

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 primarily to support the electronic filing of Form N-MFP (Monthly Schedule of Portfolio Holdings of Money Market Funds) and any amendments to the form. The EDGAR system is scheduled to be upgraded to support this functionality on August 30, 2010.

The revisions to the Filer Manual reflect changes within Volume II entitled EDGAR Filer Manual, Volume II: "EDGAR Filing," Version 15 (August 2010). 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 Division of Investment Management, for questions concerning Form N-MFP (Monthly Schedule of Portfolio Holdings of Money Market Funds) contact Adam Glazer, Senior Counsel, or C. Hunter Jones, Assistant Director of the Office of Regulatory Policy, at (202) 551-6792, for questions concerning Series and Class status, contact

Ruth Armfield Sanders, Senior Special Counsel, Office of Legal and Disclosure, at (202) 551-6989; in the Office of Information Technology, contact Rick Heroux, at (202) 551-8800.

SUPPLEMENTARY INFORMATION: 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 website.

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 may consult the Filer Manual in conjunction with our rules governing mandated electronic filing when preparing documents for electronic submission.[4]

In support of the adoption of new rule 30b1-7 under the Investment Company Act of 1940 and new Form N-MFP, which were included in the Commission's recent money market fund reform package,[5] the EDGAR system will be upgraded to Release 10.3 on August 30, 2010. EDGAR Release 10.3 will deploy new submission types N-MFP and N-MFP/A to facilitate the electronic filing of the new form. Filers must follow the Form N-MFP XML Technical Specification, available at the "Information for EDGAR Filers" web page on the Commission's

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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 April 08, 2010. See Release No. 33-9115 (April 1, 2010) [75 FR 17853].

[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 No. 33-9115 (April 1, 2010) [75 FR 17853] in which we implemented EDGAR Release 10.1. For a complete history of Filer Manual rules, please see the cites therein.

[5] See Release No. IC-29132 [75 FR 10060].

public website (www.sec.gov/info/edgar.shtml), to construct their Form N-MFP and Form N-MFP/A submissions via the EDGAR Filing website (https://edgarfiling.sec.gov) or by clicking the "Are you an EDGARLink filer or would you like to create a new Asset-Backed Securities Issuing Entity?" link from the EDGAR Portal website (www.portal.edgarfiling.sec.gov).

Also being implemented in EDGAR Release 10.3, EDGAR will begin to automatically change the status of a Series or Class to "Inactive" if it has not been updated by filers or referenced in a filing in the past 375 calendar days.

In addition, the EDGAR Filing website, EDGAR Filer Management website and EDGAR OnlineForms website Login pages now will display a message warning the filers that they are about to enter a federal computer website.

The filer manual is also being revised to address a change made previously in EDGAR to disseminate the co-registrant information for all investment company notices and orders issued in connection with 1940 Act applications. Prior to this change, only the primary registrant information was disseminated.

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 1543, Washington DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. We will post electronic format copies on the Commission's website; the address for the Filer Manual is http://www.sec.gov/info/edgar.shtml.

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).[6] It follows that the requirements of the Regulatory Flexibility Act[7] 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,[8] 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 10.3 is scheduled to become available on August 30, 2010. The Commission believes that establishing an effective date less than 30 days after publication of these rules 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,[9] Sections 3, 12, 13, 14, 15, 23, and 35A of the Securities Exchange Act

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6 5 U.S.C. 553(b).

7 5 U.S.C. 601- 612.

8 5 U.S.C. 553(d)(3).

9 15 U.S.C. 77f, 77g, 77h, 77j, and 77s(a).

of 1934,[10] Section 319 of the Trust Indenture Act of 1939,[11] and Sections 8, 30, 31, and 38 of the Investment Company Act of 1940.[12]

List of Subjects in 17 CFR Part 232

Incorporation by reference, Reporting and recordkeeping requirements, Securities.

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,"

[10] 15 U.S.C. 78c, 78l, 78m, 78n, 78o, 78w, and 78ll.

[11] 15 U.S.C. 77sss.

[12] 15 U.S.C. 80a-8, 80a-29, 80a-30, and 80a-37.

Version 8 (October 2009). The requirements for filing on EDGAR are set forth in the updated EDGAR Filer Manual, Volume II: "EDGAR Filing," Version 15 (August 2010). 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 1543, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. Electronic copies are available on the Commission's website. The address for the Filer Manual is http://www.sec.gov/info/edgar.shtml. You can also inspect 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.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

September 9, 2010

Chairman Schapiro
not participating

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No.62891 / September 10, 2010

Admin. Proc. File No. 3-13727

In the Matter of the Application of

JOSEPH RICUPERO
c/o Marni Weiss, Esq.
Weiss Imbesi PLLC
462 Seventh Avenue, 12th Floor
New York, NY 10018

For Review of Disciplinary Action Taken by

Financial Industry Regulatory Authority, Inc.

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION - REVIEW OF DISCIPLINARY PROCEEDINGS

Violations of Conduct, Procedural, and Membership and Registration Rules

Failure to Provide Requested Information

Failure to File FOCUS Reports

Failure to File Annual Audit Report

Failure to File Application for Approval to Transfer Firm Assets

Conduct Inconsistent with Just and Equitable Principles of Trade

General securities representative, general securities principal, financial and operations principal, limited representative-equity trader, chief executive officer, chief compliance officer, and sole director of former member of registered securities association failed to respond to requests for information, and failed to file three FOCUS reports, one annual audit report, and an application for approval to transfer member's assets. *Held*, association's findings of violations and sanction imposed are *sustained*.

APPEARANCES:

Marni Weiss, Esq., of Weiss Imbesi PLLC, for Joseph Ricupero.

Marc Menchel, *Alan Lawhead*, and *Vickie R. Olafson*, for Financial Industry Regulatory Authority, Inc.

Appeal filed: December 18, 2009
Last brief received: April 26, 2010

I.

Joseph Ricupero, formerly a general securities representative, general securities principal, financial and operations principal, limited representative-equity trader, chief executive officer, chief compliance officer, and sole director of America First Associates ("America First" or the "Firm"), a former NASD member firm, seeks review of disciplinary action taken by NASD.[1] NASD found that Ricupero violated NASD Procedural Rule 8210 and Conduct Rule 2110 by failing to respond to NASD's requests for information. NASD also found that Ricupero violated Conduct Rule 2110 by failing to file the Firm's Financial and Operational Combined Uniform Single ("FOCUS") reports for March, April, and May 2006 and the Firm's annual audit report for fiscal year 2005. NASD further found that Ricupero violated NASD Membership and Registration Rule 1017 and Conduct Rule 2110 by failing to file an application with NASD for approval to sell the Firm's customer accounts to a NYSE member firm.

For the Rule 8210 violation, NASD barred Ricupero from associating with any NASD member firm in all capacities. NASD declined to impose a sanction for the remaining violations. We base our findings on an independent review of the record.

II.

A. Background

In 1995, Ricupero founded America First, an introducing broker-dealer. He owned more than seventy-five percent of the Firm. On February 9, 2006, Ricupero sold the Firm's customer accounts. He terminated his NASD registration in December 2006 and is not presently associated with a member firm or working in the industry. In March 2006, Tracy Wood-Selem, the NASD staff examiner who reviewed the Firm's FOCUS reports, questioned the accuracy of two reports that the Firm filed for the months ending January and February 2006. Both reports contained identical dollar amounts of securities holdings. Wood-Selem testified at the hearing that the identical amounts were "highly unusual" given that the Firm's previously filed FOCUS reports contained slightly different amounts. She also testified that she was concerned about the

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[1] On July 26, 2007, the Commission approved a proposed rule change filed by the National Association of Securities Dealers, Inc. ("NASD") to amend NASD's Restated Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority, Inc., or FINRA, in connection with the consolidation of NASD and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange ("NYSE"). *See* Securities Exchange Act Rel. No. 56146 (July 26, 2007), 91 SEC Docket 517 (SR-NASD-2077-053). Because the disciplinary action here was instituted before that date, we continue to use the designation NASD.

information in the two reports because they were identical in all other respects, except that the February 2006 FOCUS report included $25,000 in "cash and earnings."

In a letter dated April 10, 2006, Wood-Selem asked Ricupero pursuant to Rule 8210 to provide by April 12, 2006 "a copy of the Firm's proprietary statements that correspond to the Firm's reporting of $345,520" worth of securities holdings in the February 2006 FOCUS report, and copies of the Firm's trial balances for the months of January and February 2006. Wood-Selem did not receive a response and sent a second letter dated April 13, 2006 requesting the same information pursuant to Rule 8210 by April 18, 2006 and advising Ricupero that failure to comply with the request could subject the Firm to disciplinary action.

On April 17, 2006, Wood-Selem received a letter from Ricupero addressed to "Tracy Wood Selem" stating that he could not meet the April 12, 2006 deadline because he had scheduled a vacation for a religious holiday, but would "fulfill [NASD's] request" by May 1, 2006. At the hearing, however, Ricupero testified that he failed to timely respond to Wood-Selem's first request because the responsive documents were not "readily available" and "were all boxed up" in a "storage area."

On April 27, 2006, Wood-Selem and other NASD staff attempted to visit Ricupero at the Firm. Wood-Selem testified that "it looked like [the Firm] was abandoned" because "there were wrapped chairs," and "terminals pushed to the side." On April 28, 2006, an NASD examination staff supervisor sent Ricupero a letter reminding him that NASD had not received the information requested in Wood-Selem's two previous letters. The letter questioned whether the Firm was complying with net capital and recordkeeping rules and instructed Ricupero to provide NASD with certain information about the Firm's capital.

On June 13, 2006, Wood-Selem sent Ricupero a third letter pursuant to Rule 8210 asking for the previously requested financial information by June 20, 2006 and warning him that failure to comply with the request could subject the Firm "and or its registered representative" to disciplinary action. Ricupero does not dispute that NASD properly served the three requests made pursuant to Rule 8210.

As an NASD staff examiner, Wood-Selem reviewed other compliance matters regarding the Firm. She discovered that Ricupero did not file with NASD: (1) the Firm's March, April, and May 2006 FOCUS reports, (2) the Firm's annual audit report for the year ending December 31, 2005, and (3) an application requesting that NASD approve the Firm's February 9, 2006 sale of its customer accounts to a NYSE member firm.

B. NASD Initiates a Disciplinary Proceeding.

On June 20, 2007, NASD filed a complaint against Ricupero regarding the conduct at issue in this proceeding and scheduled a hearing for December 2007. In November 2007, Ricupero produced forty-one pages of the Firm's February 2006 bank statements and clearing account statements and the Firm's January and February 2006 trial balances. In December 2007, a few days before the hearing, Ricupero produced a letter that he claimed he had sent to NASD on May 1, 2006 ("May 1, 2006 Letter"). The three-sentence letter addressed to "NASD Compliance" stated that "documents pertaining to the Focus Filing P/E 2/28/2006" are attached. The attachment contained seven of the forty-one pages that Ricupero produced in November 2007.

Ricupero testified at the hearing that he sent the May 1, 2006 Letter to Wood-Selem on that date. NASD's Hearing Panel found this testimony to be not credible. At the hearing, NASD's Department of Enforcement staff introduced a correspondence log that covered April through August 2006 and contained no indication that NASD received the May 1, 2006 Letter. In a May 14, 2008 decision, the Hearing Panel credited Wood-Selem's testimony that NASD's mail department would have directed any correspondence it received from Ricupero to her and that she received the letter for the first time when Ricupero produced it in December 2007. Ricupero testified that he had no proof that he mailed the letter or that NASD received it. The Hearing Panel found that Ricupero failed to respond to requests for information and failed to make the various required filings for the Firm. The Hearing Panel barred Ricupero from associating with any NASD member firm in all capacities and declined to impose a sanction for the remaining violations.

Ricupero appealed the Hearing Panel's decision to NASD's National Adjudicatory Council ("NAC"). The NAC found that the record supported the Hearing Panel's determination not to credit Ricupero's testimony. If Ricupero truly had sent the letter, the NAC reasoned he would have referred to it at critical points before November 2007, such as when he received a "Wells" notice in March 2007, when NASD filed the complaint in this proceeding in June 2007, when Ricupero answered the complaint in July 2007, and during the initial pre-hearing conference in August 2007. The NAC concluded that Ricupero's claim of having sent the May 1, 2006 Letter was "untrue and constitute[d] a deliberate attempt to mislead."

The NAC also found that Ricupero's disciplinary history was an aggravating factor and "demonstrates a pattern of disregard for regulatory requirements."[2] In 1999 and 2000, Ricupero consented to findings involving violations of free-riding and withholding provisions, as well as net capital violations and failure to provide prompt written notice regarding three principals' departure from the Firm, respectively. In 2008, NASD found that Ricupero failed to timely amend his Uniform Application for Securities Industry Registration or Transfer to disclose a federal court action filed against him alleging that he committed common-law fraud and violated federal securities laws, and that he and the Firm executed two settlement agreements with

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[2] In 2003, Ricupero consented to findings that he permitted another individual to act in a capacity that required registration while such registration status was inactive due to the individual's failure to comply with continuing education requirements. The NAC did not refer to this event in its decision.

improper confidentiality provisions.[3] The NAC affirmed the Hearing Panel's findings of violation and sanction imposed. This appeal followed.

III.

Pursuant to Section 19(e)(1) of the Securities Exchange Act of 1934, we will sustain NASD's disciplinary action if the record shows that Ricupero engaged in the violative conduct that NASD found and that NASD applied its rules in a manner consistent with the purposes of the Exchange Act.[4] Based on our independent review of the record, we find that a preponderance of the evidence supports NASD's findings of violation against Ricupero.

A. Failure to Provide Requested Information

NASD Rule 8210(a)(1) requires an associated person to provide information upon NASD's request.[5] From April to June 2006, NASD sent Ricupero three letters pursuant to Rule 8210 requesting information about the Firm's securities holdings and trial balances for January and February 2006. Ricupero terminated his NASD registration in December 2006 and was therefore an associated person when NASD requested information. NASD properly served and Ricupero received all three requests. The record supports NASD's findings that Ricupero failed to provide any of the requested information by the dates stated in NASD's three letters.

Ricupero argues that he responded to NASD's initial request by sending the May 1, 2006 Letter. The Hearing Panel discredited Ricupero's testimony on this point. The credibility determination of an initial fact finder is entitled to considerable weight and deference because it is based on hearing the witnesses' testimony and observing their demeanor.[6] We find no basis to disturb the Hearing Panel's determination.

Moreover, the record corroborates the Hearing Panel's finding. NASD's correspondence log contained no indication that NASD received the May 1, 2006 Letter. Unlike the April 2006 letter that was addressed to "Tracy Wood Selem," the purported May 1, 2006 Letter was addressed to "NASD Compliance." The Hearing Panel credited Wood-Selem's testimony that NASD's mail department would have directed all of Ricupero's mail to her and that she saw the

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[3] NASD ordered Ricupero and the Firm to pay a $7,500 fine and costs of $3,540.14 jointly and severally. On February 6, 2009, NASD revoked Ricupero's registration for failure to pay the fines and costs associated with the 2008 proceeding.

[4] 15 U.S.C. § 78s(e)(1).

[5] NASD Manual at 7212 (2006 ed.).

[6] *Kirlin Sec., Inc.*, Exchange Act Rel. No. 61135 (Dec. 10, 2009), 97 SEC Docket 23299, 23320 n.71.

letter for the first time in December 2007 – days before the hearing. Ricupero admitted at the hearing that he had no proof that he mailed the letter or that NASD received it. The Hearing Panel and the NAC questioned Ricupero's failure to mention the letter – potentially beneficial evidence for Ricupero – at several critical junctures before November 2007, including in response to a Wells notice, nearly eighteen months after it was allegedly sent.

Ricupero also argues that he responded to NASD's requests for information, "albeit late," by producing information in November 2007. As Ricupero admits, he did not provide the requested information by NASD's stated deadlines. Instead, Ricupero produced partial information five months after NASD filed a complaint against him. Although Ricupero was no longer associated with a member by the time NASD filed the complaint in June 2007, he remained subject to NASD's jurisdiction for two years after he terminated his registration in December 2006.[7] We have emphasized repeatedly that NASD should not have to initiate a disciplinary action to elicit a response to its information requests made pursuant to Rule 8210.[8] The cases Ricupero relies on are inapposite. In *CMG Institutional Trading, LLC,*[9] *Morton Bruce Erenstein,*[10] and *Perpetual Securities, Inc.*,[11] the applicant produced some documents in response to NASD's request *before* disciplinary action was instituted. Ricupero's failure to respond until after NASD filed a complaint constitutes a complete failure to respond in violation of Rules 8210 and 2110.[12]

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[7] NASD Bylaws, Article V, Section 4.

[8] *CMG Inst'l Trading, LLC*, Exchange Act Rel. No. 59325 (Jan. 30, 2009), 95 SEC Docket 13802, 13810; *Toni Valentino*, 57 S.E.C. 330, 339 & n.14 (2004); *Robert A. Quiel*, 53 S.E.C. 165, 168 (1997); *see also Paz Sec., Inc.*, Exchange Act Rel. No. 57656 (Apr. 11, 2008), 93 SEC Docket 5122, 5128 (finding that applicants' failure to respond until after NASD barred them following the institution of a disciplinary proceeding was tantamount to a complete failure to respond in violation of Rule 8210), *petition denied*, 566 F.3d 1172 (D.C. Cir. 2009); *Elliot M. Hershberg*, Exchange Act Rel. No. 53145 (Jan. 19, 2006), 87 SEC Docket 494, 498, 499 (agreeing with NASD's finding that Hershberg's refusal to testify until the institution of a proceeding constituted a complete failure to respond in violation of Rule 8210), *aff'd*, 210 Fed. Appx. 125 (2d Cir. 2006).

[9] Exchange Act Rel. No. 59325 (Jan. 30, 2009), 95 SEC Docket 13802.

[10] Exchange Act Rel. No. 56768 (Nov. 8, 2007), 91 SEC Docket 3114.

[11] Exchange Act Rel. No. 56613 (Oct. 4, 2007), 91 SEC Docket 2489.

[12] A violation of Exchange Act and NASD rules constitutes conduct inconsistent with just and equitable principles of trade and therefore also establishes a violation of NASD

(continued...)

B. Filing Violations

The Firm was required to but did not file: (1) its March, April, and May 2006 FOCUS reports, (2) its annual audit report for the year ending December 31, 2005, and (3) an application requesting that NASD approve the Firm's February 9, 2006 sale of its customer accounts to an NYSE member firm.[13] The Firm therefore violated Exchange Act Rules 17a-5(a) and 17a-5(d), and NASD Rule 1017(a)(3). Ricupero was the Firm's president and financial and operations principal. Ricupero does not dispute that he was responsible for making these filings and that he failed to do so.[14] We find that Ricupero is responsible for the Firm's violations of NASD Rules 1017(a)(3) and 2110.

IV.

Pursuant to Exchange Act Section 19(e)(2), we will sustain NASD's sanction unless we find, having due regard for the public interest and the protection of investors, that the sanction is

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12 (...continued)
Conduct Rule 2110. *E. Magnus Oppenheim & Co.*, Exchange Act Rel. No. 51479 (Apr. 6, 2005), 85 SEC Docket 475, 478.

13 Exchange Act Rule 17a-5(a) requires broker-dealers to file FOCUS reports with NASD on a monthly basis. 17 C.F.R. § 240.17a-5(a). Exchange Act Rule 17a-5(d) requires broker-dealers to file annually a report that is audited by an independent public accountant. 17 C.F.R. § 240.17a-5(d). NASD Rule 1017(a)(3) requires a member to file an application for approval to transfer its customer accounts, unless both the seller and acquirer are NYSE members. NASD Manual at 3129. The Firm was not a NYSE member.

14 *See Sisung Sec. Corp.*, Exchange Act Rel. No. 56741 (Nov. 5, 2007), 91 SEC Docket 3050, 3060 (holding that the "president of a brokerage firm is responsible for the firm's compliance with all applicable requirements unless and until he reasonably delegates a particular function to another person in the firm, and neither knows nor has reason to know that such person is not properly performing his duties") (citing *Steven P. Sanders*, 53 S.E.C. 889, 904 (1998); *Kirk A. Knapp*, 50 S.E.C. 858, 862 (1992)); *see also Richard F. Kresge*, Exchange Act Rel. No. 55988 (June 29, 2007), 90 SEC Docket 3072, 3090-91 (finding firm's president, who was also its compliance officer, liable for Firm's violations of NASD and Exchange Act rules); *James Michael Brown*, 50 S.E.C. 1322, 1325-26 (1992) (finding firm's president responsible for firm's failure to comply with Exchange Act reporting and recordkeeping requirements), *aff'd*, 21 F.3d 1124 (11th Cir. 1994) (Table); *cf. Sisung*, 91 SEC Docket at 3060 (finding firm's president responsible for firm's violations of Municipal Securities Rulemaking Board Rules). The record establishes that Ricupero was the Firm's only officer and director and did not delegate his responsibility.

excessive or oppressive or imposes an unnecessary or inappropriate burden on competition.[15] NASD barred Ricupero from associating with any NASD member firm in all capacities for his failure to respond in any manner to NASD's requests for information. NASD declined to impose a sanction for the remaining violations.

The sanction imposed by NASD is consistent with NASD's Sanction Guidelines. Although the Commission is not bound by the Guidelines, we use them as a benchmark in conducting our review under Exchange Act Section 19(e)(2).[16] The Sanction Guidelines provide that, absent mitigating circumstances, a bar should be the standard sanction when an individual fails to respond in any manner in violation of Rule 8210.[17] In reaching this determination, NASD applied the Sanction Guidelines's two "Principal Considerations" regarding a Rule 8210 violation, analyzing (1) the nature of the information requested; and (2) whether the requested information was provided, and, if so, the number of requests made, the time respondent took to respond, and the degree of regulatory pressure required to obtain a response.[18]

The requested information was important. Wood-Selem testified that the identical amounts of securities holdings noted in the Firm's January and February 2006 FOCUS reports were "highly unusual," thus calling into question the accuracy and reliability of the Firm's disclosure. NASD found that the unusual similarities in the two reports "could have been concealing whether the firm was in compliance with its minimum net capital requirement." The net capital rule serves as "the principal regulatory tool by which the Commission and [the self-regulatory organizations] monitor the financial health of brokerage firms and protect customers from the risks involved in leaving their cash and securities with broker-dealers."[19] As we have

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[15] 15 U.S.C. § 78s(e)(2). Ricupero does not claim, and the record does not show, that NASD's action imposes an unnecessary or inappropriate burden on competition.

[16] *CMG*, 95 SEC Docket at 13814 n.38 (citing *Perpetual Sec., Inc.*, Exchange Act Rel. No. 56613 (Oct. 4, 2007), 91 SEC Docket 2489, 2506 n.56 (stating that NASD promulgated the Sanction Guidelines in an effort to achieve greater consistency, uniformity, and fairness in its sanctions)).

[17] NASD Sanction Guidelines at 35 (2007 ed.). Out of approximately eighty sanction guidelines, the guideline for violations of Rule 8210 is one of only three that propose a bar as the standard sanction in the absence of mitigation. *Paz*, 93 SEC Docket at 5125-26.

[18] Sanction Guidelines at 35.

[19] *CMG*, 95 SEC Docket at 13809 & n.17 (citing *Touche Ross & Co. v. Redington*, 442 U.S. 560, 570 (1979)); *see also Russo Sec., Inc.*, 55 S.E.C. 58, 83 & n.63 (citing *Blaise D'Antoni & Assocs. v. SEC*, 289 F.2d 276, 277 (5th Cir.) ("The net capital rule is one of the most important weapons in the Commission's arsenal to protect investors. By limiting the ratio of a

(continued...)

held, "[e]nsuring compliance with the net capital rule is important to protect investors from the possible financial collapse of a firm."[20] Such a collapse can expose investors to pecuniary loss, including leaving the Firm's customers "unable to liquidate their securities positions [with the Firm] or open new positions until their accounts are transferred to another broker-dealer."[21] Here, the importance of the requested financial information became even clearer after NASD discovered in late April 2006 that the Firm appeared to have closed.

NASD found that Ricupero provided no information by the deadlines set in Wood-Selem's three written requests. Ricupero only produced partial information in November 2007, which was one and one-half years after Wood-Selem's first request and five months after NASD instituted this disciplinary action. NASD received the partial information only after it had followed up on the three requests with telephone calls, emails, a visit to the Firm, a letter questioning the Firm's potential net capital violations based on its apparent closure, and, finally, the institution of a disciplinary proceeding. NASD concluded that Ricupero's conduct over the extended period of time demonstrated a "pattern of total disregard for the Rule 8210 process." We agree that the record demonstrates that NASD exerted significant regulatory pressure in an attempt to elicit a response from Ricupero.

NASD found Ricupero's testimony that he sent the May 1, 2006 Letter and his varying explanations about why he could not timely access the information responsive to NASD's request to be dishonest. NASD considered Ricupero's dishonesty to be an aggravating factor:

> Ricupero's eleventh-hour claim of compliance [by producing the May 1, 2006 Letter in November 2007] in addition to his various justifications for failing to provide the documents when requested demonstrate a troubling pattern of dishonesty. Throughout the investigative phase and disciplinary process relevant to this matter, Ricupero ignored staff's Rule 8210 requests. Neither his claim of being on vacation nor his claim of having to find the documents offers any valid reason to lessen the severity of Ricupero's complete disregard of his obligation to respond to [NASD']s request for information.

NASD also found that "Ricupero has demonstrated a cavalier disregard for his duty to ensure that he responds to Rule 8210 requests for information" and that NASD "faces a 'great risk of being unable to obtain from [Ricupero] information necessary for the protection of investors.'" NASD

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19 (...continued)
broker's indebtedness to his capital, the rule operates to assure confidence and safety to the investing public."), *cert. denied*, 368 U.S. 899 (1961)).

20 *CMG*, 95 SEC Docket at 13815 & n.41 (citing *Paz*, 93 SEC Docket at 5130).

21 *CMG*, 95 SEC Docket at 13815 & n.43 (citing *Net Capital Rule*, Exchange Act Rel. No. 31512 (Nov. 24, 1992), 52 SEC Docket 4167, 4169-70).

concluded that a bar was "an appropriately remedial sanction given all of the facts and circumstances, including a lack of mitigating factors."

Ricupero claims that the bar imposed by NASD is punitive and not remedial. We have stressed the importance of Rule 8210 in connection with NASD's "obligation to police the activities of its members and associated persons."[22] Without subpoena power, NASD must rely on Rule 8210 to obtain information from its members necessary to carry out its investigations and fulfill its regulatory mandate.[23] A failure to comply with Rule 8210 is a serious violation because it subverts NASD's ability to execute its regulatory responsibilities.[24] To impose a bar as the standard sanction for a complete failure to respond to NASD information requests "reflects the judgment that, in the absence of mitigating factors, a complete failure to cooperate with NASD requests for information or testimony is so fundamentally incompatible with NASD's self-regulatory function that the risk to the markets and investors posed by such misconduct is properly remedied by a bar."[25]

NASD determined that there were no mitigating factors that would warrant a lesser sanction. Ricupero argues that we should consider the fact that his Firm "was winding down in the midst of Enforcement's requests for documentation" as a mitigating factor that warrants a lesser sanction, such as a suspension. Ricupero did not, however, raise with NASD the purported difficulties in obtaining documents resulting from the Firm's closure at any point during NASD's efforts to acquire information. Instead, Ricupero stated in a letter dated April 17, 2006 that he was unable to meet Wood-Selem's original deadline due to his vacation and religious holiday plans. Whatever difficulty Ricupero faced in responding to Wood-Selem's deadlines, he should have "raised, discussed, and resolved [it] with the NASD staff in the cooperative spirit and prompt manner contemplated by the Rules."[26]

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22 *CMG*, 95 SEC Docket at 13808 n.14 (citing *Paz*, 93 SEC Docket at 5127).

23 *Id.* at 13808 n.15 (citing *Perpetual*, 91 SEC Docket at 2502-03).

24 *See Hershberg*, 87 SEC Docket at 498 (stating that "[f]ailure to comply is a serous violation justifying stringent sanctions because it subverts NASD's ability to execute its regulatory functions") (citations omitted), *aff'd*, 210 Fed. Appx. 125 (2d Cir. 2006).

25 *Paz*, 93 SEC Docket at 5126; *Howard Brett Berger*, Exchange Act Rel. No. 58950 (Nov. 14, 2008), 94 SEC Docket 11615, 11622, *petition denied*, 347 Fed. Appx. 692 (2d Cir. 2009) (unpublished); *Charles Fawcett*, Exchange Act Rel. No. 56770 (Nov. 8, 2007), 91 SEC Docket 3147, 3157.

26 *CMG*, 95 SEC Docket at 13812 & n.28 (citing *Richard J. Rouse*, 51 S.E.C. 581, 584 n.9 (1993).

We reject Ricupero's suggestion that the fact that he has not worked in the industry since March 2006 should further mitigate the sanction. Absent a bar, Ricupero could seek to re-enter the securities industry through an association with another member firm.[27] In addition, Ricupero has a prior disciplinary history that includes the imposition of significant monetary fines and censures. In 1999 and 2000, Ricupero consented to findings involving violations of free-riding and withholding provisions, as well as net capital violations and failure to provide prompt written notice regarding three principals' departure from the Firm, respectively. In 2003, Ricupero consented to findings that he permitted another individual to act in a capacity that required registration while such registration status was inactive due to the individual's failure to comply with continuing education requirements.[28] In 2008, NASD found that Ricupero failed to timely amend his Uniform Application for Securities Industry Registration or Transfer to disclose a federal court action filed against him alleging that he committed common-law fraud and violated federal securities laws, and that he and the Firm executed two settlement agreements with improper confidentiality provisions.[29] Ricupero's disciplinary history is further evidence that he poses a risk to the investing public should he re-enter the industry.

Ricupero asserts that the suspensions imposed in *CMG Institutional Trading, LLC,*[30] *Morton Bruce Erenstein,*[31] and *Perpetual Securities, Inc.*[32] demonstrate "that where a party responds to an 8210 request even after a complaint is filed, a party should not be barred from the industry." In each of those cases, the applicants had provided some information responsive to NASD's Rule 8210 requests before NASD filed a complaint.[33] Accordingly, NASD found that the applicants violated Rule 8210 by failing to provide complete and/or timely responses to requests for information. NASD imposed sanctions consistent with the Sanction Guidelines, which recommend a suspension when the applicant did not respond in timely manner. In contrast, Ricupero provided no information before NASD filed its complaint and therefore failed to respond in any manner. Such conduct warrants a bar in the absence of mitigating factors.

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27 *Justin F. Ficken*, Exchange Act Rel. No. 58802 (Oct. 17, 2008), 94 SEC Docket 10887, 10894.

28 NASD did not consider this violation in its sanction determination.

29 NASD ordered Ricupero and the Firm to pay a $7,500 fine and costs of $3,540.14 jointly and severally. On February 6, 2009, NASD revoked Ricupero's registration for failure to pay the fines and costs associated with the 2008 proceeding.

30 Exchange Act Rel. No. 59325 (Jan. 30, 2009), 95 SEC Docket 13802.

31 Exchange Act Rel. No. 56768 (Nov. 8, 2007), 91 SEC Docket 3114.

32 Exchange Act Rel. No. 56613 (Oct. 4, 2007), 91 SEC Docket 2489.

33 *CMG*, 95 SEC Docket at 13808; *Erenstein*, 91 SEC Docket at 3119; *Perpetual*, 91 SEC Docket at 2503.

We conclude that the bar is remedial because it will prevent Ricupero and deter others from failing to respond to NASD requests for information and protect the investing public by encouraging timely cooperation.[34] Accordingly, we find NASD's decision to bar Ricupero in all capacities neither excessive nor oppressive within the meaning of Exchange Act Section 19(e).

An appropriate order will issue.[35]

By the Commission (Commissioners CASEY, WALTER, AGUILAR, and PAREDES); Chairman SCHAPIRO not participating.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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[34] *See Morton Bruce Erenstein*, Exchange Act Rel. No. 56768 (Nov. 8, 2007), 91 SEC Docket 3114, 3129 (finding that a bar against respondent for a Rule 8210 violation served as a deterrent to others who might ignore NASD's information requests and protected the investing public by encouraging the timely cooperation essential to promptly discovering and remedying industry conduct), *petition denied*, 316 Fed. Appx. 865 (11th Cir. 2008) (unpublished).

[35] We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 62891 / September 10, 2010

Admin. Proc. File No. 3-13727

In the Matter of the Application of

JOSEPH RICUPERO
c/o Marni Weiss, Esq.
Weiss Imbesi PLLC
462 7th Avenue, 12th Floor
New York, NY 10018

For Review of Disciplinary Action Taken by

Financial Industry Regulatory Authority, Inc.

ORDER SUSTAINING DISCIPLINARY ACTION

On the basis of the Commission's opinion issued this day, it is

ORDERED that the disciplinary action taken by Financial Industry Regulatory Authority, Inc. against Joseph Ricupero be, and it hereby is, sustained.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Ch. II

[Release Nos. 33-9141, 34-62881, IA-3081, IC-29414, File No. S7-21-10]

Regulatory Flexibility Agenda

AGENCY: Securities and Exchange Commission.

ACTION: Semiannual regulatory agenda.

SUMMARY: The Securities and Exchange Commission approved the publication of an agenda of its rulemaking actions pursuant to the Regulatory Flexibility Act. The agenda, which is not a part of or attached to this document, was submitted by the Commission to the Regulatory Information Service Center for inclusion in the Unified Agenda of Federal Regulatory and Deregulatory Actions, which is scheduled for publication in its entirety on www.reginfo.gov in October 2010. The version of the Unified Agenda to be published in the Federal Register will include only those rules for which the agency has indicated that preparation of an analysis under the Regulatory Flexibility Act is required. Information in the Commission's agenda was accurate on September 10, 2010, the date on which the Commission's staff completed compilation of the data. To the extent possible, rulemaking actions by the Commission after that date will be reflected in the agenda. The Commission invites questions and public comment on the agenda and on the individual agenda entries.

DATES: Comments should be received on or before December 30, 2010.

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

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/other.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-21-10 on the

subject line; or

- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper comments:

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

All submissions should refer to File Number S7-21-10. 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 website (http://www.sec.gov/rules/other.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Anne Sullivan, Office of the General Counsel, 202-551-5019.

SUPPLEMENTARY INFORMATION: The Regulatory Flexibility Act ("RFA") (Pub. L. No. 96-354, 94 Stat. 1164 (September 19, 1980)) requires each federal agency in April and October of each year to publish in the Federal Register an agenda identifying rules that the agency expects to consider in the next twelve months that are likely to have a significant economic impact on a substantial number of small entities (5 U.S.C. 602(a)). The RFA specifically provides that publication of the agenda does not preclude an agency from considering or acting on any matter not included in the agenda, and that an agency is not required to consider or act on any matter that is included in the agenda (5 U.S.C. 602(d)). Actions that do not have an estimated date are placed in the long term category; the Commission may nevertheless act on items in that category within the next twelve months. The agenda includes new entries, entries carried over from previous publications, and rulemaking actions that have been completed (or withdrawn) since publication of the last agenda. The Commission invites public comment on the agenda and on the individual agenda entries.

By the Commission.

Elizabeth M. Murphy

Elizabeth M Murphy
Secretary

Dated: September 10, 2010

Chairman Schapiro not participating

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-62883; File No. SR-FINRA-2010-033)

September 10, 2010

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change Relating to Expanding the Pilot Rule for Trading Pauses Due to Extraordinary Market Volatility to the Russell 1000® Index and Specified Exchange Traded Products

I. Introduction

On June 30, 2010, the Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1)[1] of the Securities Exchange Act of 1934 ("Act"),[2] and Rule 19b-4 thereunder,[3] a proposed rule change to amend its rules to expand the trading pause pilot in individual stocks comprising the S&P 500® Index ("S&P 500") when the price moves ten percent or more in the preceding five minute period to securities included in the Russell 1000® Index ("Russell 1000") and specified Exchange Traded Products ("ETPs").[4] The proposed rule change was published for comment in the Federal Register on July 7, 2010.[5] The Commission received 19 comments on the proposal and on broader issues

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

2 15 U.S.C. 78a.

3 17 CFR 240.19b-4.

4 For purposes of Phase II, ETPs consist of exchange-traded funds (including widely traded broad-based funds like SPY), exchange-traded vehicles (which track the performance of an asset or index, providing investors with exposure to futures contracts, currencies and commodities without actually trading futures or taking physical delivery of the asset), and exchange-traded notes.

5 See Securities Exchange Act Release No. 62416 (June 30, 2010), 75 FR 39069 (July 7, 2010) (SR-FINRA-2010-033).

Also on June 30, 2010, each of BATS Exchange, Inc. ("BATS"), NASDAQ OMX BX, Inc. ("BX"), Chicago Board Options Exchange, Incorporated ("CBOE"), Chicago Stock Exchange, Inc. ("CHX"), EDGA Exchange, Inc relating to the effectiveness of the circuit breaker pilot program to date.[6]

("EDGA"), EDGX Exchange, Inc. ("EDGX"), International Securities Exchange LLC ("ISE"), The NASDAQ Stock Market LLC ("NASDAQ"), New York Stock Exchange LLC ("NYSE"), NYSE Amex LLC ("NYSE Amex"), NYSE Arca, Inc. ("NYSE Arca"), and National Stock Exchange, Inc. ("NSX") securities exchanges filed proposed rule changes to expand the pilot program. See Securities Exchange Act Release Nos. 62407 (June 30, 2010), 75 FR 39060 (July 7, 2010); 62415 (June 30, 2010), 75 FR 39086 (July 7, 2010); 62409 (June 30, 2010), 75 FR 39078 (July 7, 2010); 62408 (June 30, 2010), 75 FR 39065 (July 7, 2010); 62417 (June 30, 2010), 75 FR 39074 (July 7, 2010); 62418 (June 30, 2010), 75 FR 39084 (July 7, 2010); 62419 (June 30, 2010), 75 FR 39070 (July 7, 2010); 62414 (June 30, 2010), 75 FR 39081 (July 7, 2010); 62411 (June 30, 2010), 75 FR 39067 (July 7, 2010); 62412 (June 30, 2010), 75 FR 39073 (July 7, 2010); 62413 (June 30, 2010), 75 FR 39076 (July 7, 2010); and 62410 (June 30, 2010), 75 FR 39063 (July 7, 2010). Those rule changes were approved today. See Securities Exchange Act Release No. 62884 (September 10, 2010).

In this order, the term "Exchanges" refers collectively to all of the exchanges. The term "Listing Markets" refers collectively to NYSE, NYSE Amex, NYSE Arca, and NASDAQ. The term "Nonlisting Markets" refers collectively to the remaining national securities exchanges. The term "SROs" refers to the Exchanges and the Financial Industry Regulatory Authority ("FINRA").

6 The Commission considered letters received as of August 25 discussing the concept of the effectiveness of the individual stock circuit breaker pilot to date as well as formal letters citing the rule filings. See Letter from Paul Schott Stevens, President & CEO, Investment Company Institute to Chairman Schapiro, Commission, dated June 22, 2010 ("ICI Letter"); Letter from Craig S. Donohue, CEO, CME Group, Inc. to Chairman Schapiro, Commission, dated June 23, 2010 ("CME Letter"); Letter from Ann L. Vlcek, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association to Elizabeth M. Murphy, Secretary, Commission, dated June 25, 2010 ("SIFMA Letter"); Letter from Peter Skopp, President, Molinete Trading Inc. to Elizabeth M. Murphy, Secretary, Commission, dated July 8, 2010 ("Molinete Letter"); Letter from Sal L. Arnuk, Co-Head, and Joseph Saluzzi, Co-Head, Themis Trading to Elizabeth M. Murphy, Secretary, Commission, dated July 8, 2010 ("Themis Letter"); Letter from Peter A. Ianello, Partner, CSS, LLC to Elizabeth M. Murphy, Secretary, Commission, dated July 15, 2010 ("CSS Letter"); Letter from Julie S. Sweet, General Counsel, Secretary, Chief Compliance Officer, Accenture plc to Elizabeth M. Murphy, Secretary, Commission, dated July 15, 2010 ("Accenture Letter"); Letter from Patrick J. Healy, CEO, Issuer Advisory Group, LLC, Washington, District of Columbia to Elizabeth M. Murphy, Secretary, Commission, dated July 18, 2010 ("Issuer Advisory Group Letter"); Letter from Alexander M. Cutler, Chair, Business Roundtable Corporate Leadership Initiative, Business Roundtable, to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("Business Roundtable Letter"); Letter from

The Commission finds that the proposals are consistent with Section 15A(b)(6) of the Act,[7] as it believes that expanding the uniform, market-wide trading pauses will serve to prevent potentially destabilizing price volatility and will thereby help promote the goals of investor protection and just and equitable principles of trade. This order approves the proposed rule change.

II. Description of the Proposals

On May 6, 2010, the U.S. equity markets experienced a severe disruption.[8] Among other things, the prices of a large number of individual securities suddenly

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Geva Patz, Android Alpha Fund to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("Android Alpha Fund Letter"); Letter from David C. Cushing, Director of Global Equity Trading, Wellington Management Company, LLP to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("Wellington Letter"); Letter from Karrie McMillan, General Counsel, Investment Company Institute to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("ICI 2 Letter"); Letter from Ira P. Shapiro, Managing Director, BlackRock, Inc., San Francisco, California to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("BlackRock Letter"); Letter from Tom Quaadman, Vice President, Center for Capital Markets Competitiveness, Washington, District of Columbia to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("CCMC Letter"); Letter from James J. Angel, Associate Professor of Finance, Georgetown University, dated June 19, 2010 [sic] ("Angel Letter"); Letter from John A. McCarthy, General Counsel, GETCO to Elizabeth M. Murphy, Secretary, Commission, dated July 20, 2010 ("GETCO Letter"); Letter from Jose Marques, Managing Director, Deutsche Bank Securities Inc. to Elizabeth M. Murphy, Secretary, Commission, dated July 21, 2010 ("Deutsche Bank Letter"); Letter from Paul Schott Stevens, President & CEO, Investment Company Institute to Chairman Schapiro, Commission, dated July 27, 2010 ("ICI 3 Letter"); Letter from Craig S. Donohue, Chief Executive Officer, CME Group to Elizabeth M. Murphy, Secretary, Commission, dated July 30, 2010 (CME 2 Letter").

7 15 U.S.C. 78o-3(b)(6). That section, among other things, requires that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade and in general, to protect investors and the public interest.

8 The events of May 6 are described more fully in the report of the staffs of the Commodity Futures Trading Commission ("CFTC") and the Commission, titled Report of the CFTC and SEC to the Joint Advisory Committee on Emerging

declined by significant amounts in a very short time period, before suddenly reversing to prices consistent with their pre-decline levels. This severe price volatility led to a large number of trades being executed at temporarily depressed prices, including many that were more than 60% away from pre-decline prices and were broken by the national securities exchanges. The Commission is concerned that events such as those that occurred on May 6 can seriously undermine the integrity of the U.S. securities markets. Accordingly, it is working on a variety of fronts to assess the causes and contributing factors of the May 6 market disruption and to fashion policy responses that will help prevent a recurrence.

The Commission also recognizes the importance of moving quickly to implement appropriate steps that could help limit potential harm from extreme price volatility. In this regard, it is pleased that the SROs began consulting soon after May 6 in an effort to develop consistent circuit breaker rules that could be implemented on an expedited basis. The SROs were able to reach agreement on a consistent approach and, on May 18 and 19, 2010, all of the SROs filed proposed rule changes with the Commission.

On June 10, 2010, the Commission granted accelerated approval, for a pilot period to end December 10, 2010, for a proposed rule change by FINRA to pause trading during periods of extraordinary market volatility in S&P 500 stocks (the "Phase I Circuit Breaker Pilot").[9] That rule requires FINRA, once a Listing Market issues a trading pause, to halt trading otherwise than on an exchange in that security until trading has

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Regulatory Issues, "Preliminary Findings Regarding the Market Events of May 6, 2010," dated May 18, 2010 ("Joint Report").

9 See Securities Exchange Act Release No. 62251 (June 10, 2010), 75 FR 34183 (June 16, 2010) (SR-FINRA-2010-025) ("Phase I Approval Order").

resumed on the primary listing market.[10] The Listing Markets are required to notify the other exchanges, market participants and FINRA of the imposition of a trading pause by immediately disseminating a special indicator over the consolidated tape. Under the rules, once the Listing Market issues a trading pause, FINRA is required to pause trading in the security otherwise than on an exchange.

At the end of the five-minute pause, the Listing Market reopens trading in the security in accordance with its procedures for doing so. Trading resumes on other exchanges and in the over-the-counter (OTC) market once trading has resumed on the Listing Market. In the event of a significant imbalance on the Listing Market at the end of the trading pause, the Listing Market may delay reopening. If the Listing Market has not reopened within ten minutes from the initiation of the trading pause, however, FINRA will halt trading otherwise than on an exchange in that security until trading has resumed on the primary Listing Market. FINRA may permit the resumption of trading if trading has commenced on at least one other national securities exchange.[11]

Several commenters on the proposal for the Phase I Circuit Breaker Pilot expressed the view that the circuit breaker pilot should be expanded beyond S&P 500 stocks, particularly to exchange traded funds ("ETFs") and the securities of other companies that were most severely affected by the market disruption on May 6, 2010.[12]

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10 The rules of the Exchanges require the Listing Markets to issue five-minute trading pauses for individual securities for which they are the primary Listing Market if the transaction price of the security moves ten percent or more from a price in the preceding five-minute period.

11 For more details on the operation of FINRA's rule, see Securities Exchange Act Release No. 62251.

12 See, e.g., Letter from Jeffrey W. Rubin, American Bar Association Business Law Section to Elizabeth M. Murphy, Secretary, Commission, dated June 3, 2010; Letter from Julie Sweet, Accenture plc to Elizabeth M. Murphy, Secretary,

In the approval order for the Phase I Circuit Breaker Pilot, the Commission agreed that consideration should be given by the exchanges and FINRA to whether the circuit breakers should be expanded to cover additional securities, but did not believe that there was a reason to delay implementation of the Phase I Circuit Breaker Pilot as a reasonable first step to address potential market volatility.

Under the current proposal, FINRA proposes to add securities included in the Russell 1000, as well as specified ETPs, to the pilot (the "Phase II Circuit Breaker Pilot") shortly after the Commission approves the proposed rule changes. FINRA believes that adding these securities to the pilot would have the beneficial effect of applying the circuit breakers' protections against excessive volatility to a larger group of securities, while at the same time allowing the opportunity, during the pilot period, for continued review of the operation of the circuit breakers and an assessment of whether the pilot should be further expanded or modified.

FINRA believes that the securities in the Russell 1000 have similar trading characteristics to securities included in the S&P 500, and therefore the 10% price movement that triggers a trading pause in the Phase I Circuit Breaker Pilot is appropriate for Russell 1000 securities.

In addition, FINRA proposed to include in the Phase II Circuit Breaker Pilot more liquid ETPs – specifically, those with a minimum average daily volume of $2,000,000 – that tend to have similar trading characteristics as securities in the S&P 500 and Russell

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Commission, dated June 3, 2010; and Letter from Karrie McMillan, Investment Company Institute to Elizabeth M. Murphy, Secretary, Commission, dated June 3, 2010 (expressing particular concern that if circuit breakers exist for individual securities contained in ETFs' baskets, but not for the ETFs themselves, ETFs could again suffer disproportionately during a market event such as that of May 6).

1000 and for which they believe a 10% circuit breaker trigger is appropriate. To assure related ETPs are subject to comparable circuit breakers, any ETPs that did not meet the $2,000,000 average daily volume threshold, but tracked similar stocks and indices as ETPs meeting this criterion and included in the pilot, were proposed for inclusion. ETPs with average-daily-volumes of less than $2,000,000, and for which there were no high-volume counterparts were not included. Also excluded were leveraged ETFs since those products by design are more volatile than the underlying stocks they track, and the current proposal only contemplates adding securities for which a 10% trigger is appropriate.

As proposed, the list of ETPs includes those that track broad-based equity indices, which FINRA recognizes has caused some debate. For example, as described in Section III, concerns have been raised about the effect that halting trading in an index-based ETP may have on a related index-based option or future. However, FINRA believes that including broad-based index ETPs is appropriate so that ETP investors are protected should the component securities experience such volatility that trading in the broad-based ETP is affected. Because the proposal is for a pilot period, FINRA will continue to assess, among other things, whether it is appropriate to have a trading pause in broad-based index ETPs when there is not a similar trading pause in related index-based options or futures.

In addition, during the pilot period, FINRA will continue to assess whether specific stocks or ETPs should be added to, or removed from, the list of securities subject to the circuit breakers. FINRA will also continue to assess whether the parameters for invoking a trading pause continue to be appropriate or should be modified.[13]

III. Discussion of Comments and Commission Findings

As of August 25, 2010, the Commission received 19 comment letters regarding the proposed rule changes. Many commenters supported the Phase II Circuit Breaker Pilot and its expansion to the Russell 1000 and the specified ETPs.[14] For example, one commenter encouraged the Commission to act expeditiously to expand the scope of the trading halt rules to securities other than the S&P 500, particularly to ETFs, and noted that ETFs experienced significant volatility on May 6, 2010 and would benefit from uniform pauses in trading.[15] Another commenter urged the Commission to approve the Phase II Circuit Breaker Pilot as quickly as possible, arguing that many of the securities that experienced the most extreme trading jolts on May 6, 2010 were not included in the Phase I Circuit Breaker Pilot, and that expansion of the pilot was appropriate both to protect additional companies from potential aberrational price movements and liquidity events affecting their securities, and to provide investors with greater certainty about the availability of the circuit breakers.[16] Yet another commenter noted that expanding the trading halt pilot to securities in the Russell 1000 would protect investors in publicly

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13 See Securities Exchange Act Release No. 62416 (June 30, 2010), 75 FR 39069 (July 7, 2010) (SR-FINRA-2010-033).

14 See Accenture Letter, Business Roundtable Letter; CCMC Letter; ICI Letter; ICI 2 Letter; ICI 3 Letter; Issuer Advisory Group Letter; Wellington Letter; Deutsche Bank Letter; SIFMA Letter; and BlackRock Letter.

15 See SIFMA Letter.

16 See Business Roundtable Letter.

traded companies not in the S&P 500 that experienced severely aberrational trading on May 6.[17]

Some commenters raised concerns about the proposed rule changes. The two main areas of concern were: (1) the ability of erroneous trades to trigger a trading pause; and (2) whether ETPs – particularly broad-based index products – should be included in the pilot.

1. Erroneous Trades Triggering the Trading Pause

Several commenters pointed out that, under the circuit breaker pilot, erroneous trades can trigger – and have triggered – trading pauses, when there otherwise is no extraordinary market volatility.[18] One commenter asserted that under the current circuit breaker logic, erroneous trades would have triggered a trading halt at least 238 times in the past 18 months.[19] This same commenter pointed out that, as of the date of its letter, three stocks had been halted under the Phase I Circuit Breaker Pilot, two of which were triggered on markets with prices that were far away from the current national best bid or offer ("NBBO") and prevailing prices at other markets.[20]

Other commenters expressed concern that any trader in the world, ill-intentioned[21] or not, has the power to halt trading in a stock simply by printing a trade outside the

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17 See Accenture Letter.

18 See, e.g., Themis Letter; Accenture Letter; Molinete Letter; SIFMA Letter; and Angel Letter.

19 See Molinete Letter.

20 Id. (referring to the trading pauses in Citigroup on June 29, 2010 and in Anadarko Petroleum on July 6, 2010). As of August 25, stock-specific circuit breakers have been triggered seven times in six stocks.

21 The Commission notes that anyone reporting a trade with the intention of triggering a trading pause could be charged with manipulation, fraud or other violations of the federal securities laws.

circuit breaker range on a trade reporting facility for the OTC market.[22] One of these commenters suggested that either a minimum number of trades outside the circuit breaker range occur before trading is halted, or that the trade first be checked for consistency with the NBBO before trading is halted.[23]

Several commenters concerned with erroneous trades triggering the circuit breakers offered alternatives to the "trading pause" mechanism used in the current pilot. A number of commenters suggested that the Commission consider moving to a "limit up/limit down" approach to moderate market volatility, similar to that utilized in the futures markets.[24] Some commenters also encouraged the Commission to consider adopting collars on market orders and eliminating stub quotes.[25] One commenter suggested that the markets trigger the single stock circuit breakers off of changes to the NBBO rather than to changes in the last trade price.[26]

The Commission believes that the ability of an erroneous trade to trigger a trading pause is a concern that FINRA should seek to address promptly. The Commission understands that FINRA is working on a variety of measures to reduce the instances of erroneous trades and to assure that, when they occur, they are resolved promptly through

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22 See Themis Letter and Angel Letter.

23 Id.

24 See SIFMA Letter; Accenture Letter; Wellington Letter; and CME 2 Letter. Under this approach, trades could occur within the established price bands, so that erroneous trades would largely be eliminated. In addition, there would not be a complete trading halt – trading would be prevented outside the applicable price band, but could continue within it.

25 See SIFMA Letter and CME 2 Letter.

26 See Molinete Letter. As an alternative, this commenter suggested requiring at least two consecutive trades outside the NBBO to trigger the circuit breaker, and the exclusion of manually-entered trades from being potential triggers.

a clear and transparent process.[27] The Commission also notes that, under the pilot rules, the Listing Market can exclude a transaction price that results from an erroneous execution from triggering a circuit breaker. In this regard, the Commission notes that the Listing Markets, pursuant to this authority, intend to implement automated processes to help prevent trades that may be erroneous – specifically, those outside the NBBO – from triggering a circuit breaker.[28] In addition, the Commission understands FINRA is developing more effective ways to prevent erroneous OTC trades from being printed on a trade reporting facility, and it encourages those efforts as well.[29] Various exchanges have taken steps to "collar" market orders, which are intended to prevent executions that occur a specified percentage away from the last sale,[30] and Commission staff has been working with FINRA on an initiative to prevent stub quotes. The Commission, in conjunction with FINRA, will continue to evaluate what further steps need to be taken to reduce the likelihood of erroneous trades and to improve the efficiency of the pilot. However, the

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27 See SR-BATS-2010-016; SR-BX-2010-040; SR-CBOE-2010-056; SR-CHX-2010-13; SR-EDGA-2010-03; SR-EDGX-2010-03; SR-FINRA-2010-032; SR-ISE-2010-62; SR-NASDAQ-2010-076; SR-NSX-2010-07; SR-NYSE-2010-47; SR-NYSEAmex-2010-60; SR-NYSEArca-2010-58 (proposed rule changes to amend certain SRO rules to set forth clearer standards and curtail SRO discretion with respect to breaking erroneous trades).

28 See Letter from Janet M. Kissane, Senior Vice President – Legal & Corporate Secretary, NYSE Euronext to Elizabeth M. Murphy, Secretary, Commission, dated August 25, 2010; Letter from Thomas P. Moran, Associate General Counsel, The NASDAQ Stock Market LLC to Elizabeth M. Murphy, Secretary, Commission, dated August 26, 2010. The Listing Markets may roll out these new automated processes on a staggered basis.

29 See, e.g., FINRA Trade Reporting Notice, dated August 19, 2010 (issuing new guidance on the use of the weighted-average price/ special pricing formula (.W) trade modifier for reporting certain types of OTC trades in NMS stocks to FINRA).

30 See, e.g., Securities Exchange Act Release Nos. 62485 (July 13, 2010), 75 FR 41914 (July 19, 2010) (SR-NYSEArca-2010-67); 60371 (July 23, 2009), 74 FR 38075 (July 30, 2009) (SR-NASDAQ-2009-70).

Commission does not believe it is appropriate to delay implementation of the Phase II Circuit Breaker Pilot pending the conclusion of those efforts.

2. Inclusion of ETPs

Many commenters addressed the inclusion of ETPs in the pilot program.[31] Several supported the proposed expansion of the Phase II Circuit Breaker Pilot to include ETPs.[32] One of these commenters stated that ETFs experienced significant volatility on May 6, and would benefit from a uniform trading pause.[33] Another commenter noted that the price of an ETF is typically highly correlated to the market price of its basket of component securities.[34] Under normal circumstances, when trading has been halted for one or two component securities, an ETF may experience a slight deviation from the price of its basket because of the challenge of pricing the non-trading security, and may trade with a wider spread to account for the associated risk. When multiple underlying securities are affected, however, the correlation between the prices of an ETF and its underlying basket may break down and the ETF may experience more severe price dislocation.[35] While this commenter thought that a different circuit breaker trigger may be appropriate for ETFs, it nonetheless encouraged the Commission to include all ETFs in the pilot where a substantial number of the component securities are subject to the

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31 See Accenture Letter; Android Alpha Fund Letter; BlackRock Letter; Business Roundtable Letter; CME Letter; CME 2 Letter; CCMC Letter; ICI Letter; ICI 2 Letter; ICI 3 Letter; Molinete Letter; SIFMA Letter.

32 See Accenture Letter; BlackRock Letter; Business Roundtable Letter; CCMC Letter; ICI Letter; ICI 2 Letter; ICI 3 Letter; SIFMA Letter.

33 See SIFMA Letter at 2.

34 See ICI Letter and ICI 2 Letter.

35 Id.

circuit breakers.[36] Doing otherwise, in its view, creates risks that ETFs could again suffer disproportionately during a market event similar to that of May 6.[37]

One commenter supported the inclusion of ETFs in the pilot program, in part because halting trading in the underlying component securities, but not in the ETF, would hinder the arbitrage mechanism that is critical to the ability of ETFs to track the performance of their underlying basket or benchmark index.[38] According to this commenter, if an ETF were allowed to continue to trade while trading in the majority of its underlying securities were halted, the arbitrage mechanism would not work effectively, with the result that liquidity for the ETF would diminish greatly, and perhaps lead to a collapse in price similar to that which occurred on May 6.[39]

Other commenters criticized various aspects of the application of the proposed rule change to ETPs. One commenter described certain ETFs – such as the S&P 500 SPDR (SPY) – as "systemically important," and expressed concern that halting trading in these ETFs, especially as a result of erroneous trades, might destabilize markets. Because the SPY, for example, is used as a hedging vehicle in many trading strategies, halting

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36 See ICI Letter. In a subsequent letter, that commenter supported examining the connection between price discovery in the equities and the futures markets, and potentially making rules consistent across markets. See ICI 2 Letter. According to this commenter, however, such an examination should not prevent including broad-based index ETFs in the pilot program. Id.

37 See ICI 2 Letter.

38 See BlackRock Letter. According to the commenter, this arbitrage mechanism generally requires liquidity providers to sell a basket of stocks equivalent to an ETF's underlying portfolio (or a correlated derivative) as a hedge when purchasing ETF shares.

39 Id. This commenter did, however, question the exclusion of lower-volume ETFs from the Phase II Circuit Breaker Pilot, and urged that these ETFs be included in the pilot at the earliest opportunity. See discussion on pages 6-7 describing the rationale for selecting the list of ETPs for inclusion in the pilot program.

trading in it could cause liquidity providers broadly to withdraw from the market, increasing volatility and perhaps leading to a chain reaction like that witnessed on May 6.[40] This commenter did not believe that allowing ETFs to continue to trade while some of the underlying component securities were halted would be detrimental, because market participants would determine their own fair value of the halted component securities.[41]

Another commenter expressed significant concern with the proposed expansion of the pilot to broad-based equity index ETFs, as it believed there could be potentially significant disruptions to trading across related markets.[42] This commenter noted that the indices underlying the most active ETFs are the same as those underlying the most active cash index options, index futures, and options on ETFs.[43] If a different circuit breaker mechanism applied to broad-based equity index ETFs and ETF options than applied to index futures and index options, or differed from the overall market-wide circuit breakers, the commenter feared this could lead to further market stress during periods of

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40 See Molinete Letter at 4.

41 Id. at 4-5.

42 See CME Letter and CME 2 Letter. This commenter expressed further concerns with the prospect of multiple constituent stocks in an index being halted without the market-wide circuit breaker being triggered. The commenter thought this would create complexity and confusion in understanding the index calculation. In addition, the commenter was of the view that the halting of high capitalization, highly-liquid index components would be disruptive because it could affect whether the index triggers a market-wide circuit breaker, the intra-day index values circulated for risk management purposes may not be reflective of the true value of the underlying market, and large liquidity providers in index futures and ETFs may have difficulty hedging with the result that they withdraw from the market.

43 Id. The commenter also noted that these markets are very closely linked and the absence of effective coordination across comparable markets was one factor cited by many as having contributed to certain market issues experienced on May 6. The Commission addresses issues of cross-market linkage in its discussion infra.

turbulence, perhaps impeding liquidity and exacerbating risk management challenges.[44] In addition, the commenter thought that the inability of market makers to hedge using equity index ETFs during a trading pause could lead to their withdrawing liquidity across all markets, including in the E-mini index futures.[45] Accordingly, the commenter believed that the circuit breakers applicable to equity index-based ETFs (as well as index futures, index options, options on ETFs, and swaps) should be consistent with both the methodology and levels of the market-wide circuit breakers.[46] Specifically, the commenter recommended the adoption of uniform price limits across all broad-based index products based upon the S&P 500, the DJIA, and the NASDAQ 100, which would preclude trading beyond the enumerated limit but not within it.[47] This commenter also recommended that automated risk and volatility mitigation mechanisms be implemented in place of trading halts in individual securities.[48]

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44 Id.

45 CME Letter.

46 CME Letter. This commenter also noted that, while approximately 70% of the trades broken on May 6, 2010 were in ETFs, they were not in the most liquid domestic, large cap index products.

47 CME 2 Letter. These price limits would be established at the 5%, 10% and 20% levels, and would be implemented for a 10 minute period, after which trading would continue to the next applicable limit.

48 Id. Specifically, the commenter recommended that all markets adopt: (1) automated means – similar to the commenter's stop logic functionality – to briefly pause the market in the event that cascading sell orders precipitate a material market decline because of a transitory dearth of liquidity; (2) functionality – similar to the commenter's protection point functionality – to automatically apply limit prices to all orders, including market and stop orders; and (3) automated price banding functionality and maximum order size restrictions to help prevent erroneous trades. For as long as single stock circuit breakers continue to be employed, however, the commenter believed regulators and the markets should establish uniform policies and procedures to address situations where the computation of the market-wide circuit breaker index value is negatively affected due to the triggering of stock specific circuit breakers on the component

The Commission believes that, on balance, the inclusion of ETPs, including broad-based index equity ETFs, in the Phase II Circuit Breaker Pilot is warranted and consistent with the Act. The Commission notes that there are a number of scenarios in which the application of a circuit breaker to trading in an ETF would promote market stability. For example, if an ETF triggers a circuit breaker when none of its component stocks is experiencing abnormal moves, then it is likely that the ETF is suffering from a temporary liquidity imbalance. In that case, the ETF would no longer be suitable for use as a hedging instrument since its price would no longer reflect an accurate consensus market value of the ETF or its underlying stocks. By pausing the ETF under these circumstances, the Exchanges would allow liquidity to rebuild and provide time for the market to self-correct without allowing the aberrant price of the ETF to adversely affect the trading and pricing of the underlying stocks, other ETFs or other related products.

In another scenario, an ETF might trigger a circuit breaker, even though its component stocks have not, because the ETF is leading its underlying stocks in price discovery. In that case, the prices of many of the underlying stocks may follow, triggering their own circuit breakers shortly after the ETF does. In a broad market event such as this, the net result would be that trading in the ETF and individual stocks have each been paused, providing time for the market as a whole to re-evaluate prices.

In yet another scenario, a number of individual component stocks might trigger their circuit breakers even though the related ETF has not yet done so. In that case, different market participants may very well have differing opinions on the market value for the ETF because they will be required to estimate the value of those component

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securities.

stocks that have been paused. If only a small number of component stocks is paused (perhaps due to some temporary liquidity imbalances in those stocks) then there likely would be minimal effect on the ETF, and the ETF circuit breakers appropriately would not be triggered. But if a large number of component stocks trigger halts, the market likely is experiencing a broad-based move, either for fundamental reasons, or because of a large-scale liquidity imbalance similar to that of May 6. As noted above, if many component stocks of an ETF are paused, but the ETF itself continues to trade, the arbitrage relationship between the ETF and its component stocks likely will break down as market participants find they cannot hedge their exposures and, as a consequence, cease to provide liquidity. Without a circuit breaker mechanism that also applies to ETFs, the ETF could experience excessive volatility that is not necessarily driven by the prices of its underlying stocks. By pausing the ETF, market participants would be given time to re-evaluate prices and replenish liquidity as needed.

The Commission acknowledges that a variety of ETFs do indeed trade without incident when most, and sometimes all, of their underlying components are not trading (e.g., ETFs on international stocks). However, market makers and other participants trading these ETFs account for this known and permanent structural difference by building alternative methods for hedging and pricing into their trading models. Market participants trading ETFs for which the component stocks normally trade at the same time would not necessarily have the opportunity to implement new hedging and pricing strategies in real time if underlying component stocks were suddenly paused. Rather, they would most likely withdraw from the market leaving the ETF with little liquidity and even further need for a trading pause.[49]

The above arguments demonstrating the need to couple pauses in ETFs with pauses in underlying stocks are equally applicable to the futures market, and the Commission acknowledges the comments and concerns of the CME for consistent treatment across instrument types. However, the Commission notes that the CME's markets already have mechanisms for limiting or pausing trading, and thus some inconsistency exists today between the two markets. Maintaining the status quo, moreover, would leave ETFs without a trading pause mechanism. In addition, the Commission notes that there will need to be substantial work to determine how best to make the volatility constraints in the futures markets and the securities markets consistent.

Commenters have also raised related concerns that a pause in a broad-based ETF (such as the SPY) could lead to significant liquidity pressures on other index-based products in the futures market (such as the E-mini).[50] Although this is a potential point of concern, as noted above the futures markets already have in place volatility mechanisms that should help mitigate the effect of such an event. Moreover, it should be noted that currently there could be a pause on the futures market (e.g., in the E-mini) which could create liquidity pressure for corresponding ETFs – but there is currently no mechanism to protect the ETF against aberrant prices as a result of such liquidity pressures.

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49 The Commission notes that a pause in the ETF could also affect trading in underlying component stocks that were not otherwise halted to the extent that the ETF was no longer available as a hedging mechanism.

50 See CME Letter.

In response to the comment that the Commission instead implement automated risk and volatility mitigation mechanisms – such as price banding or stop logic functionality – the Commission notes that, even as the circuit breaker pilot is being expanded, the Commission is simultaneously exploring possible alternatives to a circuit breaker approach that may include price limit bands or other mechanisms described by the commenters.

One commenter noted that the proposal would exclude many ETFs with trading volumes below the criteria set by FINRA, although such ETFs were significantly affected in the cancelled trades of May 6.[51] The Commission acknowledges that fact, but notes that, as FINRA has indicated, the potential application of the circuit breakers to less liquid securities is more complex, as different triggering thresholds for may be appropriate for them. As the pilot progresses, the Commission will work with FINRA to consider expanding the circuit breakers to cover additional securities in an appropriate manner.

The Commission acknowledges the point made by commenters that broad-based index products were not significantly implicated in the cancelled trades on May 6.[52] However, the Commission notes that broad-based index products did experience substantial volatility on May 6[53] and, like other securities, could benefit from the protections of a circuit breaker. In addition, a sudden change in price, due to a loss of liquidity or otherwise, to a widely traded ETF could have an adverse market-wide effect

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51 See BlackRock Letter.

52 See CME Letter.

53 See Joint Report, supra note 8, at 39 (noting that many ETFs "experienced extreme daily lows" on May 6, and that a "significant number of ETFs" experienced extreme daily highs on May 6).

even more far-reaching than that of May 6. It is important that the use of circuit breakers not be limited to only those ETFs that happened to have experienced severe dislocations on May 6, since there is no fundamental reason why broad-based ETFs could not experience a similar liquidity crisis. In addition, there were no circuit breakers in effect for underlying stocks on May 6. If a similar event occurred when many underlying stocks in an index were halted by circuit breakers, broad-based ETFs could experience greater volatility than occurred on May 6.

3. Other Areas of Comment

Other areas of comment included potential ways to expand or modify the circuit breaker pilot going forward,[54] the need to carefully study the effect of the pilot,[55] the effect and continued advisability of individual market volatility moderators in addition to the uniform single-stock circuit breakers,[56] and possible modifications to the market-wide circuit breakers.[57]

With regard to expanding or modifying the circuit breaker pilot, as noted above, the Commission intends to continue working with FINRA to consider expanding the pilot to include additional securities, or modifying the circuit breaker mechanism or pursuing other approaches to moderating market volatility, in the coming months. In addition, as noted in the Joint Report, the Commission currently is evaluating the extent to which

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54 See Angel Letter (recommending that the trading pause be expanded to cover the open, close, and after-hours trading); ICI Letter (recommending examining whether a different circuit breaker trigger is appropriate for ETFs); Wellington Letter (recommending that the Commission require the Exchanges to continuously disclose the high/low trigger of a security and its maximum remaining life).

55 See Android Alpha Fund Letter.

56 See Deutsche Bank Letter.

57 See CME 2 Letter; SIFMA Letter.

individual market volatility moderators exacerbated the market instability that occurred on May 6, 2010, and expects to develop appropriate policy recommendations based on the outcome of that analysis. Finally, as noted in the Joint Report, the Commission intends to work with the CFTC to consider whether modifications to the existing market-wide circuit breakers are warranted in light of the events of May 6. While all of these issues warrant further study in the coming months, the Commission does not believe they provide a basis for not approving the Phase II Circuit Breaker Pilot at this time. The fact that better alternatives to address inordinate market volatility ultimately may be developed does not provide a basis for the Commission not to approve FINRA's proposal if, as the Commission believes, the proposed rule change is consistent with Section 15A(b)(6) of the Act.

4. Findings

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association. In particular, the Commission finds that the proposal is consistent with the provisions of Section 15A(b)(6) of the Act,[58] which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade and, in general, to protect investors and the public interest.[59]

The proposed rule changes will expand the trading pause pilot to include the securities in the Russell 1000 and specified ETPs. The Commission believes that

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58 15 U.S.C. 78o–3(b)(6).

59 In approving the proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

expanding the uniform, market-wide trading pauses will serve to prevent potentially destabilizing price volatility and will thereby help promote the goals of investor protection and fair and orderly markets.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[60] that the proposed rule change (SR-FINRA-2010-033) be, and hereby is, approved.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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60 15 U.S.C. 78s(b)(2).

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-62884; File Nos. SR-BATS-2010-018; SR-BX-2010-044; SR-CBOE-2010-065; SR-CHX-2010-14; SR-EDGA-2010-05; SR-EDGX-2010-05; SR-ISE-2010-66; SR-NASDAQ-2010-079; SR-NYSE-2010-49; SR-NYSEAmex-2010-63; SR-NYSEArca-2010-61; SR-NSX-2010-08)

September 10, 2010

Self-Regulatory Organizations; BATS Exchange, Inc.; NASDAQ OMX BX, Inc.; Chicago Board Options Exchange, Incorporated; Chicago Stock Exchange, Inc.; EDGA Exchange, Inc.; EDGX Exchange, Inc.; International Securities Exchange LLC; The NASDAQ Stock Market LLC; New York Stock Exchange LLC; NYSE Amex LLC; NYSE Arca, Inc.; National Stock Exchange, Inc.; Order Approving Proposed Rule Changes Relating to Expanding the Pilot Rule for Trading Pauses Due to Extraordinary Market Volatility to the Russell 100®Index and Specified Exchange Traded Products

I. Introduction

On June 30, 2010, each of BATS Exchange, Inc. ("BATS"), NASDAQ OMX BX, Inc. ("BX"), Chicago Board Options Exchange, Incorporated ("CBOE"), Chicago Stock Exchange, Inc. ("CHX"), EDGA Exchange, Inc ("EDGA"), EDGX Exchange, Inc. ("EDGX"), International Securities Exchange LLC ("ISE"), The NASDAQ Stock Market LLC ("NASDAQ"), New York Stock Exchange LLC ("NYSE"), NYSE Amex LLC ("NYSE Amex"), NYSE Arca, Inc. ("NYSE Arca"), and National Stock Exchange, Inc. ("NSX") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1)[1] of the Securities Exchange Act of 1934 ("Act"),[2] and Rule 19b-4 thereunder,[3] proposed rule changes to amend certain of their respective rules to expand the trading pause pilot in individual stocks comprising the S&P 50®Index ("S&P 500") when the price moves ten percent or more in the preceding five minute period to securities included in the Russell 100®Index ("Russell 1000") and specified Exchange

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

2 15 U.S.C. 78a.

3 17 CFR 240.19b-4.

28 of 82

Traded Products ("ETPs").[4] The proposed rule changes were published for comment in the Federal Register on July 7, 2010.[5] The Commission received 19 comments on the proposal and on broader issues relating to the effectiveness of the circuit breaker pilot program to date.[6] The NYSE responded to the comments in a letter dated July 23, 2010,[7]

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4 The term "Exchanges" shall refer collectively to all of the exchanges in this order. The term "Listing Markets" refers collectively to NYSE, NYSE Amex, NYSE Arca, and NASDAQ. The term "Nonlisting Markets" refers collectively to the remaining national securities exchanges.

The Commission notes that NYSE and NYSE Amex do not currently trade ETPs. Therefore, the expansion of the pilot to the select list of ETPs does not apply to these two markets.

For purposes of Phase II, ETPs consist of exchange-traded funds (including widely traded broad-based funds like SPY), exchange-traded vehicles (which track the performance of an asset or index, providing investors with exposure to futures contracts, currencies and commodities without actually trading futures or taking physical delivery of the asset), and exchange-traded notes.

5 See Securities Exchange Act Release Nos. 62407 (June 30, 2010), 75 FR 39060 (July 7, 2010); 62415 (June 30, 2010), 75 FR 39086 (July 7, 2010); 62409 (June 30, 2010), 75 FR 39078 (July 7, 2010); 62408 (June 30, 2010), 75 FR 39065 (July 7, 2010); 62417 (June 30, 2010), 75 FR 39074 (July 7, 2010); 62418 (June 30, 2010), 75 FR 39084 (July 7, 2010); 62419 (June 30, 2010), 75 FR 39070 (July 7, 2010); 62414 (June 30, 2010), 75 FR 39081 (July 7, 2010); 62411 (June 30, 2010), 75 FR 39067 (July 7, 2010); 62412 (June 30, 2010), 75 FR 39073 (July 7, 2010); 62413 (June 30, 2010), 75 FR 39076 (July 7, 2010); and 62410 (June 30, 2010), 75 FR 39063 (July 7, 2010) ("Phase II Circuit Breaker Pilot Notices").

On June 30, 2010, FINRA filed a proposed rule change, which was approved today. See Securities Exchange Act Release No. 62416 (June 30, 2010), 75 FR 39069 (July 7, 2010); Securities Exchange Act Release No. 62883 (September 10, 2010) (SR-FINRA-2010-033).

6 The Commission considered letters received as of August 25 discussing the concept of the effectiveness of the individual stock circuit breaker pilot to date as well as formal letters citing the rule filings. See Letter from Paul Schott Stevens, President & CEO, Investment Company Institute to Chairman Schapiro, Commission, dated June 22, 2010 ("ICI Letter"); Letter from Craig S. Donohue, CEO, CME Group, Inc. to Chairman Schapiro, Commission, dated June 23, 2010 ("CME Letter"); Letter from Ann L. Vlcek, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association to Elizabeth M. Murphy, Secretary, Commission, dated June 25, 2010 ("SIFMA Letter"); Letter from Peter Skopp, President, Molinete Trading Inc. to Elizabeth

and in a letter dated August 25, 2010.[8] Nasdaq submitted a response on August 26,

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M. Murphy, Secretary, Commission, dated July 8, 2010 ("Molinete Letter"); Letter from Sal L. Arnuk, Co-Head, and Joseph Saluzzi, Co-Head, Themis Trading to Elizabeth M. Murphy, Secretary, Commission, dated July 8, 2010 ("Themis Letter"); Letter from Peter A. Ianello, Partner, CSS, LLC to Elizabeth M. Murphy, Secretary, Commission, dated July 15, 2010 ("CSS Letter"); Letter from Julie S. Sweet, General Counsel, Secretary, Chief Compliance Officer, Accenture plc to Elizabeth M. Murphy, Secretary, Commission, dated July 15, 2010 ("Accenture Letter"); Letter from Patrick J. Healy, CEO, Issuer Advisory Group, LLC, Washington, District of Columbia to Elizabeth M. Murphy, Secretary, Commission, dated July 18, 2010 ("Issuer Advisory Group Letter"); Letter from Alexander M. Cutler, Chair, Business Roundtable Corporate Leadership Initiative, Business Roundtable, to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("Business Roundtable Letter"); Letter from Geva Patz, Android Alpha Fund to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("Android Alpha Fund Letter"); Letter from David C. Cushing, Director of Global Equity Trading, Wellington Management Company, LLP to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("Wellington Letter"); Letter from Karrie McMillan, General Counsel, Investment Company Institute to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("ICI 2 Letter"); Letter from Ira P. Shapiro, Managing Director, BlackRock, Inc., San Francisco, California to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("BlackRock Letter"); Letter from Tom Quaadman, Vice President, Center for Capital Markets Competitiveness, Washington, District of Columbia to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("CCMC Letter"); Letter from James J. Angel, Associate Professor of Finance, Georgetown University, dated June 19, 2010 [sic] ("Angel Letter"); Letter from John A. McCarthy, General Counsel, GETCO to Elizabeth M. Murphy, Secretary, Commission, dated July 20, 2010 ("GETCO Letter"); Letter from Jose Marques, Managing Director, Deutsche Bank Securities Inc. to Elizabeth M. Murphy, Secretary, Commission, dated July 21, 2010 ("Deutsche Bank Letter"); Letter from Paul Schott Stevens, President & CEO, Investment Company Institute to Chairman Schapiro, Commission, dated July 27, 2010 ("ICI 3 Letter"); Letter from Craig S. Donohue, Chief Executive Officer, CME Group to Elizabeth M. Murphy, Secretary, Commission, dated July 30, 2010 (CME 2 Letter").

7 See Letter from Janet M. Kissane, Senior Vice President – Legal & Corporate Secretary, NYSE Euronext to Elizabeth M. Murphy, Secretary, Commission, dated July 23, 2010 ("Response Letter").

8 See Letter from Janet M. Kissane, Senior Vice President – Legal & Corporate Secretary, NYSE Euronext to Elizabeth M. Murphy, Secretary, Commission, dated August 25, 2010.

2010.[9]

The Commission finds that the proposals are consistent with Section 6(b)(5) of the Act,[10] as it believes that expanding the uniform, market-wide trading pauses will serve to prevent potentially destabilizing price volatility and will thereby help promote the goals of investor protection and fair and orderly markets. This order approves the proposed rule changes.

II. Description of the Proposals

On May 6, 2010, the U.S. equity markets experienced a severe disruption.[11] Among other things, the prices of a large number of individual securities suddenly declined by significant amounts in a very short time period, before suddenly reversing to prices consistent with their pre-decline levels. This severe price volatility led to a large number of trades being executed at temporarily depressed prices, including many that were more than 60% away from pre-decline prices and were broken by the Exchanges. The Commission is concerned that events such as those that occurred on May 6 can seriously undermine the integrity of the U.S. securities markets. Accordingly, it is

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9 See Letter from Thomas P. Moran, Associate General Counsel, The NASDAQ Stock Market LLC to Elizabeth M. Murphy, Secretary, Commission, dated August 26, 2010.

10 15 U.S.C. 78f(b)(5). That section, among other things, requires that the rules of national securities exchanges be designed to prevent fraudulent and manipulative acts and practices, 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.

11 The events of May 6 are described more fully in the report of the staffs of the Commodity Futures Trading Commission ("CFTC") and the Commission, titled Report of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues, "Preliminary Findings Regarding the Market Events of May 6, 2010," dated May 18, 2010 ("Joint Report").

working on a variety of fronts to assess the causes and contributing factors of the May 6 market disruption and to fashion policy responses that will help prevent a recurrence.

The Commission also recognizes the importance of moving quickly to implement appropriate steps that could help limit potential harm from extreme price volatility. In this regard, it is pleased that the SROs began consulting soon after May 6 in an effort to develop consistent circuit breaker rules that could be implemented on an expedited basis. The SROs were able to reach agreement on a consistent approach and, on May 18 and 19, 2010, all of the SROs filed proposed rule changes with the Commission.

On June 10, 2010, the Commission granted accelerated approval, for a pilot period to end December 10, 2010, for proposed rule changes by the Exchanges to pause trading during periods of extraordinary market volatility in S&P 500 stocks (the "Phase I Circuit Breaker Pilot").[12] The rules require the Listing Markets to issue five-minute trading pauses for individual securities for which they are the primary Listing Market if the transaction price of the security moves ten percent or more from a price in the preceding five-minute period. The Listing Markets are required to notify the other Exchanges and market participants of the imposition of a trading pause by immediately disseminating a special indicator over the consolidated tape. Under the rules, once the Listing Market issues a trading pause, the other Exchanges are required to pause trading in the security on their markets.

At the end of the five-minute pause, the Listing Market reopens trading in the security in accordance with its procedures for doing so. Trading resumes on other Exchanges and in the over-the-counter (OTC) market once trading has resumed on the

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12 See Securities Exchange Act Release No. 62252 (June 10, 2010), 75 FR 34186 (June 16, 2010) ("Phase I Approval Order").

Listing Market. In the event of a significant imbalance on the Listing Market at the end of the trading pause, the Listing Market may delay reopening. If the Listing Market has not reopened within ten minutes from the initiation of the trading pause, however, the other Exchanges may resume trading.[13]

Several commenters on the proposal for the Phase I Circuit Breaker Pilot expressed the view that the circuit breaker pilot should be expanded beyond S&P 500 stocks, particularly to exchange traded funds ("ETFs") and the securities of other companies that were most severely affected by the market disruption on May 6, 2010.[14] In the approval order for the Phase I Circuit Breaker Pilot, the Commission agreed that consideration should be given by the Exchanges to whether the circuit breakers should be expanded to cover additional securities, but did not believe that there was a reason to delay implementation of the Phase I Circuit Breaker Pilot as a reasonable first step to address potential market volatility.

Under the current proposal, the Exchanges propose to add securities included in the Russell 1000, as well as specified ETPs, to the pilot (the "Phase II Circuit Breaker Pilot") shortly after the Commission approves the proposed rule changes. The Exchanges believe that adding these securities to the pilot would have the beneficial effect of

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13 For more details on the operation of the Exchanges' rule, see Securities Exchange Act Release No. 62252.

14 See, e.g., Letter from Jeffrey W. Rubin, American Bar Association Business Law Section to Elizabeth M. Murphy, Secretary, Commission, dated June 3, 2010; Letter from Julie Sweet, Accenture plc to Elizabeth M. Murphy, Secretary, Commission, dated June 3, 2010; and Letter from Karrie McMillan, Investment Company Institute to Elizabeth M. Murphy, Secretary, Commission, dated June 3, 2010 (expressing particular concern that if circuit breakers exist for individual securities contained in ETFs' baskets, but not for the ETFs themselves, ETFs could again suffer disproportionately during a market event such as that of May 6).

applying the circuit breakers' protections against excessive volatility to a larger group of securities, while at the same time allowing the opportunity, during the pilot period, for continued review of the operation of the circuit breakers and an assessment of whether the pilot should be further expanded or modified.

The Exchanges believe that the securities in the Russell 1000 have similar trading characteristics to securities included in the S&P 500, and therefore the 10% price movement that triggers a trading pause in the Phase I Circuit Breaker Pilot is appropriate for Russell 1000 securities. Based on the analyses of certain of the Exchanges, the number of times that the trading pause would be triggered for Russell 1000 securities would be similar to the number of instances for S&P 500 securities.

In addition, the Exchanges proposed to include in the Phase II Circuit Breaker Pilot the more liquid ETPs – specifically, those with a minimum average daily volume of $2,000,000 – that tend to have similar trading characteristics as securities in the S&P 500 and Russell 1000 and for which they believe a 10% circuit breaker trigger is appropriate.[15] In addition, to assure related ETPs are subject to comparable circuit breakers, the Exchanges proposed to include any ETP that did not meet the $2,000,000 average daily volume threshold, but tracked similar stocks and indices as ETPs meeting this criterion and proposed to be included in the pilot. ETPs with average-daily-volumes of less than $2,000,000, and for which there were no high-volume counterparts were not included. Also excluded were leveraged ETFs since those products by design are more

15 For details on how the Exchanges developed the pilot list of ETPs, see, e.g., Securities Exchange Act Release No. 62413 (June 30, 2010), 75 FR 39076 (July 7, 2010) (SR-NYSEArca-2010-61).

volatile than the underlying stocks they track, and the current proposal only contemplates adding securities for which a 10% trigger is appropriate.[16]

As proposed, the list of ETPs includes those that track broad-based equity indices, which the Exchanges recognize has caused some debate. For example, as described in Section III, concerns have been raised about the effect that halting trading in an index-based ETP may have on a related index-based option or future. However, the Exchanges believe that including broad-based index ETPs is appropriate so that ETP investors are protected should the component securities experience such volatility that trading in the broad-based ETP is affected. Because the proposal is for a pilot period, the Exchanges will continue to assess, among other things, whether it is appropriate to have a trading pause in broad-based index ETPs when there is not a similar trading pause in related index-based options or futures.

In addition, during the pilot period, the Exchanges will continue to assess whether specific stocks or ETPs should be added to, or removed from, the list of securities subject to the circuit breakers. The Exchanges will also continue to assess whether the parameters for invoking a trading pause continue to be appropriate or should be modified.[17]

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16 One consequence of excluding leveraged ETFs is that they could still suffer significant price dislocations even though trading in the stocks they track might be paused as discussed above.

The Exchanges do not believe that the 10% price movement is an appropriate threshold for leveraged ETPs because, by definition, leveraged ETPs are based on multiples of price movements in the underlying index. Accordingly, a 10% percent price movement in a leveraged ETP may not signify extraordinary volatility. Because the Exchanges are not proposing to adopt revised price movement thresholds at this time, they are not proposing to include leveraged ETPs for now.

17 See Phase II Circuit Breaker Pilot Notices, supra note 5.

III. Discussion of Comments and Commission Findings

As of August 25, 2010, the Commission received 19 comment letters regarding the proposed rule changes. Many commenters supported the Phase II Circuit Breaker Pilot and its expansion to the Russell 1000 and the specified ETPs.[18] For example, one commenter encouraged the Commission to act expeditiously to expand the scope of the trading halt rules to securities other than the S&P 500, particularly to ETFs, and noted that ETFs experienced significant volatility on May 6, 2010 and would benefit from uniform pauses in trading.[19] Another commenter urged the Commission to approve the Phase II Circuit Breaker Pilot as quickly as possible, arguing that many of the securities that experienced the most extreme trading jolts on May 6, 2010 were not included in the Phase I Circuit Breaker Pilot, and that expansion of the pilot was appropriate both to protect additional companies from potential aberrational price movements and liquidity events affecting their securities, and to provide investors with greater certainty about the availability of the circuit breakers.[20] Yet another commenter noted that expanding the trading halt pilot to securities in the Russell 1000 would protect investors in publicly traded companies not in the S&P 500 that experienced severely aberrational trading on May 6.[21]

Some commenters raised concerns about the proposed rule changes. The two main areas of concern were: (1) the ability of erroneous trades to trigger a trading pause;

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18 See Accenture Letter, Business Roundtable Letter; CCMC Letter; ICI Letter; ICI 2 Letter; ICI 3 Letter; Issuer Advisory Group Letter; Wellington Letter; Deutsche Bank Letter; SIFMA Letter; and BlackRock Letter.

19 See SIFMA Letter.

20 See Business Roundtable Letter.

21 See Accenture Letter.

and (2) whether ETPs – particularly broad-based index products – should be included in the pilot.

1. Erroneous Trades Triggering the Trading Pause

Several commenters pointed out that, under the circuit breaker pilot, erroneous trades can trigger – and have triggered – trading pauses, when there otherwise is no extraordinary market volatility.[22] One commenter asserted that under the current circuit breaker logic, erroneous trades would have triggered a trading halt at least 238 times in the past 18 months.[23] This same commenter pointed out that, as of the date of its letter, three stocks had been halted under the Phase I Circuit Breaker Pilot, two of which were triggered on markets with prices that were far away from the current national best bid or offer ("NBBO") and prevailing prices at other markets.[24]

Other commenters expressed concern that any trader in the world, ill-intentioned[25] or not, has the power to halt trading in a stock simply by printing a trade outside the circuit breaker range on a trade reporting facility for the OTC market.[26] One of these commenters suggested that either a minimum number of trades outside the circuit breaker

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22 See, e.g., Themis Letter; Accenture Letter; Molinete Letter; SIFMA Letter; and Angel Letter.

23 See Molinete Letter.

24 Id. (referring to the trading pauses in Citigroup on June 29, 2010 and in Anadarko Petroleum on July 6, 2010). As of August 25, stock-specific circuit breakers have been triggered seven times in six stocks.

25 The Commission notes that anyone reporting a trade with the intention of triggering a trading pause could be charged with manipulation, fraud or other violations of the federal securities laws.

26 See Themis Letter and Angel Letter.

range occur before trading is halted, or that the trade first be checked for consistency with the NBBO before trading is halted.[27]

Several commenters concerned with erroneous trades triggering the circuit breakers offered alternatives to the "trading pause" mechanism used in the current pilot. A number of commenters suggested that the Commission consider moving to a "limit up/limit down" approach to moderate market volatility, similar to that utilized in the futures markets.[28] Some commenters also encouraged the Commission to consider adopting collars on market orders and eliminating stub quotes.[29] One commenter suggested that the markets trigger the single stock circuit breakers off of changes to the NBBO rather than to changes in the last trade price.[30]

The Commission believes that the ability of an erroneous trade to trigger a trading pause is a concern that the Exchanges should seek to address promptly. The Commission understands that the Exchanges are working on a variety of measures to reduce the instances of erroneous trades and to assure that, when they occur, they are resolved promptly through a clear and transparent process.[31] The Commission also notes that,

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27 Id.

28 See SIFMA Letter; Accenture Letter; Wellington Letter; and CME 2 Letter. Under this approach, trades could occur within the established price bands, so that erroneous trades would largely be eliminated. In addition, there would not be a complete trading halt – trading would be prevented outside the applicable price band, but could continue within it.

29 See SIFMA Letter and CME 2 Letter.

30 See Molinete Letter. As an alternative, this commenter suggested requiring at least two consecutive trades outside the NBBO to trigger the circuit breaker, and the exclusion of manually-entered trades from being potential triggers.

31 See SR-BATS-2010-016; SR-BX-2010-040; SR-CBOE-2010-056; SR-CHX-2010-13; SR-EDGA-2010-03; SR-EDGX-2010-03; SR-FINRA-2010-032; SR-ISE-2010-62; SR-NASDAQ-2010-076; SR-NSX-2010-07; SR-NYSE-2010-47; SR-NYSEAmex-2010-60; SR-NYSEArca-2010-58 (proposed rule changes to

under the pilot rules, the Listing Market can exclude a transaction price that results from an erroneous execution from triggering a circuit breaker. In this regard, the Commission notes that the Listing Markets, pursuant to this authority, intend to implement automated processes to help prevent trades that may be erroneous – specifically, those outside the NBBO – from triggering a circuit breaker.[32] Various Exchanges have taken steps to "collar" market orders, which are intended to prevent executions that occur a specified percentage away from the last sale,[33] and Commission staff has been working with the Exchanges on an initiative to prevent stub quotes. The Commission, in conjunction with the Exchanges, will continue to evaluate what further steps need to be taken to reduce the likelihood of erroneous trades and to improve the efficiency of the pilot. However, the Commission does not believe it is appropriate to delay implementation of the Phase II Circuit Breaker Pilot pending the conclusion of those efforts.

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amend certain SRO rules to set forth clearer standards and curtail SRO discretion with respect to breaking erroneous trades).

32 See Letter from Janet M. Kissane, Senior Vice President – Legal & Corporate Secretary, NYSE Euronext to Elizabeth M. Murphy, Secretary, Commission, dated August 25, 2010; Letter from Thomas P. Moran, Associate General Counsel, The NASDAQ Stock Market LLC to Elizabeth M. Murphy, Secretary, Commission, dated August 26, 2010. The Listing Markets may roll out these new automated processes on a staggered basis.

In addition, the Commission understands FINRA is developing more effective ways to prevent erroneous OTC trades from being printed on a trade reporting facility, and it encourages those efforts. See, e.g., FINRA Trade Reporting Notice, dated August 19, 2010 (issuing new guidance on the use of the weighted-average price/special pricing formula (.W) trade modifier for reporting certain types of OTC trades in NMS stocks to FINRA).

33 See, e.g., Securities Exchange Act Release Nos. 62485 (July 13, 2010), 75 FR 41914 (July 19, 2010) (SR-NYSEArca-2010-67); 60371 (July 23, 2009), 74 FR 38075 (July 30, 2009) (SR-NASDAQ-2009-70).

2. Inclusion of ETPs

Many commenters addressed the inclusion of ETPs in the pilot program.[34] Several supported the proposed expansion of the Phase II Circuit Breaker Pilot to include ETPs.[35] One of these commenters stated that ETFs experienced significant volatility on May 6, and would benefit from a uniform trading pause.[36] Another commenter noted that the price of an ETF is typically highly correlated to the market price of its basket of component securities.[37] Under normal circumstances, when trading has been halted for one or two component securities, an ETF may experience a slight deviation from the price of its basket because of the challenge of pricing the non-trading security, and may trade with a wider spread to account for the associated risk. When multiple underlying securities are affected, however, the correlation between the prices of an ETF and its underlying basket may break down and the ETF may experience more severe price dislocation.[38] While this commenter thought that a different circuit breaker trigger may be appropriate for ETFs, it nonetheless encouraged the Commission to include all ETFs in the pilot where a substantial number of the component securities are subject to the circuit breakers.[39] Doing otherwise, in its view, creates risks that ETFs could again suffer disproportionately during a market event similar to that of May 6.[40]

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34 See Accenture Letter; Android Alpha Fund Letter; BlackRock Letter; Business Roundtable Letter; CME Letter; CME 2 Letter; CCMC Letter; ICI Letter; ICI 2 Letter; ICI 3 Letter; Molinete Letter; SIFMA Letter.

35 See Accenture Letter; BlackRock Letter; Business Roundtable Letter; CCMC Letter; ICI Letter; ICI 2 Letter; ICI 3 Letter; SIFMA Letter.

36 See SIFMA Letter at 2.

37 See ICI Letter and ICI 2 Letter.

38 Id.

39 See ICI Letter. In a subsequent letter, that commenter supported examining the

One commenter supported the inclusion of ETFs in the pilot program, in part because halting trading in the underlying component securities, but not in the ETF, would hinder the arbitrage mechanism that is critical to the ability of ETFs to track the performance of their underlying basket or benchmark index.[41] According to this commenter, if an ETF were allowed to continue to trade while trading in the majority of its underlying securities were halted, the arbitrage mechanism would not work effectively, with the result that liquidity for the ETF would diminish greatly, and perhaps lead to a collapse in price similar to that which occurred on May 6.[42]

Other commenters criticized various aspects of the application of the proposed rule change to ETPs. One commenter described certain ETFs – such as the S&P 500 SPDR (SPY) – as "systemically important," and expressed concern that halting trading in these ETFs, especially as a result of erroneous trades, might destabilize markets. Because the SPY, for example, is used as a hedging vehicle in many trading strategies, halting trading in it could cause liquidity providers broadly to withdraw from the market, increasing volatility and perhaps leading to a chain reaction like that witnessed on May

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connection between price discovery in the equities and the futures markets, and potentially making rules consistent across markets. See ICI 2 Letter. According to this commenter, however, such an examination should not prevent including broad-based index ETFs in the pilot program. Id.

40 See ICI 2 Letter.

41 See BlackRock Letter. According to the commenter, this arbitrage mechanism generally requires liquidity providers to sell a basket of stocks equivalent to an ETF's underlying portfolio (or a correlated derivative) as a hedge when purchasing ETF shares.

42 Id. This commenter did, however, question the exclusion of lower-volume ETFs from the Phase II Circuit Breaker Pilot, and urged that these ETFs be included in the pilot at the earliest opportunity. See discussion on pages 6-7 describing the rationale for selecting the list of ETPs for inclusion in the pilot program.

6.[43] This commenter did not believe that allowing ETFs to continue to trade while some of the underlying component securities were halted would be detrimental, because market participants would determine their own fair value of the halted component securities.[44]

Another commenter expressed significant concern with the proposed expansion of the pilot to broad-based equity index ETFs, as it believed there could be potentially significant disruptions to trading across related markets.[45] This commenter noted that the indices underlying the most active ETFs are the same as those underlying the most active cash index options, index futures, and options on ETFs.[46] If a different circuit breaker mechanism applied to broad-based equity index ETFs and ETF options than applied to index futures and index options, or differed from the overall market-wide circuit breakers, the commenter feared this could lead to further market stress during periods of turbulence, perhaps impeding liquidity and exacerbating risk management challenges.[47] In addition, the commenter thought that the inability of market makers to hedge using

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43 See Molinete Letter at 4.

44 Id. at 4-5.

45 See CME Letter and CME 2 Letter. This commenter expressed further concerns with the prospect of multiple constituent stocks in an index being halted without the market-wide circuit breaker being triggered. The commenter thought this would create complexity and confusion in understanding the index calculation. In addition, the commenter was of the view that the halting of high capitalization, highly-liquid index components would be disruptive because it could affect whether the index triggers a market-wide circuit breaker, the intra-day index values circulated for risk management purposes may not be reflective of the true value of the underlying market, and large liquidity providers in index futures and ETFs may have difficulty hedging with the result that they withdraw from the market.

46 Id. The commenter also noted that these markets are very closely linked and the absence of effective coordination across comparable markets was one factor cited by many as having contributed to certain market issues experienced on May 6. The Commission addresses issues of cross-market linkage in its discussion infra.

47 Id.

equity index ETFs during a trading pause could lead to their withdrawing liquidity across all markets, including in the E-mini index futures.[48] Accordingly, the commenter believed that the circuit breakers applicable to equity index-based ETFs (as well as index futures, index options, options on ETFs, and swaps) should be consistent with both the methodology and levels of the market-wide circuit breakers.[49] Specifically, the commenter recommended the adoption of uniform price limits across all broad-based index products based upon the S&P 500, the DJIA, and the NASDAQ 100, which would preclude trading beyond the enumerated limit but not within it.[50] This commenter also recommended that automated risk and volatility mitigation mechanisms be implemented in place of trading halts in individual securities.[51]

In its response to comments, NYSE stated that the "prompt review and implementation of revised and coordinated market wide circuit breakers is . . . a high

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48 See CME Letter.

49 See CME Letter. This commenter also noted that, while approximately 70% of the trades broken on May 6, 2010 were in ETFs, they were not in the most liquid domestic, large cap index products.

50 See CME 2 Letter. These price limits would be established at the 5%, 10% and 20% levels, and would be implemented for a 10 minute period, after which trading would continue to the next applicable limit.

51 Id. Specifically, the commenter recommended that all markets adopt: (1) automated means – similar to the commenter's stop logic functionality – to briefly pause the market in the event that cascading sell orders precipitate a material market decline because of a transitory dearth of liquidity; (2) functionality – similar to the commenter's protection point functionality – to automatically apply limit prices to all orders, including market and stop orders; and (3) automated price banding functionality and maximum order size restrictions to help prevent erroneous trades. For as long as single stock circuit breakers continue to be employed, however, the commenter believed regulators and the markets should establish uniform policies and procedures to address situations where the computation of the market-wide circuit breaker index value is negatively affected due to the triggering of stock specific circuit breakers on the component securities.

priority."[52] NYSE also indicated that it would continue to review the operation of the pilot, including its effect on how index-based products trade across multiple markets, and would propose "such changes as may be warranted for those securities."[53]

The Commission believes that, on balance, the inclusion of ETPs, including broad-based index equity ETFs, in the Phase II Circuit Breaker Pilot is warranted and consistent with the Act. The Commission notes that there are a number of scenarios in which the application of a circuit breaker to trading in an ETF would promote market stability. For example, if an ETF triggers a circuit breaker when none of its component stocks is experiencing abnormal moves, then it is likely that the ETF is suffering from a temporary liquidity imbalance. In that case, the ETF would no longer be suitable for use as a hedging instrument because its price would no longer reflect an accurate consensus market value of the ETF or its underlying stocks. By pausing the ETF under these circumstances, the Exchanges would allow liquidity to rebuild and provide time for the market to self-correct without allowing the aberrant price of the ETF to adversely affect the trading and pricing of the underlying stocks, other ETFs or other related products.

In another scenario, an ETF might trigger a circuit breaker, even though its component stocks have not, because the ETF is leading its underlying stocks in price discovery. In that case, the prices of many of the underlying stocks may follow, triggering their own circuit breakers shortly after the ETF does. In a broad market event such as this, the net result would be that trading in the ETF and individual stocks have each been paused, providing time for the market as a whole to re-evaluate prices.

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52 See Response Letter.

53 Id.

In yet another scenario, a number of individual component stocks might trigger their circuit breakers even though the related ETF has not yet done so. In that case, different market participants may very well have differing opinions on the market value for the ETF because they will be required to estimate the value of those component stocks that have been paused. If only a small number of component stocks is paused (perhaps due to some temporary liquidity imbalances in those stocks) then there likely would be minimal effect on the ETF, and the ETF circuit breakers appropriately would not be triggered. But if a large number of component stocks trigger halts, the market likely is experiencing a broad-based move, either for fundamental reasons, or because of a large-scale liquidity imbalance similar to that of May 6. As noted above, if many component stocks of an ETF are paused, but the ETF itself continues to trade, the arbitrage relationship between the ETF and its component stocks likely will break down as market participants find they cannot hedge their exposures and, as a consequence, cease to provide liquidity. Without a circuit breaker mechanism that also applies to ETFs, the ETF could experience excessive volatility that is not necessarily driven by the prices of its underlying stocks. By pausing the ETF, market participants would be given time to re-evaluate prices and replenish liquidity as needed.

The Commission acknowledges that a variety of ETFs do indeed trade without incident when most, and sometimes all, of their underlying components are not trading (e.g., ETFs on international stocks). However, market makers and other participants trading these ETFs account for this known and permanent structural difference by building alternative methods for hedging and pricing into their trading models. Market participants trading ETFs for which the component stocks normally trade at the same time would not necessarily have the opportunity to implement new hedging and pricing strategies in real time if underlying component stocks were suddenly paused. Rather, they would most likely withdraw from the market leaving the ETF with little liquidity and even further need for a trading pause.[54]

The above arguments demonstrating the need to couple pauses in ETFs with pauses in underlying stocks are equally applicable to the futures market, and the Commission acknowledges the comments and concerns of the CME for consistent treatment across instrument types. However, the Commission notes that the CME's markets already have mechanisms for limiting or pausing trading, and thus some inconsistency exists today between the two markets. Maintaining the status quo, moreover, would leave ETFs without a trading pause mechanism. In addition, the Commission notes that there will need to be substantial work to determine how best to make the volatility constraints in the futures markets and the securities markets consistent.

Commenters also raised related concerns that a pause in a broad-based ETF (such as the SPY) could lead to significant liquidity pressures on other index-based products in the futures market (such as the E-mini).[55] Although this is a potential point of concern, as noted above the futures markets already have in place volatility mechanisms that should help mitigate the effect of such an event. Moreover, it should be noted that currently there could be a pause on the futures market (e.g., in the E-mini) which could create

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54 The Commission notes that a pause in the ETF could also affect trading in underlying component stocks that were not otherwise halted to the extent that the ETF was no longer available as a hedging mechanism.

55 See CME Letter.

liquidity pressure for corresponding ETFs – but there is currently no mechanism to protect the ETF against aberrant prices as a result of such liquidity pressures.

NYSE also recognized these concerns in its response to comments, and committed to working with regulators and other markets in coordinating alerts to trading interruptions "so consistent application of pauses will be effected."[56] NYSE also described "the prompt review and implementation of revised and coordinated market wide circuit breakers" as "a high priority."[57]

In response to the comment that the Commission instead implement automated risk and volatility mitigation mechanisms – such as price banding or stop logic functionality – the Commission notes that, even as the circuit breaker pilot is being expanded, the Commission is simultaneously exploring possible alternatives to a circuit breaker approach that may include price limit bands or other mechanisms described by the commenters.

One commenter noted that the proposal would exclude many ETFs with trading volumes below the criteria set by the Exchanges and FINRA, although such ETFs were significantly affected in the cancelled trades of May 6.[58] The Commission acknowledges that fact, but notes that, as the Exchanges have indicated, the potential application of the circuit breakers to less liquid securities is more complex, as different triggering thresholds may be appropriate for them. As the pilot progresses, the Commission will work with the SROs to consider expanding the circuit breakers to cover additional securities in an appropriate manner.

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56 See NYSE Response Letter.

57 Id.

58 See BlackRock Letter.

The Commission acknowledges the point made by commenters that broad-based index products were not significantly implicated in the cancelled trades on May 6.[59] However, the Commission notes that broad-based index products did experience substantial volatility on May 6[60] and, like other securities, could benefit from the protections of a circuit breaker. In addition, a sudden change in price, due to a loss of liquidity or otherwise, to a widely traded ETF could have an adverse market-wide effect even more far-reaching than that of May 6. It is important that the use of circuit breakers not be limited to only those ETFs that happened to have experienced severe dislocations on May 6, since there is no fundamental reason why broad-based ETFs could not experience a similar liquidity crisis. In addition, there were no circuit breakers in effect for underlying stocks on May 6. If a similar event occurred when many underlying stocks in an index were halted by circuit breakers, broad-based ETFs could experience greater volatility than occurred on May 6.

3. Other Areas of Comment

Other areas of comment included potential ways to expand or modify the circuit breaker pilot going forward,[61] the need to carefully study the effect of the pilot,[62] the effect and continued advisability of individual market volatility moderators in addition to

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59 See CME Letter.

60 See Joint Report, supra note 11, at 39 (noting that many ETFs "experienced extreme daily lows" on May 6, and that a "significant number of ETFs" experienced extreme daily highs on May 6).

61 See Angel Letter (recommending that the trading pause be expanded to cover the open, close, and after-hours trading); ICI Letter (recommending examining whether a different circuit breaker trigger is appropriate for ETFs); Wellington Letter (recommending that the Commission require the Exchanges to continuously disclose the high/low trigger of a security and its maximum remaining life).

62 See Android Alpha Fund Letter.

the uniform single-stock circuit breakers,[63] and possible modifications to the market-wide circuit breakers.[64]

With regard to expanding or modifying the circuit breaker pilot, as noted above, the Commission intends to continue working with the Exchanges to consider expanding the pilot to include additional securities, or modifying the circuit breaker mechanism or pursuing other approaches to moderating market volatility, in the coming months. In addition, as noted in the Joint Report, the Commission currently is evaluating the extent to which individual market volatility moderators exacerbated the market instability that occurred on May 6, 2010, and expects to develop appropriate policy recommendations based on the outcome of that analysis. Finally, as noted in the Joint Report, the Commission intends to work with the CFTC to consider whether modifications to the existing market-wide circuit breakers are warranted in light of the events of May 6. While all of these issues warrant further study in the coming months, the Commission does not believe they provide a basis for not approving the Phase II Circuit Breaker Pilot at this time. The fact that better alternatives to address inordinate market volatility ultimately may be developed does not provide a basis for the Commission not to approve the Exchanges' proposals if, as the Commission believes, the proposed rule changes are consistent with Section 6(b)(5) of the Act.

4. Findings

The Commission finds that the proposed rule changes are consistent with the requirements of the Act and the rules and regulations thereunder applicable to national securities exchanges. In particular, the Commission finds that the proposals are

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63 See Deutsche Bank Letter.

64 See CME 2 Letter; SIFMA Letter.

consistent with Section 6(b)(5) of the Act,[65] which among other things requires that the rules of national securities exchanges be designed to prevent fraudulent and manipulative acts and practices, 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.[66]

The proposed rule changes will expand the trading pause pilot to include the securities in the Russell 1000 and specified ETPs. The Commission believes that expanding the uniform, market-wide trading pauses will serve to prevent potentially destabilizing price volatility and will thereby help promote the goals of investor protection and fair and orderly markets.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[67] that the proposed rule changes (SR-BATS-2010-018; SR-BX-2010-044; SR-CBOE-2010-065; SR-CHX-2010-14; SR-EDGA-2010-05; SR-EDGX-2010-05; SR-ISE-2010-66; SR-NASDAQ-2010-079; SR-NYSE-2010-49; SR-NYSEAmex-2010-63; SR-NYSEArca-2010-61; SR-NSX-2010-08) be, and hereby are, approved.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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65 15 U.S.C. 78f(b)(5).

66 In approving the proposed rule change, the Commission notes that it has considered the proposed rules' impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

67 15 U.S.C. 78s(b)(2).

Chairman Schapiro not participating

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-62885; File No. SR-FINRA-2010-032)

September 10, 2010

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Granting Approval of Proposed Rule Change Relating to Clearly Erroneous Transactions

I. Introduction

On June 17, 2010, the Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), and Rule 19b-4 thereunder, a proposed rule change to amend its rules to set forth clearer standards and curtail its discretion with respect to breaking erroneous trades.[1] The proposed rule change was published for comment in the Federal Register on June 28, 2010.[2] The Commission received nine comment letters on the proposal.[3] BATS

1 Also, on June 17, 2010, each of BATS Exchange, Inc. ("BATS"), NASDAQ OMX BX, Inc. ("BX"), Chicago Board Options Exchange, Incorporated ("CBOE"), Chicago Stock Exchange, Inc. ("CHX"), EDGA Exchange, Inc. ("EDGA"), EDGX Exchange, Inc. ("EDGX"), International Securities Exchange LLC ("ISE"), The NASDAQ Stock Market LLC ("Nasdaq"), National Stock Exchange, Inc. ("NSX"), New York Stock Exchange LLC ("NYSE"), NYSE Amex LLC ("NYSE Amex"), NYSE Arca, Inc. ("NYSE Arca") (collectively, the "Exchanges") filed similar proposed rule changes with respect to breaking erroneous trades. See Securities Exchange Act Release Nos. 62330 (June 21, 2010), 75 FR 36725; 62331 (June 21, 2010), 75 FR 36746; 62332 (June 21, 2010), 75 FR 36749; 62333 (June 21, 2010), 75 FR 36759; 62334 (June 21, 2010), 75 FR 36732; 62335 (June 21, 2010), 75 FR 37494; 62336 (June 21, 2010), 75 FR 36743; 62337 (June 21, 2010), 75 FR 36739; 62338 (June 21, 2010), 75 FR 36762; 62339 (June 21, 2010), 75 FR 36765; 62340 (June 21, 2010), 75 FR 36768; and 62342 (June 21, 2010), 75 FR 36752. These proposals also were approved today. See Securities Exchange Act Release No. 62886 (Sept. 10, 2010).

2 See Securities Exchange Act Release No. 62341 (June 21, 2010), 75 FR 36756.

3 See letter from Peter Ianello, Partner, CSS, LLC, to Elizabeth Murphy, Secretary, Commission, dated July 15, 2010 ("CSS Letter"); letter from Gary DeWaal, Senior Managing Director and Group General Counsel, Newedge USA, LLC, to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("Newedge Letter"); letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("ICI Letter"); David C. Cushing, Director of Global Equity Trading, Wellington Management Company, LLP, to Elizabeth

responded to the comments in a letter dated August 16, 2010.[4] This order approves the proposed rule change.

II. Background and Description of the Proposal

On May 6, 2010, the U.S. equity markets experienced a severe disruption.[5] Among other things, the prices of a large number of individual securities suddenly declined by significant amounts in a very short time period, before suddenly reversing to prices consistent with their pre-decline levels. This severe price volatility led to a large number of trades being executed at temporarily depressed prices, including many that occurred at prices dramatically away from pre-decline levels. In response, the Exchanges and FINRA exercised their authority under their clearly erroneous execution rules to break trades that were effected at prices 60% or more away from pre-decline prices, using a process that was not sufficiently clear or transparent to market participants. There are reports that the lack of clear guidelines for dealing with clearly erroneous transactions under circumstances such as occurred on May 6, and the lack of transparency

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M. Murphy, Secretary, Commission, dated July 19, 2010 ("Wellington Letter"); letter from John A. McCarthy, General Counsel, GETCO, to Elizabeth Murphy, Secretary, Commission, dated July 20, 2010 ("GETCO Letter"); letter from Ira P. Shapiro, Managing Director, BlackRock, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated July 20, 2010 ("BlackRock Letter"); and letter from Manisha Kimmel, Executive Director, Financial Information Forum, On behalf of the FIF Front Office Committee, to Elizabeth M. Murphy, Secretary, Commission, dated July 21, 2010 ("FIF Letter"); letter from Ann Vlcek, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, to Elizabeth M. Murphy, Secretary, Commission, dated July 26, 2010 ("SIFMA Letter"); and letter from Leonard J. Amoruso, General Counsel, Knight Capital Group, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated July 27, 2010 ("Knight Letter").

4 See letter from Eric J. Swanson, SVP and General Counsel, BATS, to Elizabeth M. Murphy, Secretary, Commission, dated August 16, 2010 ("BATS Letter").

5 The events of May 6 are described more fully in the report of the staffs of the Commodity Futures Trading Commission ("CFTC") and the Commission, titled Report of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues, "Preliminary Findings Regarding the Market Events of May 6, 2010," dated May 18, 2010.

surrounding the Exchanges' and FINRA's decision to break only trades at least 60% away from the market, added to the confusion and uncertainty faced by investors on May 6.[6]

The Commission is concerned that events such as those that occurred on May 6 can undermine the integrity of the U.S. securities markets. Accordingly, it is working on a variety of fronts to assess the causes and contributing factors of the May 6 market disruption and to fashion policy responses that will help prevent a recurrence. The Commission also recognizes the importance of moving quickly to implement steps that could help limit potential harm from extreme price volatility. On June 10, 2010, the Commission approved rules, on a pilot basis, that require the Exchanges to pause trading in securities included in the S&P 500 Index if the price moves 10% or more in a five-minute period.[7] By establishing circuit breakers that uniformly pause trading in these securities across all markets, the new rules are designed to facilitate coordinated price discovery and provide time for investors to trade at rational prices. In addition to the individual stock trading pause rules, FINRA worked with the Exchanges to develop proposed amendments to their clearly erroneous execution rules to provide greater transparency and certainty to the process of breaking trades.

The current clearly erroneous execution rule sets forth procedures FINRA must use to break trades. Specifically, the current rule provides that FINRA will break trades in Exchange-listed stocks only if the price of the trades exceeds a specified "Reference Price" – usually the consolidated last sale – by an amount that equals or exceeds specified "Numerical Guidelines."

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6 See, e.g., Written Statement of Leonard J. Amoruso, Senior Managing Director and General Counsel, Knight Capital Group, Inc., Submitted before the CFTC-SEC Advisory Committee on Emerging Regulatory Issues, Panel Discussion, "The events of May 6 – views and observations regarding liquidity, trading and the apparent breakdown of an orderly market," dated June 22, 2010.

7 See Securities Exchange Act Release Nos. 62251; 75 FR 34183 (June 10, 2010); and 62252, 75 FR 34186 (June 16, 2010).

IV.

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

A. Accordingly, it is hereby ORDERED, effective immediately, that Morrice is suspended from appearing or practicing before the Commission as an attorney.

B. After three (3) years from the date of this order, Morrice has the right to apply for reinstatement by submitting an affidavit to the Commission's Office of General Counsel truthfully stating, under penalty of perjury, that he has complied with the Order, that he is not subject to any suspension or disbarment as an attorney by a court of the United States or of any state, territory, district, commonwealth, or possession, and that he has not been convicted of a felony or misdemeanor involving moral turpitude as set forth in Rule 102(e) of the Commission's Rules of Practice.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62895/September 13, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14043

In the Matter of **PROSPERO GROUP,** **Respondent.**	**ORDER INSTITUTING PROCEEDINGS 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 Prospero Group ("Prospero" or "Respondent").

II.

After an investigation, the Division of Enforcement alleges that:

A. Prospero is a Nevada corporation that reports having its principal executive offices in New York, New York but appears to have its primary place of business in Nassau, the Bahamas. Prospero purports to be an oil and gas company and/or "multi-faceted business operation" with investments in resort development, malaria treatments, and water purification. Its common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act. Prospero's common stock is quoted on the Pink Sheets operated by Pink OTC Markets Inc.

B. Prospero has failed to comply with Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder, while its common stock was registered with the Commission, in that it has not filed an Annual Report on Form 10-K since December 15, 2009 (for its fiscal year ending March 31, 2009) or quarterly reports on Form 10-Q for any fiscal period subsequent to its fiscal quarter ending December 31, 2008. Accordingly, Prospero has been delinquent on its filing obligations since at least August 15, 2009.

III.

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 allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that proceedings be instituted pursuant to Section 12(j) of the Exchange Act to determine:

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

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

IV.

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

IT IS FURTHER 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 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 upon Respondent personally or by certified mail.

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.

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 on this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

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

The Numerical Guidelines vary depending on the price of the stock and during the regular trading session are 10% if the consolidated last sale is $25.00 or less, 5% if the consolidated last sale is more than $25 and up to and including $50, and 3% if the consolidated last sale is more than $50. These percentages double during pre-open and post-close trading sessions. For events involving five or more securities, the Numerical Guidelines currently are 10% during pre-open, regular, and post-close trading sessions.

While the current rule does not give FINRA discretion to break trades that do not exceed the Numerical Guidelines, it does permit FINRA discretion to select a percentage threshold at which trades will be broken that is higher than the Numerical Guidelines. As noted above, on May 6 the Exchanges selected 60% as the threshold for breaking trades in a process that, from the perspective of market participants, was not clear or transparent, and led to further uncertainty and confusion in the market. Thus, the events of May 6 highlight the need to clarify the clearly erroneous execution review process across all markets, and reduce the discretion of FINRA to deviate from the objective standards in its rule when dealing with clearly erroneous transactions.

Under the proposed rule change, FINRA will no longer have the discretion to deviate from the specified percentage threshold at which trades will be broken in many situations, including those where the single-stock circuit breakers are applicable and in other larger "Multi-Stock Events" involving five or more securities. Under the proposed rule, a Multi-Stock Event is determined by looking at the number of securities with potentially erroneous executions occurring within a period of five minutes or less.

When an individual stock trading pause is triggered, transactions could occur before the trading pause is fully implemented on all of the Exchanges and in the over-the-counter (OTC) market. In such event, FINRA proposes to review, on its own motion, all transactions triggering an individual stock trading pause and subsequent transactions that may occur before the trading pause is in effect.[8] FINRA would use the price that triggered the trading pause (the "Trading Pause Trigger Price")[9] as the Reference Price and break trades that are 10% or more away from the Reference Price for stocks priced $25 or less, 5% or more away from the Reference Price for stocks priced from $25 to $50, and 3% or more away from the Reference Price for stocks priced more than $50. If the security is a leveraged exchange-traded fund (ETF) or exchange-traded note (ETN), these percentage thresholds would be multiplied by the leverage multiplier.

For situations in which a stock is not subject to an individual stock trading pause (e.g., because the stock is not in the circuit breaker pilot program, or when the stock is part of the pilot program but the circuit breaker does not apply because it is the beginning or end of the day), the trade break rules will differ based on the number of stocks involved. In the event of Multi-Stock Events involving 20 or more securities, FINRA proposes to review on its own motion and break all transactions at prices equal to or greater than 30% away from the Reference Price in each affected security during the review period selected. In such event, FINRA may use a Reference Price other than the consolidated last sale. To ensure consistent application across markets,

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8 Such reviews would be limited to transactions that executed at a price lower than the Trading Pause Trigger Price in the event of a price decline and higher than the Trading Pause Trigger Price in the event of a price rise. Where a trading pause was triggered by a price decline (rise), FINRA shall deem as clearly erroneous all such transactions that occurred at a price lower (higher) than the Trading Pause Trigger Price but only if such prices exceeded the Trading Pause Trigger Price by an amount equal to or exceeding the Numerical Guidelines.

9 FINRA proposes to use the Trading Pause Trigger Price as the Reference Price for such clearly erroneous execution reviews of a transaction triggering a trading pause and the transactions that occur immediately after such transactions but before the trading pause is in effect. The Trading Pause Trigger Price reflects a price calculated by the primary listing market over a rolling five-minute period and may differ from the execution price of a transaction that triggered a trading pause. The primary listing market that issued an individual stock trading pause will determine and communicate to FINRA the Trading Pause Trigger Price for such stock.

FINRA will consult with the Exchanges to determine the appropriate review period, which may be greater than the period (of five minutes or less) that triggered the application of this provision, as well as select one or more specific points in time prior to the transactions in question and use transaction prices at or immediately prior to the time(s) selected as the Reference Price(s).

Similarly, in the event of Multi-Stock Events involving five or more, but less than twenty, securities, FINRA proposes to review on its own motion and break all transactions at prices equal to or greater than 10% away from the Reference Price. In such event, the Reference Price will generally be the consolidated last sale immediately prior to the execution(s) under review. However, if there is relevant news impacting a security, periods of extreme volatility, sustained illiquidity, or widespread systems issues, FINRA may use a different Reference Price, where necessary for the maintenance of a fair and orderly market and the protection of investors, and where it is in the public interest.

The current rule provides that FINRA may consider "Additional Factors"[10] in determining whether to break trades. The proposed rule change limits the circumstances during which FINRA may consider those Additional Factors. Specifically, under the proposed rule, FINRA would only be permitted to consider Additional Factors in the context of clearly erroneous reviews that do not involve Multi-Stock Events involving five or more securities or individual stock trading pauses, as described above. In such event, FINRA would consider the

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10 Additional Factors that FINRA may consider include but are not limited to: system malfunctions or disruptions, volume and volatility for the security, derivative securities products that correspond to greater than 100% in the direction of a tracking index, news released for the security, whether trading in the security was recently halted or resumed, whether the security is an IPO, whether the security was subject to a stock split, reorganization, or other corporate action, overall market conditions, pre-opening and post-closing session executions, validity of consolidated tapes trades and quotes, consideration of primary market indications, and executions inconsistent with the trading pattern in the stock.

Additional Factors with a view toward maintaining a fair and orderly market and the protection of investors and the public interest.

FINRA has proposed that this rule change be implemented as a pilot that would end on December 10, 2010.

III. Discussion of Comment Letters and Commission Findings

The Commission received nine comment letters on the proposed rule changes filed by FINRA and the Exchanges. Five commenters were generally supportive of the principles underlying the proposed rule change, to provide greater transparency and certainty to investors, market participants, and the public regarding the handling of clearly erroneous transactions.[11] However, these commenters also believed that the proposed rule change should go further, and offered a number of suggestions as discussed below. Two commenters generally did not oppose the proposed rule change, but believed it was "overly complex and opaque"[12] and does "not adequately address the most significant flaws in the current rules."[13] One commenter believed that trades should only be cancelled in extraordinary circumstances, stating that the Commission and the SROs should instead consider alternatives that would prevent the execution of erroneous trades rather than canceling them after the fact.[14] Another commenter supported a "principles-based approach" to handling clearly erroneous trades instead of numerical thresholds,

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11 See ICI Letter, at 1, FIF Letter, at 1, Newedge Letter, at 1-2, GETCO Letter, at 2, and SIFMA Letter, at 1-2 (also stating its belief that it is "critical for the options markets to achieve consistency in their existing clearly erroneous execution rules before additional rule changes are implemented…"). See also BlackRock Letter at 1 (supporting amendments to rules that contribute to market volatility).

12 See CSS Letter, at 1.

13 See BlackRock Letter, at 1.

14 See Wellington Letter, at 3-4. See also FIF Letter, at 1-2 (supporting trade validation and rejection mechanisms) and GETCO Letter, at 3 (supporting protections designed to reject clearly erroneous orders that reach market centers).

particularly with respect to transactions involving illiquid stocks and the dissemination of news or a fundamental change that requires a significant reevaluation of underlying business conditions.[15] Additionally, BATS responded to the comments on the similar proposal by the Exchanges.[16] These comments are discussed in greater detail below.

A. Comments Recommending Other Comprehensive Approaches

Some commenters believed that FINRA's rule relating to clearly erroneous trades should be more definitive, and expressed the view that the proposed rule change was not sufficiently clear in all cases when trades would actually be cancelled.[17] For example, one commenter noted that FINRA "appear[s] to be able to cancel trades for many reasons other than significant price discrepancies – including, for example, systems malfunctions, news released regarding a security, whether a security was subject to a stock split or reorganization."[18] This commenter believed FINRA should adopt "no-bust" zones for transactions executed within specified price ranges, and cancel trades outside of the "no-bust" zones absent a compelling public interest to the contrary.[19]

Two commenters questioned whether the proposed rule change would achieve its stated goals of making the erroneous trade execution review process more transparent and less arbitrary.[20] Specifically, these commenters were concerned that the proposed rule change did not

15 See Knight Letter, at 3.

16 See BATS Letter. The response from BATS is discussed in this Order because FINRA's proposed clearly erroneous rule is similar to those of the Exchanges.

17 See Newedge Letter, at 4-5, and BlackRock Letter, at 2.

18 See Newedge Letter, at 4

19 Id.

20 See BlackRock Letter, at 2, and CSS Letter, at 1-2.

clearly establish a reference price upon which the Numerical Guidelines would be based.[21] They noted that FINRA retains the flexibility in certain circumstances to use a Reference Price other than the consolidated last sale, as well as to determine the review period for Multi-Stock Events involving twenty or more securities.[22] These commenters believed that if FINRA retained discretion in these areas, the proposed rule change may not achieve the goal of making the trade break process more transparent and less arbitrary,[23] or could create mass confusion.[24]

In response to comments made on similar proposals made by the Exchanges, BATS acknowledged that the proposals do not "in all circumstances provide 100% advanced certainty with respect to whether a particular execution will be deemed to be clearly erroneous," but stated its belief that "its proposal reflects a significant improvement . . . over its existing rule."[25] Specifically, BATS noted that its discretion to utilize "additional factors" would now be limited to instances involving less than five securities under review and further limited to securities that are not subject to a single stock circuit breaker.[26] BATS believed its limited discretion in this regard is necessary and appropriate for maintaining fair and orderly markets.[27]

With respect to the concern expressed by some commenters that the proposed rule change does not clearly establish a reference price upon which the Numerical Guidelines would be based, BATS, which proposed similar discretionary provisions, stated that it is "critical" for it to retain some limited discretion to use a different reference price when applying the clearly

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21 Id.

22 Id.

23 See BlackRock Letter, at 2.

24 See CSS Letter, at 1-2.

25 See BATS Letter, at 1.

26 Id. at 5.

27 Id.

erroneous thresholds because "there are circumstances under which last sale would be an inappropriate reference price. . . ."[28] BATS noted, however, that this discretion is limited because its "rule is designed to generally guide BATS to look at the last sale as the reference price" for those securities not subject to a circuit breaker and its proposal tries to be "abundantly clear and objective that if a security is subject to a single stock circuit breaker, the reference price will be the circuit breaker trigger price."[29] BATS also noted that the determination of the point in time from which to derive the reference price on May 6 had "nothing to do" with the delay in announcing which trades would be broken on May 6; rather, the delay was attributable to the time it took the Exchanges and FINRA to determine the appropriate percentage at which trades would be broken.[30]

The Commission appreciates the suggestions and responses offered by these commenters to make the process by which FINRA addresses clearly erroneous executions more certain and transparent by reducing its discretion. The Commission intends to continue working with FINRA to further clarify, as appropriate, its process for breaking erroneous trades that arise in contexts not covered by the proposed rule change, as well as to continue to evaluate the operations of and potential refinements to such processes in contexts covered by the proposed rule change. Nevertheless, the Commission believes that the proposed rule change represents a productive first step by FINRA in bringing greater clarity and transparency to the process for breaking clearly erroneous trades, and that these improvements should not be delayed pending consideration of further changes.

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28 Id. at 3-4.

29 Id.

30 Id.

B. Comments Recommending Alternative Approaches

Four commenters were of the view that, rather than breaking erroneous trades, FINRA should allow the trades to stand and adjust the price in line with the market.[31] These commenters were particularly concerned about the risk, when trades are broken, that market participants suddenly may find themselves exposed on one side of the market when they thought they had a hedged position.[32] As one commenter stated, "[t]his uncertainty is even more problematic during periods of heightened volatility in the markets, when liquidity may be reduced as some market participants limit their trading until they are able to determine their positions, or volatility may increase further because of speculative hedging in an attempt to protect unknown positions."[33] These commenters believed that a price adjustment process would substantially reduce the uncertainty created by the potential for broken trades, and thus would be a better way to address erroneous executions.[34]

Other commenters urged alternatives to clearly erroneous execution rules. For example, one commenter believed that the proposed rule would "provide market participants more certainty as to whether or not their trades will stand in the event of market volatility," but urged the Commission to move to a "futures-style limit up/down functionality" as a better alternative to the circuit breaker trading halt approach.[35] This commenter argued that the limit up/limit down

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31 See GETCO Letter, at 3, Newedge Letter, at 5, BlackRock Letter, at 2, and Knight Letter, at 2.

32 Id.

33 See GETCO Letter, at 3.

34 See GETCO Letter, at 3, Newedge Letter, at 5, BlackRock Letter, at 2, and Knight Letter, at 2.

35 See GETCO Letter, at 2-3.

approach "would virtually eliminate clearly erroneous trades."[36] Another commenter also believed that the Commission should consider a "limit up/limit down approach or hybrid approach."[37] Other commenters suggested alternative procedures, systems or rules to prevent erroneous trades from occurring, such as by rejecting orders that are materially away from the market.[38]

The Commission appreciates the suggestions offered by these commenters to make more fundamental changes to the way in which FINRA addresses clearly erroneous executions. In the coming months, the Commission expects to continue to work with the markets and market participants on ways to reduce the occurrence of erroneous trades and improve the method by which they are resolved, as well as on enhancements to the mechanisms for addressing excessive market volatility, such as those that currently are reflected in the single-stock circuit breaker pilot. As noted above, however, the Commission believes that the proposed rule change represents a productive first step by FINRA in bringing greater clarity and transparency to the process for breaking clearly erroneous trades, and that these improvements should not be delayed pending consideration of more far-reaching initiatives.

C. Other Comments

One commenter was concerned that the proposed rule change was not clear as to how news or information regarding the review and cancellation of clearly erroneous trades would be

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36 See GETCO Letter, at 3.

37 See SIFMA Letter, at 2.

38 See FIF Letter, at 2, Wellington Letter, at 2-4, and SIFMA Letter, at 2. See also CSS Letter, at 2 (suggesting that circuit breakers for individual stocks based off of a percentage change from the previous day's closing price (or the opening price to allow for the dissemination of overnight news) would eliminate the need for erroneous trade rules).

disseminated to the markets.[39] This commenter believed that the proposed rule should require FINRA to disseminate this information quickly and in a non-discriminatory fashion to market participants in order to minimize the market impact and not favor any one group of market participants over another.[40] In its response letter with respect to its proposal, BATS stated that it emails members with respect to clearly erroneous reviews and determinations according to a consistent and well established protocol that, according to BATS, strikes an appropriate balance between notifying members of significant market events and avoiding notifications every time a transaction is reviewed as potentially clearly erroneous.[41] In addition, BATS believes that the existing requirement that an SRO promptly notify affected members of clearly erroneous reviews and determinations is sufficient.[42] BATS also stated that communication between the exchanges and members should remain flexible as such methods are constantly changing.[43] BATS indicated that it is not aware of discrimination amongst participants with respect to the dissemination of information in relation to clearly erroneous reviews and believes that the "anti-discrimination requirements of the Act would sufficiently restrain" discrimination.[44]

Another commenter believed that the Commission should require FINRA to clarify the application of the clearly erroneous execution rule when an event causes the price to cross to a different specified percentage threshold for breaking trades. Specifically, the commenter asked, "if a market decline triggers the CEE rules intra-day with respect to a stock that was priced at $25.01, so the CEE price is below $25, the proposed amendments do not explain at what price

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39 See Newedge Letter, at 6.

40 Id.

41 See BATS Letter, at 2.

42 Id.

43 Id.

44 Id.

trading would be calculated for the next application of the CEE rules. Would it be at 5 percent for stocks between $25 and $50 or 10 percent for stocks priced less than $25?"[45] That commenter also expressed concern that the proposed rule change might provide an opportunity for market participants to manipulate events involving multiple stocks that are not subject to the single-stock circuit breakers. This might occur, for example, when an event subject to a 10% threshold (e.g., involving 20 securities) could be forced into the 30% threshold category (e.g., by manipulating the 21st security and causing an erroneous trade), by a market participant seeking the flexibility to trade at wider spreads with respect to all impacted securities.[46]

Another commenter noted that, when an individual stock trading pause is triggered, trades will be broken at specified percentages away from the Trading Pause Trigger Price.[47] According to this commenter, this calculation "has the practical effect of doubling the clearly erroneous price window for most U.S. equity securities and is a significant expansion of the window for certain securities."[48] This commenter suggested using more conservative parameters such as the greater of 2% or $0.05 from the Trading Pause Trigger Price or, alternatively, using the Trading Pause Trigger Price, in addition to a comparison to the last sale, as part of an analysis for clearly erroneous trades."[49] This commenter also favored providing FINRA discretion to break trades after the deadlines specified in its rule in extraordinary circumstances.[50]

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45 See ICI Letter, at 3.

46 Id.

47 See SIFMA Letter, at 2-3.

48 Id.

49 Id.

50 Id.

With respect to the dissemination of information regarding the review and resolution of clearly erroneous trades, the Commission understands that the practice of FINRA is to promptly notify participants that specified trades are under review and, once that review is complete, to describe the resolution thereof. Although the Commission believes prompt communication by email, phone, website or otherwise concerning erroneous trade reviews should generally assure dissemination in a non-discriminatory fashion, as noted above, it intends to continue to work with FINRA on additional ways to improve the transparency of this process.

With respect to an event that causes the price to cross to a different specified percentage threshold for breaking trades, the Commission believes that the proposal is sufficiently clear regarding the applicability of the new rule. As to the specific example provided by the commenter, under the proposed rule, if a stock triggers a trading pause, the Trading Pause Trigger Price would be used as the Reference Price. The Trading Pause Trigger Price is calculated by the listing market over a rolling five minute period. If the Trading Pause Trigger Price is calculated at a level below $25.00, as identified in the example, then the 10% threshold would apply to clearly erroneous execution reviews of the Trigger Trade and other transactions that occur immediately after a Trigger Trade but before the trading pause is fully implemented across markets. If another series of transactions trigger a second trading pause, the review process set forth in the rule would be repeated and a new Reference Price would be calculated to determine the appropriate percentage threshold.

With respect to the potential for market participants to engage in manipulation in order to achieve a higher trade break percentage threshold, the Commission emphasizes that it will vigorously pursue instances of illegal market manipulation. In addition, during the pilot period, the Commission will work with FINRA to review the operation of the amended rule, and make improvements as warranted, including if it appears the selected percentage thresholds create distortions or incent improper or illegal behavior.

With respect to the chosen parameters, the Commission notes that the parameters that were selected were the product of a coordinated and deliberate effort by FINRA and the Exchanges to improve the handling of clearly erroneous trades. Regarding the specific comment expressing concern that breaking trades only when they are 10%, 5% or 3% away from the Trading Pause Trigger Price has the practical effect of doubling the trading pause parameters, the Commission notes that, as an initial matter, implementation of the individual stock trading pause should prevent most trades from occurring at prices outside of the Trading Pause Trigger Price. To the extent trades occur outside of such price before the trading pause is fully applied across all markets, the Commission believes that it is appropriate to break these "leakage" trades only when they are a meaningful percentage away from the Trading Pause Trigger Price. This is consistent with the traditional approach of the Exchanges and FINRA to take the more extreme step of breaking a trade only in cases where it occurs at a price sufficiently away from the current market price that the parties should have been on notice it may be "clearly erroneous." Of course, the pilot program may indicate that different parameters are better to accomplish the stated goals. If so, the parameters could be changed as part of the overall initiative. The Commission will further study and consider the examples and suggestions offered by the commenters during the pilot period.

D. Commission Findings

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to FINRA. In particular, the Commission finds that the proposed rule change is consistent with the requirements of Section

15A(b)(6) of the Act,[51] which, among other things, requires that the rules of FINRA be designed to prevent fraudulent and manipulative acts and practices, 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.

In the Commission's view, the proposed rule change will help assure that the determination of whether a clearly erroneous trade has occurred will be based on clear and objective criteria, and that the resolution of the incident will occur promptly through a transparent process. The proposed rule change also should help assure consistent results in handling erroneous trades across the U.S. markets, thus furthering fair and orderly markets, the protection of investors and the public interest. Finally, the Commission notes that the proposed rule change is being implemented on a pilot basis so that the Commission and FINRA can monitor the effects of the pilot on the markets and investors, and consider appropriate adjustments, as necessary.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[52] that the proposed rule change (SR-FINRA-2010-032), be, and hereby is, approved.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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51 15 U.S.C. 78o–3(b)(6).

52 15 U.S.C. 78s(b)(2).

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-62886; File Nos. SR-BATS-2010-016; SR-BX-2010-040; SR-CBOE-2010-056; SR-CHX-2010-13; SR-EDGA-2010-03; SR-EDGX-2010-03; SR-ISE-2010-62; SR-NASDAQ-2010-076; SR-NSX-2010-07; SR-NYSE-2010-47; SR-NYSEAmex-2010-60; SR-NYSEArca-2010-58)

September 10, 2010

Self-Regulatory Organizations; BATS Exchange, Inc.; NASDAQ OMX BX, Inc.; Chicago Board Options Exchange, Incorporated; Chicago Stock Exchange, Inc.; EDGA Exchange, Inc.; EDGX Exchange, Inc.; International Securities Exchange LLC; The NASDAQ Stock Market LLC; National Stock Exchange, Inc.; New York Stock Exchange LLC; NYSE Amex LLC; NYSE Arca, Inc.; Order Granting Approval of Proposed Rule Changes Relating to Clearly Erroneous Transactions

I. Introduction

On June 17, 2010, each of BATS Exchange, Inc. ("BATS"), NASDAQ OMX BX, Inc. ("BX"), Chicago Board Options Exchange, Incorporated ("CBOE"), Chicago Stock Exchange, Inc. ("CHX"), EDGA Exchange, Inc. ("EDGA"), EDGX Exchange, Inc. ("EDGX"), International Securities Exchange LLC ("ISE"), The NASDAQ Stock Market LLC ("Nasdaq"), National Stock Exchange, Inc. ("NSX"), New York Stock Exchange LLC ("NYSE"), NYSE Amex LLC ("NYSE Amex"), and NYSE Arca, Inc. ("NYSE Arca") (collectively, the "Exchanges") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), and Rule 19b-4 thereunder, proposed rule changes to amend certain of their respective rules to set forth clearer standards and curtail their discretion with respect to breaking erroneous trades.[1] On June 18, 2010, BX, EDGA, EDGX, ISE, Nasdaq, NSX, and NYSE Arca submitted amendments to their respective proposed rule changes. On June 21, 2010, CHX submitted an amendment to its proposed rule

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1 Also, on June 17, 2010, Financial Industry Regulatory Authority, Inc. ("FINRA") filed a similar proposed rule change with respect to breaking erroneous trades. See Securities Exchange Act Release No. 62341 (June 21, 2010), 75 FR 36756 (June 28, 2010). The FINRA proposal also was approved today. See Securities Exchange Act Release No. 62885 (Sept. 10, 2010).

change. The proposed rule changes, as amended, submitted by BATS, BX, CBOE, CHX, EDGA, EDGX, ISE, Nasdaq, NYSE, and NYSE Amex, were published for comment in the Federal Register on June 28, 2010.[2] The proposed rule change, as amended, submitted by NYSE Arca was published for public comment in the Federal Register on June 29, 2010.[3] On June 30, 2010, CHX submitted an additional amendment to its proposed rule changes.[4] The Commission received nine comment letters on the proposals.[5] BATS responded to the comments in a letter

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2 See Securities Exchange Act Release Nos. 62330 (June 21, 2010), 75 FR 36725; 62331 (June 21, 2010), 75 FR 36746; 62332 (June 21, 2010), 75 FR 36749; 62333 (June 21, 2010), 75 FR 36759; 62334 (June 21, 2010), 75 FR 36732; 62336 (June 21, 2010), 75 FR 36743; 62337 (June 21, 2010), 75 FR 36739; 62338 (June 21, 2010), 75 FR 36762; 62339 (June 21, 2010), 75 FR 36765; 62340 (June 21, 2010), 75 FR 36768; and 62342 (June 21, 2010), 75 FR 36752.

3 See Securities Exchange Act Release No. 62335 (June 21, 2010), 75 FR 37494.

4 In Amendment No. 2, CHX amended its proposed rule change to conform defined terms in its proposed rule text to defined terms used in the remainder of its rule. This is a technical amendment.

5 See letter from Peter Ianello, Partner, CSS, LLC, to Elizabeth Murphy, Secretary, Commission, dated July 15, 2010 ("CSS Letter"); letter from Gary DeWaal, Senior Managing Director and Group General Counsel, Newedge USA, LLC, to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("Newedge Letter"); letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("ICI Letter"); David C. Cushing, Director of Global Equity Trading, Wellington Management Company, LLP, to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("Wellington Letter"); letter from John A. McCarthy, General Counsel, GETCO, to Elizabeth Murphy, Secretary, Commission, dated July 20, 2010 ("GETCO Letter"); letter from Ira P. Shapiro, Managing Director, BlackRock, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated July 20, 2010 ("BlackRock Letter"); and letter from Manisha Kimmel, Executive Director, Financial Information Forum, On behalf of the FIF Front Office Committee, to Elizabeth M. Murphy, Secretary, Commission, dated July 21, 2010 ("FIF Letter"); letter from Ann Vlcek, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, to Elizabeth M. Murphy, Secretary, Commission, dated July 26, 2010 ("SIFMA Letter"); and letter from Leonard J. Amoruso, General Counsel, Knight Capital Group, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated July 27, 2010 ("Knight Letter").

dated August 16, 2010.[6] This order approves the proposed rule changes, as amended.

II. Background and Description of the Proposals

On May 6, 2010, the U.S. equity markets experienced a severe disruption.[7] Among other things, the prices of a large number of individual securities suddenly declined by significant amounts in a very short time period, before suddenly reversing to prices consistent with their pre-decline levels. This severe price volatility led to a large number of trades being executed at temporarily depressed prices, including many that occurred at prices dramatically away from pre-decline levels. In response, the Exchanges and FINRA exercised their authority under their clearly erroneous execution rules to break trades that were effected at prices 60% or more away from pre-decline prices, using a process that was not sufficiently clear or transparent to market participants. There are reports that the lack of clear guidelines for dealing with clearly erroneous transactions under circumstances such as occurred on May 6, and the lack of transparency surrounding the Exchanges' and FINRA's decision to break only trades at least 60% away from the market, added to the confusion and uncertainty faced by investors on May 6.[8]

The Commission is concerned that events such as those that occurred on May 6 can undermine the integrity of the U.S. securities markets. Accordingly, it is working on a variety of fronts to assess the causes and contributing factors of the May 6 market disruption and to fashion

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6 See letter from Eric J. Swanson, SVP and General Counsel, BATS, to Elizabeth M. Murphy, Secretary, Commission, dated August 16, 2010 ("BATS Letter").

7 The events of May 6 are described more fully in the report of the staffs of the Commodity Futures Trading Commission ("CFTC") and the Commission, titled Report of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues, "Preliminary Findings Regarding the Market Events of May 6, 2010," dated May 18, 2010.

8 See, e.g., Written Statement of Leonard J. Amoruso, Senior Managing Director and General Counsel, Knight Capital Group, Inc., Submitted before the CFTC-SEC Advisory Committee on Emerging Regulatory Issues, Panel Discussion, "The events of May 6 – views and observations regarding liquidity, trading and the apparent breakdown of an orderly market," dated June 22, 2010.

policy responses that will help prevent a recurrence. The Commission also recognizes the importance of moving quickly to implement steps that could help limit potential harm from extreme price volatility. On June 10, 2010, the Commission approved rules, on a pilot basis, that require the Exchanges to pause trading in securities included in the S&P 500 Index if the price moves 10% or more in a five-minute period.[9] By establishing circuit breakers that uniformly pause trading in these securities across all markets, the new rules are designed to facilitate coordinated price discovery and provide time for investors to trade at rational prices. In addition to the individual stock trading pause rules, the Exchanges and FINRA worked together to develop proposed amendments to their clearly erroneous execution rules to provide greater transparency and certainty to the process of breaking trades.

The current clearly erroneous execution rules set forth procedures the Exchanges must use to break trades. Specifically, the current rules provide that the Exchanges will break trades in Exchange-listed stocks only if the price of the trades exceeds a specified "Reference Price" – usually the consolidated last sale – by an amount that equals or exceeds specified "Numerical Guidelines." The Numerical Guidelines vary depending on the price of the stock and during the regular trading session are 10% if the consolidated last sale is $25.00 or less, 5% if the consolidated last sale is more than $25 and up to and including $50, and 3% if the consolidated last sale is more than $50. These percentages double during pre-open and post-close trading sessions. For events involving five or more securities, the Numerical Guidelines currently are 10% during pre-open, regular, and post-close trading sessions.

While the current rules do not give the Exchanges discretion to break trades that do not exceed the Numerical Guidelines, they do permit the Exchanges discretion to select a percentage

9 See Securities Exchange Act Release Nos. 62251; 75 FR 34183 (June 10, 2010); and 62252, 75 FR 34186 (June 16, 2010).

threshold at which trades will be broken that is higher than the Numerical Guidelines. As noted above, on May 6 the Exchanges selected 60% as the threshold for breaking trades in a process that, from the perspective of market participants, was not clear or transparent, and led to further uncertainty and confusion in the market. Thus, the events of May 6 highlight the need to clarify the clearly erroneous execution review process across all markets, and reduce the discretion of the Exchanges to deviate from the objective standards in their respective rules when dealing with clearly erroneous transactions.

Under the proposed rule changes, the Exchanges will no longer have the discretion to deviate from the specified percentage threshold at which trades will be broken in many situations, including those where the single-stock circuit breakers are applicable and in other larger "Multi-Stock Events" involving five or more securities. Under the proposed rules, a Multi-Stock Event is determined by looking at the number of securities with potentially erroneous executions occurring within a period of five minutes or less.

When an individual stock trading pause is triggered, transactions could occur before the trading pause is fully implemented on all of the Exchanges and in the over-the-counter (OTC) market. In such event, the Exchanges propose to review, on their own motion, all transactions triggering an individual stock trading pause and subsequent transactions that may occur before the trading pause is in effect.[10] The Exchanges would use the price that triggered the trading pause (the "Trading Pause Trigger Price")[11] as the Reference Price and break trades that are 10%

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10 Such reviews would be limited to transactions that executed at a price lower than the Trading Pause Trigger Price in the event of a price decline and higher than the Trading Pause Trigger Price in the event of a price rise.

11 The Exchanges propose to use the Trading Pause Trigger Price as the Reference Price for such clearly erroneous execution reviews of a transaction triggering a trading pause and the transactions that occur immediately after such transactions but before the trading pause is in effect. The Trading Pause Trigger Price reflects a price calculated by the

or more away from the Reference Price for stocks priced $25 or less, 5% or more away from the Reference Price for stocks priced from $25 to $50, and 3% or more away from the Reference Price for stocks priced more than $50. If the security is a leveraged exchange-traded fund (ETF) or exchange-traded note (ETN), these percentage thresholds would be multiplied by the leverage multiplier.

For situations in which a stock is not subject to an individual stock trading pause (e.g., because the stock is not in the circuit breaker pilot program, or when the stock is part of the pilot program but the circuit breaker does not apply because it is the beginning or end of the day), the trade break rules will differ based on the number of stocks involved. In the event of Multi-Stock Events involving 20 or more securities, the Exchanges propose to review on their own motion and break all transactions at prices equal to or greater than 30% away from the Reference Price in each affected security during the review period selected. In such event, the Exchanges may use a Reference Price other than the consolidated last sale. To ensure consistent application across markets, the Exchanges will consult to determine the appropriate review period, which may be greater than the period (of five minutes or less) that triggered the application of this provision, as well as select one or more specific points in time prior to the transactions in question and use transaction prices at or immediately prior to the time(s) selected as the Reference Price(s).

Similarly, in the event of Multi-Stock Events involving five or more, but less than twenty, securities, the Exchanges propose to review on their own motion and break all transactions at prices equal to or greater than 10% away from the Reference Price. In such event,

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primary listing market over a rolling five-minute period and may differ from the execution price of a transaction that triggered a trading pause. The primary listing market that issued an individual stock trading pause will determine and communicate to the Exchanges the Trading Pause Trigger Price for such stock.

the Reference Price will generally be the consolidated last sale immediately prior to the execution(s) under review. However, if there is relevant news impacting a security, periods of extreme volatility, sustained illiquidity, or widespread systems issues, the Exchanges may use a different Reference Price, where necessary for the maintenance of a fair and orderly market and the protection of investors, and where it is in the public interest.

The current rules provide that the Exchanges may consider "Additional Factors"[12] in determining whether to break trades. The proposed rule changes limit the circumstances during which the Exchanges may consider those Additional Factors. Specifically, under the proposed rules, the Exchanges would only be permitted to consider Additional Factors in the context of clearly erroneous reviews that do not involve Multi-Stock Events involving five or more securities or individual stock trading pauses, as described above. In such event, the Exchanges would consider the Additional Factors with a view toward maintaining a fair and orderly market and the protection of investors and the public interest.

Finally, the proposed rule changes limit the discretion of the Exchanges to deviate from the Numerical Guidelines in the event of system disruptions or malfunctions. The proposed rules make clear that this provision only applies to a disruption or malfunction of an Exchange system, not to that of a user of an Exchange system. The proposed rules also remove the language "extraordinary market conditions or other circumstances" as a basis for nullifying trades outside

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12 Additional Factors that the Exchanges may consider include but are not limited to: system malfunctions or disruptions, volume and volatility for the security, derivative securities products that correspond to greater than 100% in the direction of a tracking index, news released for the security, whether trading in the security was recently halted or resumed, whether the security is an IPO, whether the security was subject to a stock split, reorganization, or other corporate action, overall market conditions, pre-opening and post-closing session executions, validity of consolidated tapes trades and quotes, consideration of primary market indications, and executions inconsistent with the trading pattern in the stock.

of the Numerical Guidelines, further limiting the discretion of the Exchanges. The proposed rules also retain the current requirement that, absent extraordinary circumstances, an action taken in connection with a review of a potentially erroneous transaction must be taken in a timely fashion, generally within thirty (30) minutes of detection of the erroneous transaction.

The Exchanges have proposed that these rule changes be implemented as a pilot that would end on December 10, 2010.

III. Discussion of Comment Letters and Commission Findings

The Commission received nine comment letters on the proposed rule changes filed by the Exchanges and FINRA. Five commenters were generally supportive of the principles underlying the proposed rule changes, to provide greater transparency and certainty to investors, market participants, and the public regarding the handling of clearly erroneous transactions.[13] However, these commenters also believed that the proposed rule changes should go further, and offered a number of suggestions as discussed below. Two commenters generally did not oppose the proposed rule changes, but believed they were "overly complex and opaque"[14] and "do not adequately address the most significant flaws in the current rules."[15] One commenter believed that trades should only be cancelled in extraordinary circumstances, stating that the Commission and the SROs should instead consider alternatives that would prevent the execution of erroneous trades rather than canceling them after the fact.[16] Another commenter supported a "principles-

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13 See ICI Letter, at 1, FIF Letter, at 1, Newedge Letter, at 1-2, GETCO Letter, at 2, and SIFMA Letter, at 1-2 (also stating its belief that it is "critical for the options markets to achieve consistency in their existing clearly erroneous execution rules before additional rule changes are implemented…"). See also BlackRock Letter at 1 (supporting amendments to rules that contribute to market volatility).

14 See CSS Letter, at 1.

15 See BlackRock Letter, at 1.

16 See Wellington Letter, at 3-4. See also FIF Letter, at 1-2 (supporting trade validation and

based approach" to handling clearly erroneous trades instead of numerical thresholds, particularly with respect to transactions involving illiquid stocks and the dissemination of news or a fundamental change that requires a significant reevaluation of underlying business conditions.[17] Additionally, BATS responded to the comments.[18] These comments are discussed in greater detail below.

A. Comments Recommending Other Comprehensive Approaches

Some commenters believed that the Exchanges' rules relating to clearly erroneous trades should be more definitive, and expressed the view that the proposed rule changes were not sufficiently clear in all cases when trades would actually be cancelled.[19] For example, one commenter noted that the Exchanges "appear to be able to cancel trades for many reasons other than significant price discrepancies – including, for example, systems malfunctions, news released regarding a security, whether a security was subject to a stock split or reorganization."[20] This commenter believed the Exchanges should adopt "no-bust" zones for transactions executed within specified price ranges, and cancel trades outside of the "no-bust" zones absent a compelling public interest to the contrary.[21]

Two commenters questioned whether the proposed rule changes would achieve their stated goals of making the erroneous trade execution review process more transparent and less

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rejection mechanisms) and GETCO Letter, at 3 (supporting protections designed to reject clearly erroneous orders that reach market centers).

17 See Knight Letter, at 3.

18 See BATS Letter.

19 See Newedge Letter, at 4-5, and BlackRock Letter, at 2.

20 See Newedge Letter, at 4

21 Id.

arbitrary.[22] Specifically, these commenters were concerned that the proposed rule changes did not clearly establish a reference price upon which the Numerical Guidelines would be based.[23] They noted that the Exchanges retain the flexibility in certain circumstances to use a Reference Price other than the consolidated last sale, as well as to determine the review period for Multi-Stock Events involving twenty or more securities.[24] These commenters believed that if the Exchanges retained discretion in these areas, the proposed rule changes may not achieve the goal of making the trade break process more transparent and less arbitrary,[25] or could create mass confusion.[26]

In response, BATS acknowledged that the proposals do not "in all circumstances provide 100% advanced certainty with respect to whether a particular execution will be deemed to be clearly erroneous," but stated its belief that "its proposal reflects a significant improvement . . . over its existing rule."[27] Specifically, BATS noted that its discretion to utilize "additional factors" would now be limited to instances involving less than five securities under review and further limited to securities that are not subject to a single stock circuit breaker.[28] BATS believed its limited discretion in this regard is necessary and appropriate for maintaining fair and orderly markets.[29]

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22 See BlackRock Letter, at 2, and CSS Letter, at 1-2.

23 Id.

24 Id.

25 See BlackRock Letter, at 2.

26 See CSS Letter, at 1-2.

27 See BATS Letter, at 1.

28 Id. at 5.

29 Id.

With respect to the concern expressed by some commenters that the proposed rule changes do not clearly establish a reference price upon which the Numerical Guidelines would be based, BATS stated that it is "critical" for it to retain some limited discretion to use a different reference price when applying the clearly erroneous thresholds because "there are circumstances under which last sale would be an inappropriate reference price. . . ."[30] BATS noted, however, that this discretion is limited because its "rule is designed to generally guide BATS to look at the last sale as the reference price" for those securities not subject to a circuit breaker and its proposal tries to be "abundantly clear and objective that if a security is subject to a single stock circuit breaker, the reference price will be the circuit breaker trigger price."[31] BATS also noted that the determination of the point in time from which to derive the reference price on May 6 had "nothing to do" with the delay in announcing which trades would be broken on May 6; rather, the delay was attributable to the time it took the Exchanges to determine the appropriate percentage at which trades would be broken.[32]

The Commission appreciates the suggestions and responses offered by these commenters to make the process by which the Exchanges address clearly erroneous executions more certain and transparent by reducing their discretion. The Commission intends to continue working with the Exchanges to further clarify, as appropriate, their processes for breaking erroneous trades that arise in contexts not covered by the proposed rule changes, as well as to continue to evaluate the operations of and potential refinements to such processes in contexts covered by the proposed rule changes. Nevertheless, the Commission believes that the proposed rule changes represent a productive first step by the Exchanges in bringing greater clarity and transparency to the process

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30 Id. at 3-4.

31 Id.

32 Id.

for breaking clearly erroneous trades, and that these improvements should not be delayed pending consideration of further changes.

B. Comments Recommending Alternative Approaches

Four commenters were of the view that, rather than breaking erroneous trades, the Exchanges should allow the trades to stand and adjust the price in line with the market.[33] These commenters were particularly concerned about the risk, when trades are broken, that market participants suddenly may find themselves exposed on one side of the market when they thought they had a hedged position.[34] As one commenter stated, "[t]his uncertainty is even more problematic during periods of heightened volatility in the markets, when liquidity may be reduced as some market participants limit their trading until they are able to determine their positions, or volatility may increase further because of speculative hedging in an attempt to protect unknown positions."[35] These commenters believed that a price adjustment process would substantially reduce the uncertainty created by the potential for broken trades, and thus would be a better way to address erroneous executions.[36]

Other commenters urged alternatives to clearly erroneous execution rules. For example, one commenter believed that the proposed rules would "provide market participants more certainty as to whether or not their trades will stand in the event of market volatility," but urged the Commission to move to a "futures-style limit up/down functionality" as a better alternative to

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33 See GETCO Letter, at 3, Newedge Letter, at 5, BlackRock Letter, at 2, and Knight Letter, at 2.

34 Id.

35 See GETCO Letter, at 3.

36 See GETCO Letter, at 3, Newedge Letter, at 5, BlackRock Letter, at 2, and Knight Letter, at 2.

the circuit breaker trading halt approach.[37] This commenter argued that the limit up/limit down approach "would virtually eliminate clearly erroneous trades."[38] Another commenter also believed that the Commission should consider a "limit up/limit down approach or hybrid approach."[39] Other commenters suggested alternative procedures, systems or rules to prevent erroneous trades from occurring, such as by rejecting orders that are materially away from the market.[40]

The Commission appreciates the suggestions offered by these commenters to make more fundamental changes to the way in which the Exchanges address clearly erroneous executions. In the coming months, the Commission expects to continue to work with the markets and market participants on ways to reduce the occurrence of erroneous trades and improve the method by which they are resolved, as well as on enhancements to the mechanisms for addressing excessive market volatility, such as those that currently are reflected in the single-stock circuit breaker pilot. As noted above, however, the Commission believes that the proposed rule changes represent a productive first step by the Exchanges in bringing greater clarity and transparency to the process for breaking clearly erroneous trades, and that these improvements should not be delayed pending consideration of more far-reaching initiatives.

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37 See GETCO Letter, at 2-3.

38 See GETCO Letter, at 3.

39 See SIFMA Letter, at 2.

40 See FIF Letter, at 2, Wellington Letter, at 2-4, and SIFMA Letter, at 2. See also CSS Letter, at 2 (suggesting that circuit breakers for individual stocks based off of a percentage change from the previous day's closing price (or the opening price to allow for the dissemination of overnight news) would eliminate the need for erroneous trade rules).

C. Other Comments

One commenter was concerned that the proposed rule changes were not clear as to how news or information regarding the review and cancellation of clearly erroneous trades would be disseminated to the markets.[41] This commenter believed that the proposed rules should require the Exchanges to disseminate this information quickly and in a non-discriminatory fashion to market participants in order to minimize the market impact and not favor any one group of market participants over another.[42] In its response letter, BATS stated that it emails members with respect to clearly erroneous reviews and determinations according to a consistent and well established protocol that, according to BATS, strikes an appropriate balance between notifying members of significant market events and avoiding notifications every time a transaction is reviewed as potentially clearly erroneous.[43] In addition, BATS believes that the existing requirement that an SRO promptly notify affected members of clearly erroneous reviews and determinations is sufficient.[44] BATS also stated that communication between the exchanges and members should remain flexible as such methods are constantly changing.[45] BATS indicated that it is not aware of discrimination amongst participants with respect to the dissemination of information in relation to clearly erroneous reviews and believes that the "anti-discrimination requirements of the Act would sufficiently restrain" discrimination.[46]

Another commenter believed that the Commission should require the Exchanges to clarify the application of the clearly erroneous execution rules when an event causes the price to

41 See Newedge Letter, at 6.

42 Id.

43 See BATS Letter, at 2.

44 Id.

45 Id.

46 Id.

cross to a different specified percentage threshold for breaking trades. Specifically, the commenter asked, "if a market decline triggers the CEE rules intra-day with respect to a stock that was priced at $25.01, so the CEE price is below $25, the proposed amendments do not explain at what price trading would be calculated for the next application of the CEE rules. Would it be at 5 percent for stocks between $25 and $50 or 10 percent for stocks priced less than $25?"[47] That commenter also expressed concern that the proposed rule changes might provide an opportunity for market participants to manipulate events involving multiple stocks that are not subject to the single-stock circuit breakers. This might occur, for example, when an event subject to a 10% threshold (e.g., involving 20 securities) could be forced into the 30% threshold category (e.g., by manipulating the 21st security and causing an erroneous trade), by a market participant seeking the flexibility to trade at wider spreads with respect to all impacted securities.[48]

Another commenter noted that, when an individual stock trading pause is triggered, trades will be broken at specified percentages away from the Trading Pause Trigger Price.[49] According to this commenter, this calculation "has the practical effect of doubling the clearly erroneous price window for most U.S. equity securities and is a significant expansion of the window for certain securities."[50] This commenter suggested using more conservative parameters such as the greater of 2% or $0.05 from the Trading Pause Trigger Price or, alternatively, using the Trading Pause Trigger Price, in addition to a comparison to the last sale, as part of an

47 See ICI Letter, at 3.

48 Id.

49 See SIFMA Letter, at 2-3.

50 Id.

analysis for clearly erroneous trades."[51] This commenter also favored providing the Exchanges discretion to break trades after the deadlines specified in their rules in extraordinary circumstances.[52]

With respect to the dissemination of information regarding the review and resolution of clearly erroneous trades, the Commission understands that the practice of the Exchanges is to promptly notify participants that specified trades are under review and, once that review is complete, to describe the resolution thereof. Although the Commission believes prompt communication by email, phone, website or otherwise concerning erroneous trade reviews should generally assure dissemination in a non-discriminatory fashion, as noted above, it intends to continue to work with the Exchanges on additional ways to improve the transparency of this process.

With respect to an event that causes the price to cross to a different specified percentage threshold for breaking trades, the Commission believes that the proposals are sufficiently clear regarding the applicability of the new rules. As to the specific example provided by the commenter, under the proposed rules, if a stock triggers a trading pause, the Trading Pause Trigger Price would be used as the Reference Price. The Trading Pause Trigger Price is calculated by the listing market over a rolling five minute period. If the Trading Pause Trigger Price is calculated at a level below $25.00, as identified in the example, then the 10% threshold would apply to clearly erroneous execution reviews of the Trigger Trade and other transactions that occur immediately after a Trigger Trade but before the trading pause is fully implemented across markets. If another series of transactions trigger a second trading pause, the review

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51 Id.

52 Id.

process set forth in the rules would be repeated and a new Reference Price would be calculated to determine the appropriate percentage threshold.

With respect to the potential for market participants to engage in manipulation in order to achieve a higher trade break percentage threshold, the Commission emphasizes that it will vigorously pursue instances of illegal market manipulation. In addition, during the pilot period, the Commission will work with the Exchanges to review the operation of the amended rules, and make improvements as warranted, including if it appears the selected percentage thresholds create distortions or incent improper or illegal behavior.

With respect to the chosen parameters, the Commission notes that the parameters that were selected were the product of a coordinated and deliberate effort by the Exchanges and FINRA to improve the handling of clearly erroneous trades. Regarding the specific comment expressing concern that breaking trades only when they are 10%, 5% or 3% away from the Trading Pause Trigger Price has the practical effect of doubling the trading pause parameters, the Commission notes that, as an initial matter, implementation of the individual stock trading pause should prevent most trades from occurring at prices outside of the Trading Pause Trigger Price. To the extent trades occur outside of such price before the trading pause is fully applied across all markets, the Commission believes that it is appropriate to break these "leakage" trades only when they are a meaningful percentage away from the Trading Pause Trigger Price. This is consistent with the traditional approach of the Exchanges and FINRA to take the more extreme step of breaking a trade only in cases where it occurs at a price sufficiently away from the current market price that the parties should have been on notice it may be "clearly erroneous." Of course, the pilot program may indicate that different parameters are better to accomplish the stated goals. If so, the parameters could be changed as part of the overall initiative. The

Commission will further study and consider the examples and suggestions offered by the commenters during the pilot period.

D. Commission Findings

The Commission finds that the proposed rule changes are consistent with the requirements of the Act and the rules and regulations thereunder applicable to national securities exchanges. In particular, the Commission finds that the proposed rule changes submitted by the Exchanges are consistent with the requirements of Section 6(b) of the Act[53] and with Section 6(b)(5) of the Act[54] which, among other things, requires that the rules of national securities exchanges be designed to prevent fraudulent and manipulative acts and practices, 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.

In the Commission's view, the proposed rule changes will help assure that the determination of whether a clearly erroneous trade has occurred will be based on clear and objective criteria, and that the resolution of the incident will occur promptly through a transparent process. The proposed rule changes also should help assure consistent results in handling erroneous trades across the U.S. markets, thus furthering fair and orderly markets, the protection of investors and the public interest. Finally, the Commission notes that the proposed rule changes are being implemented on a pilot basis so that the Commission and the Exchanges can monitor the effects of the pilot on the markets and investors, and consider appropriate adjustments, as necessary.

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53 15 U.S.C. 78f(b).

54 15 U.S.C. 78f(b)(5).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[55] that the proposed rule changes (SR-BATS-2010-016; SR-BX-2010-040; SR-CBOE-2010-056; SR-CHX-2010-13; SR-EDGA-2010-03; SR-EDGX-2010-03; SR-ISE-2010-62; SR-NASDAQ-2010-076; SR-NSX-2010-07; SR-NYSE-2010-47; SR-NYSEAmex-2010-60; SR-NYSEArca-2010-58), be, and hereby are, approved.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

55 15 U.S.C. 78s(b)(2).

Commissioner Casey not participating

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62888 / September 10, 2010

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3183 / September 10, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14040

In the Matter of DAVID N. KENNEALLY, CPA (inactive), Respondent.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTION

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 David N. Kenneally ("Kenneally" or "Respondent") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

II.

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

[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.

Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.3. below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Kenneally, age 47, is a resident of Rossmoor, California. Kenneally was New Century Financial Corporation's ("New Century") controller (July 2005 to March 2007) and assistant controller (July 2003 to July 2005). Kenneally is licensed as a CPA in California, but his license is inactive.

2. New Century was a real estate investment trust with its principal executive offices in Irvine, California. New Century's stock was registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act") and traded on the New York Stock Exchange until it was delisted on March 13, 2007. On April 2, 2007, New Century filed for Chapter 11 bankruptcy protection. On July 15, 2008, the bankruptcy court entered an order confirming a liquidation plan effective August 1, 2008, which provided for the transfer of all remaining assets to a liquidating trust for the benefit of unsecured creditors. After all distributions have been made, the liquidating trustee will file a certificate of dissolution on behalf of New Century.

3. On December 7, 2009, the Commission filed a complaint against Kenneally in SEC v. Morrice, Civil Action No. CV 09-1426 DDP (FMOx), in the United States District Court for the Central District of California. On August 17, 2010, a final judgment was entered by consent against Kenneally, permanently enjoining him from future violations of Sections 10(b) and 13(b)(5) of the Exchange Act, 15 U.S.C. §§ 78j(b) and 78m(b)(5), and Rules 10b-5, 13b2-1, and 13b2-2 thereunder, 17 C.F.R. §§ 240.10b-5, 240.13b2-1, and 240.13b2-2, and from aiding and abetting violations of Section 13(a) of the Exchange Act, 15 U.S.C. §78m(a), and Rules 12b-20, 13a-11, and 13a-13 thereunder, 17 C.F.R. §§ 240.12b-20, 240.13a-11, and 240.13a-13.

4. The Commission's complaint alleges, among other things, that in the second and third quarters of 2006, Kenneally, contrary to Generally Accepted Accounting Principles, implemented changes to New Century's method for estimating its loan repurchase obligation and failed to ensure that New Century's backlog of pending loan repurchase requests were properly accounted for, resulting in an understatement of New Century's repurchase reserve and a material overstatement of New Century's financial results. The complaint alleges that Kenneally, by his conduct, violated Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b-5, 13b2-1, and 13b2-2 thereunder, and aided and abetted New Century's violations of Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20, 13a-11, and 13a-13 thereunder.

IV.

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

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

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

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

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

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

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

Commissioner Casey not participating

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62889 / September 10, 2010

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3184 / September 10, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14041

In the Matter of PATTI M. DODGE, 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 Patti M. Dodge ("Dodge" or "Respondent") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

II.

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

[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.

Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over her and the subject matter of these proceedings, and the findings contained in Section III.3. below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Dodge, age 49, is a resident of Irvine, California. Dodge was New Century Financial Corporation's ("New Century") executive vice president of investor relations (November 2006 to June 2007), CFO (July 2004 to November 2006), and Controller (September 1996 to July 2004). Dodge was licensed as a CPA in California until 1988.

2. New Century was a real estate investment trust with its principal executive offices in Irvine, California. New Century's stock was registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act") and traded on the New York Stock Exchange until it was delisted on March 13, 2007. On April 2, 2007, New Century filed for Chapter 11 bankruptcy protection. On July 15, 2008, the bankruptcy court entered an order confirming a liquidation plan effective August 1, 2008, which provided for the transfer of all remaining assets to a liquidating trust for the benefit of unsecured creditors. After all distributions have been made, the liquidating trustee will file a certificate of dissolution on behalf of New Century.

3. On December 7, 2009, the Commission filed a complaint against Dodge in SEC v. Morrice, Civil Action No. CV 09-1426 DDP (FMOx), in the United States District Court for the Central District of California. On August 17, 2010, a final judgment was entered by consent against Dodge, permanently enjoining her from future violations of Section 17(a) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. § 77q(a), and Sections 10(b) and 13(b)(5) of the Exchange Act, 15 U.S.C. §§ 78j(b) and 78m(b)(5), and Rules 10b-5, 13b2-1, 13b2-2, and 13a-14 thereunder, 17 C.F.R. §§ 240.10b-5, 240.13b2-1, 240.13b2-2, and 240.13a-14, and from aiding and abetting violations of Section 13(a) of the Exchange Act, 15 U.S.C. § 78m(a), and Rules 12b-20, 13a-11, and 13a-13 thereunder, 17 C.F.R. §§ 240.12b-20, 240.13a-11, and 240.13a-13.

4. The Commission's complaint alleges, among other things, that New Century's second and third quarter 2006 Forms 10-Q and two late 2006 private stock offerings contained false and misleading statements regarding its subprime mortgage business. The complaint further alleges that Dodge knew about certain negative trends in New Century's loan portfolio from reports she received and that she participated in the disclosure process, but she did not take adequate steps to ensure that the negative trends were properly disclosed. In addition, the Commission's complaint alleges that in the second and third quarters of 2006, New Century, contrary to Generally Accepted Accounting Principles, changed its method for estimating its loan repurchase obligation and failed to account for a backlog of pending loan repurchase requests,

resulting in an understatement of New Century's repurchase reserve and a material overstatement of New Century's financial results. The complaint further alleges that Dodge was told of the methodology changes and the backlog of repurchase requests but did not ensure that they were properly accounted for and disclosed. The complaint alleges that Dodge, by her conduct, violated Section 17(a) of the Securities Act, Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b-5, 13b2-1, 13b2-2, and 13a-14 thereunder, and Section 304(a) of the Sarbanes-Oxley Act of 2002, and aided and abetted New Century's violations of Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20, 13a-11, and 13a-13 thereunder.

IV.

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

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

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

B. After three (3) years from the date of this order, Respondent may request that the Commission consider her 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 her practice before the Commission will be reviewed either by the independent audit committee of the public company for which she works or in some other acceptable manner, as long as she practices before the Commission in this capacity; and/or

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

(a) Respondent, or the public accounting firm with which she 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 she 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 her 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 her state CPA license is current and she has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Casey
not participating

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62890 / September 10, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14042

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

I.

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

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.3. below, which are admitted, Respondent

[1] Rule 102(e)(3)(i) provides, in relevant part, that:

> The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . suspend from appearing or practicing before it any . . . attorney . . . who has been by name . . . permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

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. Morrice, age 53, is a resident of Laguna Beach, California. Morrice co-founded New Century Financial Corporation ("New Century") in 1995 and was its president (1995 to June 2007) and CEO (July 2006 to June 2007). Morrice is and has been an attorney licensed to practice in the State of California since 1982.

2. New Century was a real estate investment trust with its principal executive offices in Irvine, California. New Century's stock was registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act") and traded on the New York Stock Exchange until it was delisted on March 13, 2007. On April 2, 2007, New Century filed for Chapter 11 bankruptcy protection. On July 15, 2008, the bankruptcy court entered an order confirming a liquidation plan effective August 1, 2008, which provided for the transfer of all remaining assets to a liquidating trust for the benefit of unsecured creditors. After all distributions have been made, the liquidating trustee will file a certificate of dissolution on behalf of New Century.

3. On December 7, 2009, the Commission filed a complaint against Morrice in SEC v. Morrice, Civil Action No. CV 09-1426 DDP (FMOx), in the United States District Court for the Central District of California. On August 13, 2010, a final judgment was entered by consent against Morrice, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. § 77q(a), and Sections 10(b) and 13(b)(5) of the Exchange Act, 15 U.S.C. §§ 78j(b) and §78m(b)(5), and Rules 10b-5, 13b2-2, and 13a-14 thereunder, 17 C.F.R. §§ 240.10b-5, 240.13b2-2, and 240.13a-14, and from aiding and abetting violations of Section 13(a) of the Exchange Act, 15 U.S.C. § 78m(a), and Rules 12b-20, 13a-11, and 13a-13 thereunder, 17 C.F.R. §§ 240.12b-20, 240.13a-11, and 240.13a-13.

4. The Commission's complaint alleges, among other things, that New Century's second and third quarter 2006 Forms 10-Q and two late 2006 private stock offerings contained false and misleading statements regarding its subprime mortgage business. The complaint further alleges that Morrice knew about certain negative trends from reports he received and that he participated in the disclosure process, but he did not take adequate steps to ensure that the negative trends were properly disclosed. The complaint alleges that Morrice, by his conduct, violated Section 17(a) of the Securities Act, Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b-5, 13b2-2 and 13a-14 thereunder, and Section 304(a) of the Sarbanes-Oxley Act of 2002; and aided and abetted New Century's violations of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-11, and 13a-13 thereunder.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62899 / September 13, 2010

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3185 / September 13, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14044

In the Matter of **KMJ CORBIN & COMPANY, LLP** **KENDALL G. MERKLEY, CPA, and** **ANTHONY J. PRICE, CPA** **Respondents.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 4C AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative and cease-and-desist proceedings be, and hereby are, instituted against KMJ Corbin & Company, LLP ("KMJ"); Kendall G. Merkley, CPA ("Merkley"); and Anthony J. Price, CPA ("Price") ("Respondents") pursuant to Sections 4C[1] and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.[2]

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[1] Section 4C provides, in relevant part, that:

The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

[2] Rule 102(e)(1)(ii) provides, in pertinent part, that:

The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found . . . to have engaged in unethical or improper professional conduct.

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over Respondents and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds[3] that:

A. SUMMARY

1. This matter involves improper professional conduct by KMJ Corbin & Company, LLP, Kendall G. Merkley, and Anthony J. Price in connection with audits and reviews of the financial statements of Home Solutions of America, Inc. ("HSOA") from December 31, 2004 through the second quarter of 2007 ("the Engagements"). The Respondents did not conduct the Engagements in accordance with Public Company Accounting Oversight Board ("PCAOB") Standards, and HSOA's financial statements did not present fairly, in all material respects, HSOA's financial position, operating results, and cash flows in conformity with generally accepted accounting principles ("GAAP"). By causing KMJ to issue false and misleading audit reports and failing to comply with PCAOB Standards and Rules, Merkley was a cause of HSOA's violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder and caused KMJ's violation of Regulation S-X Rule 2-02(b)(1).

2. On November 30, 2009, the Commission filed a complaint against HSOA and seven individuals alleging, in part, that HSOA's financial statements for the year ended December 31, 2004 through the quarter ended June 30, 2007 were materially misstated because HSOA: (i) improperly deferred expenses related to year-end bonuses; (ii) improperly recorded fictitious and premature revenue; and (iii) failed to disclose material transactions with related parties.[4] HSOA misstated its 2004, 2005, and 2006 net income by 10%, 7%, and 61%, respectively, and its first and second quarter 2007 net income by 308% and 106%, respectively. In its complaint, the

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

[4] *SEC v. Home Solutions of America, Inc., et al*, Civil No. 3:09-cv-02269-N (N.D.Tx.).

Commission alleges that the Chairman of the Board and CEO and the CFO made or caused to be made materially false statements to KMJ relating to bonuses and certain revenue transactions. Additionally, the Commission alleges that a vice president and a director, who was assisted by the vice president and director's business partner with respect to a 2006 transaction, made or caused to be made materially false statements to KMJ regarding the related party transactions discussed below. In a settlement with the Commission, without admitting or denying the allegations in the Commission's complaint, HSOA consented to the entry of a permanent injunction from violating the antifraud and reporting provisions of the federal securities laws. Additionally, on January 5, 2010, the Commission entered an order revoking the registration of HSOA's common stock.[5]

B. RESPONDENTS

3. **KMJ Corbin & Company, LLP** is an accounting firm registered with the PCAOB and with offices in Costa Mesa and San Diego, California. As of July 2010, KMJ was engaged to audit 15 public company issuer clients. From 2002 until it resigned on February 9, 2009, KMJ served as the independent auditor for HSOA.

4. **Kendall G. Merkley**, CPA, age 49 and a resident of Glendora, California, is licensed as a certified public accountant in the state of California. Merkley served as KMJ's managing partner from 2005 to 2008. Merkley was the engagement partner on KMJ's engagements to audit and review HSOA's 2003 through 2006 financial statements and the concurring partner on KMJ's 2002 engagement.

5. **Anthony J. Price,** CPA, age 40 and a resident of Huntington Beach, California, is licensed as a certified public accountant in the state of California. Price served on KMJ's HSOA engagement as the manager on the 2004 and 2005 audits and 2005 and 2006 reviews. Additionally, Price assisted Merkley in supervising the 2006 audit after being promoted to partner in September 2006 and served as the engagement partner supervising KMJ's reviews for the first and second quarters of 2007.

C. RELEVANT ENTITY

6. HSOA touted itself as a leading remediation and construction company, and claimed to have multimillion dollar contracts and robust financial results, in the aftermath of Hurricane Katrina and other weather-related disasters. HSOA's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act and listed on the NASDAQ National Market, before being delisted on January 7, 2008, for failure to file timely periodic reports.

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5 See Release No. 34-61285, January 5, 2010.

D. FACTS

7. While supervising and conducting KMJ's audits and reviews of HSOA's financial statements for 2004, 2005, 2006 and the periods ended March 31 and June 30, 2007, Merkley (except as to 2007) and Price failed to adhere to PCAOB Standards and Rules. In summary, Merkley and Price failed to: (i) obtain sufficient competent evidential matter regarding bonuses, revenues, and cost of revenues with respect to KMJ's 2004, 2005, and 2006 audit engagements; (ii) comply with PCAOB Auditing Standard No. 3, *Audit Documentation*; (iii) adequately plan the audit and properly supervise assistants in connection with the 2006 engagement; and (iv) conduct reviews of interim financial information in accordance with PCAOB Standards and Rules. Additionally, Merkley caused KMJ to issue inaccurate audit reports in that he should have known that KMJ's audit reports were false because they incorrectly represented that the audits were conducted in accordance with PCAOB standards and that HSOA's financial statements were prepared in conformity with GAAP.

Failure to Obtain Sufficient Competent Evidential Matter

8. An auditor is to obtain sufficient competent evidence to afford a reasonable basis for an opinion regarding the financial statements under audit (*See PCAOB Standards and Related Rules*, AU § 326.01).[6] Although audit evidence includes representations from management, management's representations are not a substitute for performing sufficient auditing procedures to afford a reasonable basis for an opinion regarding the financial statements under audit (*See PCAOB Standards and Related Rules*, AU § 333.02).

9. The amount and kinds of required evidence depend on the circumstances and the auditor's professional judgment, but evidence has to be "persuasive" though it need not be "convincing" (*See PCAOB Standards and Related Rules*, AU § 326.22). With respect to such judgment, an auditor must maintain an attitude of professional skepticism and assess the risk that the financial statements may contain a material misstatement due to fraud (*See PCAOB Standards and Related Rules*, AU § 316.13). In developing his or her opinion, the auditor should consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements (*See PCAOB Standards and Related Rules*, AU § 326.25).

Bonuses

10. Merkley and Price failed to obtain sufficient competent evidential matter regarding HSOA's bonuses to support KMJ's 2004, 2005, and 2006 audit opinions. Merkley and Price accepted management's representations that HSOA should report bonus expenses in the year paid, even though they were aware of evidence that they should have known contradicted management's

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[6] Citations to PCAOB Standards and Rules refer to standards and rules in effect at the time of the conduct discussed herein.

assertions. At other times, Merkley and Price failed to consider relevant evidential matter as to the periods in which bonus expenses should have been reflected.

2004 Audit

11. Merkley and Price did not discover that HSOA had not accrued a liability for year-end bonuses until April 2005, approximately two weeks after KMJ issued its audit report on HSOA's 2004 financial statements. Merkley initially rejected management's justification for expensing bonuses when paid and flagged his concerns about HSOA's accounting in an e-mail sent to HSOA's CFO, stating that the presumption is that the bonus, which is derived from and directly related to the 2004 results, was earned in 2004, and simply paid in 2005 after the 2004 results were finalized through the audit process. After discussion with HSOA's CFO and in a subsequent e-mail to HSOA's CFO and with a copy to Price, Merkley conveyed that the only way KMJ would be satisfied with HSOA's accounting treatment of bonuses was if HSOA were to represent that (i) HSOA's CEO had discretion to pay an amount less than the bonus pool approved by the board, and (ii) that the bonuses were not fully vested, because recipients had agreed in writing to repay a prorated share of their bonuses if they left the company before the end of the calendar year in which the bonuses were paid. After HSOA management revised its memorandum to include these points in support of expensing the 2004 EBITDA bonus in 2005, Merkley accepted management's representations.

12. HSOA's accounting did not comply with GAAP because HSOA did not record the bonuses in 2004, when HSOA incurred the liability.[7] As a result, HSOA overstated its 2004 net income by 10%. Merkley should have known that the representations that HSOA management made to justify not accruing the 2004 EBITDA bonus in HSOA's 2004 financial statements were untrue as of KMJ's report date and, therefore, could not support the conclusions KMJ reached during the 2004 audit. Although Merkley and Price discussed it with executive management, neither Merkley nor Price corroborated management's assertions, or disclosed the bonus issue to the non-management members of HSOA's board of directors. Similarly, neither Merkley nor Price updated the 2004 audit work papers to include or make any reference to the memorandum obtained from management.

2005 Audit

13. Less than three weeks after accepting management's assertion that the 2004 EBITDA bonus should be expensed in 2005, over the purported vesting period (i.e., from the date paid through the end of the calendar year in which paid), Merkley and Price took a contrary position regarding HSOA's accounting for the 2004 EBITDA bonus during KMJ's review of HSOA's March 31, 2005 financial statements. KMJ's work papers document that it expected to

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[7] *See* Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies" ("FAS 5"), paragraph 8. FAS 5 states, in part, a loss contingency shall be accrued by a charge to income if information exists prior to issuance of the financial statements that a liability has been incurred at the date of the financial statements and that the amount of the loss can be reasonably estimated.

see, but did not see, a liability at March 31, 2005 for 2004 bonuses to be paid in April 2005. As a result, KMJ proposed and HSOA recorded an adjustment to expense the entire 2004 EBITDA bonus in the quarter ended March 31, 2005. KMJ's work papers do not document the basis for the conclusion that it was appropriate to expense the 2004 EBITDA bonuses in the first quarter 2005. Similarly, KMJ's work papers do not document what facts supported expensing the 2004 EBITDA bonus in the first quarter 2005 that would not also support expensing the 2004 EBITDA in 2004. KMJ's work papers also do not document why, as represented in the bonus memo, it was not appropriate to expense the 2004 EBITDA bonuses over the purported vesting period.

14. In connection with KMJ's 2005 audit engagement, Merkley and Price did not consider evidence that HSOA was inappropriately accounting for EBITDA bonuses. After Merkley and Price learned that HSOA had not recorded a liability for approximately $1.7 million of bonuses approved by HSOA's board of directors, Merkley sent HSOA's CFO an e-mail stating his concern about not recording this bonus in 2005. Despite Merkley's concerns, HSOA did not correct its accounting for bonuses at year-end 2005. Furthermore, neither Merkley nor Price proposed an audit adjustment to correct HSOA's accounting, documented any justification for not accruing the 2005 EBITDA bonus, nor disclosed the issue to HSOA's board of directors. In accepting management's accounting, Merkley and Price appear to have again relied upon the bonus memorandum provided to them in April 2005 without corroboration and without incorporating it into KMJ's work paper files. HSOA's accounting for year-end bonuses did not comply with GAAP and resulted in HSOA understating its first quarter 2005 net income by 19% and overstating its year-end 2005 net income by 7%.

2006 Audit

15. At year-end 2006, Merkley and Price learned that HSOA had adopted a new bonus plan pursuant to which management earned cash bonuses under a tiered structure.[8] Merkley and Price questioned HSOA's management as to why HSOA's bonus accrual was less than the amount that was apparently payable under the new bonus structure. Despite evidence that second-tier bonuses had been earned but not accrued, Merkley and Price accepted management's oral representation, as documented in KMJ's work papers, that the amount accrued "is more reflective of the amount that will be paid for 2006 performance" without corroboration from members of HSOA's board of directors other than HSOA's Chairman or documentation of management's estimate.[9] HSOA's accounting for year-end bonuses did not comply with GAAP and resulted in HSOA understating its 2006 net income by 3%.

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[8] Under the new bonus plan, HSOA awarded first tier cash bonuses if the Company exceeded an approved EBITDA target and second tier cash bonuses if the Company exceeded the first tier target by 20%. HSOA accrued only amounts payable under the first tier even though it was obvious by December 2006 that the Company had also exceeded the second tier target.

[9] In April 2007, HSOA paid bonuses equivalent to amounts that were due based upon the achievement of the objective criteria of the bonus plan, which was approximately double the amount management accrued as of year-end 2006.

Revenues and Costs of Revenues

16. Merkley and Price also failed to obtain sufficient competent evidential matter that HSOA's 2006 revenues and cost of revenues were presented in conformity with GAAP.

17. Because KMJ determined that HSOA's internal controls were ineffective, Merkley and Price intended to base KMJ's 2006 audit opinion principally on the results of substantive audit procedures. As analytical review procedures alone are unlikely to provide sufficient competent evidential matter for accounts with significant risks of material misstatement (*See PCAOB Standards and Related Rules*, AU § 329.09), Merkley and Price planned to validate significant accounts, such as revenues and costs of revenues, by performing substantive tests of details, including examining supporting documents and recalculating amounts. KMJ staff working under Merkley and Price's supervision performed inadequate substantive tests to verify HSOA's 2006 revenues, particularly with respect to revenues reported using percentage-of-completion accounting.

Limited Substantive Evidence Supporting Revenues based on Percentage-of-Completion Accounting

18. HSOA derived approximately 57% of its consolidated 2006 revenues from Fireline Restoration Services, Inc. ("Fireline"), its largest subsidiary, and Home Solutions Restoration ("HSR"), an internal reporting group comprised of Florida Environmental Remediation Services ("FERS"), Home Solutions Restoration of Louisiana ("HSRLA"), and Associated Contractors LLC ("Associated"). Fireline and HSR recorded the majority of their respective revenues using percentage-of-completion accounting. KMJ tested HSOA's accounting by obtaining schedules detailing the contract amount, total estimated costs, costs incurred, and the percentage of the contract value earned based on the costs incurred.

19. KMJ's testing of HSOA's revenues recorded using percentage-of-completion accounting and associated costs was flawed in three major respects: (i) it did not utilize planned audit scopes, (ii) it performed only limited substantive testing on items selected for testing, and (iii) it did not test transactions completed prior to year-end.

20. KMJ staff selected audit samples utilizing audit scopes in excess of the "tolerable misstatement" amount determined by KMJ and approved during KMJ's initial planning work. For example, individually significant items, based on KMJ's calculation of tolerable misstatement for Fireline and Associated, were $280,000 and $152,250, respectively, but the KMJ staff selected, without explanation, items greater than $1 million and $2 million, respectively. As a result of using higher audit scopes, fewer projects were subjected to substantive auditing procedures than planned.

21. Moreover, in addition to subjecting fewer projects to substantive auditing procedures, KMJ insufficiently tested the projects it did select. For example, at Fireline, KMJ concluded that it had obtained sufficient competent evidential matter by selecting for testing 14 projects with a contract value in excess of $1 million and calculating that it had tested 89% of total

contract values.[10] Although Merkley and Price intended KMJ staff to test project values by examining underlying executed agreements, KMJ staff inappropriately included five projects in its calculation for which HSOA could not provide executed agreements to support the listed contract values. These five contracts represented 19% of the total contract values. Additionally, KMJ staff examined invoices to support only five items for five projects, which it selected on a haphazard basis. In aggregate, KMJ substantively tested only $1.5 million of Fireline's costs, approximately 50% of which Fireline incurred prior to HSOA's acquisition of Fireline, and therefore contributed little audit evidence to support HSOA's 2006 revenues. As a result of its procedures, KMJ substantively tested only $1.3 million (3.3%) of Fireline's 2006 revenues of $39.3 million.

22. Finally, KMJ did not substantively test projects HSOA completed between July 1, 2006, the date HSOA acquired Fireline, and December 31, 2006. Consequently, KMJ's testing of substantial amounts of Fireline's 2006 revenues was largely based on simple analytical comparisons and representations by management.

Reliance on Management Representations Without Obtaining Corroborating Evidence

23. During 2006, HSOA management materially misstated HSOA's net income by recording fictitious and premature revenues from (i) a significant customer; (ii) targets of pending acquisitions (i.e., Fireline and Associated); and (iii) related parties. Merkley and Price relied on representations of HSOA management but failed to obtain corroborating evidence or did not recognize multiple inconsistencies that should have alerted them to management's misrepresentations, and to seek additional competent evidential matter on which to base KMJ's 2006 audit opinion.

Fictitious Revenues from a Significant Customer

24. In connection with KMJ's first quarter 2006 review, Merkley and Price identified and inquired about a significant, unusual arrangement with HSOA's largest customer, which purportedly allowed HSOA to unilaterally charge the customer up to $2 million per month for agreeing to have personnel on standby, regardless of whether HSOA incurred any costs. Merkley and Price also learned that HSOA modified an agreement defining the terms of future work by HSOA executed by the customer in April 2006 by having the customer initial, in May 2006, a provision allowing HSOA to invoice the customer for standby mobilization services retroactive to January 2006.[11] Merkley and Price reviewed a copy of the agreement modified in May 2006,

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[10] KMJ calculated it had tested 89% of project contract values by dividing the sum of the contract values for the 14 projects it selected by the total values for all listed projects. KMJ's calculation was flawed because the numerator included amounts it was unable to test and because the denominator excluded contracts completed during the year.

[11] On May 10, 2006, HSOA faxed KMJ a copy of an agreement, executed by the customer on April 7, 2006, that defined payment terms for the first $20 million of work performed by HSOA for the customer after April 1, 2006. On the first page of this agreement, HSOA management inserted a provision purportedly allowing

reviewed journal entries recording $3 million of revenue based on the modification, and engaged in discussions with HSOA management. As such, Merkley and Price should have known that the nature and business purpose of the purported arrangement was questionable, HSOA lacked contemporaneous documentation and HSOA recorded the related revenues outside of HSOA's normal billing process. Merkley and Price accepted HSOA's recognition of $3 million of revenue on the condition that HSOA specifically disclose the revenue recorded under the agreements in its Form 10-Q, and with the understanding that the amounts would be subject to more stringent audit procedures by KMJ at year-end. Additionally, KMJ required, at least in connection with the first and second quarter 2006 reviews, that management represent in writing that HSOA's revenue recognition complied with GAAP and that related receivables were collectible.

25. Although management did make these representations to KMJ, management did not state, and KMJ did not document, how HSOA's accounting treatment complied with GAAP. Moreover, in subsequent quarters, neither Merkley nor Price raised any additional questions about the arrangement despite several inconsistent facts, including that: (i) HSOA did not have a purchase order or other documentation that evidenced why HSOA billed the customer for only 50% of the amounts purportedly billable in the first quarter of 2006; (ii) HSOA ceased accruing revenue from purported standby mobilization services after the first quarter 2006; (iii) the customer, which had accounted for approximately 23% of HSOA's revenues in 2005, awarded HSOA almost no new work after it terminated discussions to be acquired by HSOA in April 2006; and (iv) the customer made no payments against amounts invoiced for purported standby mobilization services.

26. At year-end 2006, Merkley and Price planned to rely upon the customer's confirmation of the balance due to HSOA. The confirmation request sent to the customer, however, did not ask the customer to confirm significant terms of the arrangement, such as the date the agreement was entered into, its payment terms, agreement as to the amount invoiced for the period ended March 31, 2006, and the reason why no amounts were invoiced for subsequent periods. Moreover, the customer did not return the confirmation, and made no payments on the invoices in question. Nevertheless, Merkley and Price accepted management's representations based on the written agreement, which they knew had not been executed contemporaneously with the purported agreement to allow HSOA to invoice the customer for standby mobilization services, that HSOA's reported revenues complied with GAAP and that a significant portion of the receivable balance should be reserved as uncollectible due to the customer's deteriorating economic conditions.[12]

HSOA to invoice the customer up to $2 million per month beginning January 2006. Merkley and Price subsequently saw copies of the agreement on which the customer had initialed and faxed back to HSOA on May 11, 2006. HSOA's CEO, however, never disclosed to Merkley, Price or KMJ that the customer had initialed the provision based on an oral agreement that HSOA could not invoice the customer unless it first issued a purchase order for such services.

[12] KMJ did not review any documentation of management's analysis of the collectability of individual invoices or aggregate balances. Similarly, KMJ did not request or review HSOA's correspondence with the

Fictitious Revenues from Targets of Pending Acquisitions

27. Merkley and Price also overlooked evidence that should have caused them to raise additional questions about revenue recognized by HSOA in advance of its acquisitions of Fireline and Associated in the second and third quarters of 2006, respectively.

28. Immediately prior to its acquisition of Fireline as of July 1, 2006, HSOA recognized $8.4 million of revenue based on a purported transaction negotiated with the president of Fireline. In connection with its review of HSOA's financial information as of June 30, 2006, KMJ inquired about the agreement, but did not question the transaction's abnormally high margin. After HSOA acquired Fireline, Merkley and Price failed to notice or ignored the fact that Fireline's accounts payable and accrued liabilities at June 30 and September 30, 2006, in aggregate were less than the $8.4 million receivable on HSOA's books and records and that Fireline's accounts payable and accrued liabilities per its audited financial statements as of June 30, 2006 were less than $8.4 million. KMJ did not examine, and HSOA did not have, an executed contract for the project purportedly completed by HSOA prior to June 30, 2006. KMJ also failed to consider facts indicating that HSOA continued to record costs supposedly associated with the project in the third and fourth quarters of 2006, even though HSOA recognized 100% of the revenue in the second quarter.

29. Similarly, immediately prior to its acquisition of Associated as of October 1, 2006, HSOA recognized $4 million of revenue based on purported transactions with Associated. In connection with its 2006 audit engagement, KMJ obtained contracts and examined invoices sent by HSOA covering periods immediately before the effective date of HSOA's acquisition of Associated. Merkley and Price overlooked several inconsistencies that should have alerted them to make additional inquires and require more competent evidence. First, KMJ failed to notice that certain of the invoices were unlike HSOA's typical invoices to Associated. Although HSOA typically issued sequentially-numbered invoices by project, certain of the invoices examined by KMJ were identified with an "A" suffix rather than the next number in the invoice sequence (the "A Invoices"). Each of the A Invoices included amounts billed or items other than time and materials, such as management fees, for which HSOA had not invoiced Associated in any other invoices. Additionally, KMJ did not note that certain of the A Invoices invoiced Associated for time periods that overlapped time periods for other invoices examined by KMJ for the same project, or note that the A Invoices billed labor at rates above the rates used on other invoices.

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customer soliciting payment of the standby mobilization receivable balance. Price continued to rely upon management's representations regarding the standby mobilization agreement after the customer's president told Price in December 2007 or January 2008 that it did not owe amounts for standby mobilization and that his oral agreement with HSOA's CEO was that HSOA could not invoice for standby mobilization prior to being issued a purchase order for such services. The customer's president did not provide Price with any evidence to support the existence of the oral agreement with HSOA's CEO, but acknowledged initialing in May 2006 the mobilization provision added to the agreement originally executed in April 2006. It was not until 2009, when the staff showed Merkley and Price e-mails they had not previously seen between HSOA's CEO and the customer's president that Merkley and Price concluded they could not rely upon management's representations. Promptly thereafter, Merkley and Price caused KMJ to resign as HSOA's auditor.

Furthermore, KMJ did not inquire or otherwise determine if these atypical invoices were reflected in Associated's books and records.

Fictitious Revenues from Related Parties

30. At year-end 2006, Fireline's president executed a scheme to inflate Fireline's receivables and related revenues by causing private companies that he controlled to enter into contracts with HSOA to perform construction work. He then directed Fireline employees to create documents and make accounting entries that made it appear that Fireline was performing on these related party contracts.[13] As a result, HSOA inflated its reported revenue and receivables by $3.2 million and $6.9 million for the year ended December 31, 2006 and six months ended June 30, 2007, respectively. HSOA also did not disclose the existence of these transactions as required by Financial Accounting Standards No. 57, *Related Party Disclosures*.

31. Evidence exists that KMJ should have been aware of at least some of the related party transactions. For instance, in connection with its 2006 audit work at Fireline, KMJ staff examined contracts for two of the four related party projects for which revenue was reported, apparently without recognizing that Fireline's president executed the contracts on behalf of the customer or that the contracts had been backdated. For one project, Fireline's controller confirmed to Price that the customer was affiliated with Fireline and was working as an intermediary between Fireline and a third party customer. As such, Price should have known that HSOA had not disclosed its related party transactions in accordance with GAAP.

<u>Failure to Comply with PCAOB Auditing Standard No. 3</u>

32. PCAOB Auditing Standard No. 3 requires, in part, that "documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement: (a) to understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached, and (b) to determine who performed the work and the date such work was completed as well as the person who reviewed the work and the date of such review" *(See Auditing Standard No. 3, paragraph 6)*.

33. Merkley and Price did not ensure that KMJ's 2005 reviews and audit were documented in accordance with PCAOB Auditing Standard No. 3 despite previously acknowledging to the PCAOB that its 2004 documentation was not adequate.[14] In fact, the

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13 In connection with the 2006 audit, Fireline's president had his partner in some of the related party entities falsely confirmed to KMJ that HSOA had a $650,000 payable to one of the related parties.

14 Prior to issuing its audit opinion on the 2005 financial statements, KMJ acknowledged that its 2004 audit documentation was not adequate in its response to the PCAOB's draft inspection report on selected KMJ engagements, including HSOA. See Part IV, Response of the Firm to Draft Inspection Report of Inspection of Corbin & Company, LLP issued by the PCAOB on April 6, 2006 (http://pcaobus.org/Inspections/Reports/Documents/2006_Corbin_and_Company.pdf).

majority of KMJ's 2005 review and audit work papers bear no evidence of review and none of the work papers bear evidence of a partner level review.[15]

<u>Failure to Plan and Supervise Adequately the 2006 Audit</u>

34. An auditor is required to plan and perform the audit "to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud" (*See PCAOB Standards and Related Rules*, AU § 110.02). In planning, the auditor should assess the risk of material misstatement due to fraud or error, which includes consideration of "conditions that may require extension or modification of audit tests, such as the risk of material error or fraud or the existence of related party transactions" (*See PCAOB Standards and Related Rules*, AU §§ 312.16 and 311.03). Based upon the auditor's risk assessment and other planning considerations, the auditor should prepare a written audit program setting forth "in reasonable detail the audit procedures that the auditor believes are necessary to accomplish the objectives of the audit" (*See PCAOB Standards and Related Rules*, AU § 311.05). An auditor is also required to review work performed by assistants "to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report" (*See PCAOB Standards and Related Rules*, AU § 311.13).

35. Merkley and Price failed to adequately plan, or properly supervise assistants, in connection with the 2006 audit. Merkley and Price allowed assistants to assess the risk of material misstatements and designate the extent of testing to address identified risks approximately two weeks *after* completing audit procedures for significant accounts, including revenues and cost of revenues. Moreover, Merkley and Price did not ensure that assistants tailored standard audit programs to be responsive to identified risks and to be consistent with other planning conclusions. As such, the extent of testing KMJ actually performed did not correspond with the risks of material misstatement for all significant areas. Nonetheless, Merkley and Price approved KMJ's planning and audit documentation.

<u>Failure to Conduct Reviews of Interim Financial Information in Accordance with PCAOB Standards and Rules</u>

36. The objective of a review of interim financial information is to provide the accountant with a basis for communicating awareness of any material modifications that should be made to the interim financial information for it to conform with GAAP (*See PCAOB Standards and Related Rules*, AU § 722.07). *PCAOB Standards and Rules,* AU § 722 establishes standards and provides guidance on the nature, timing, and extent of the procedures to be performed by an independent accountant when conducting a review of interim financial information (*See PCAOB Standards and Related Rules*, AU § 722.01). A review of interim financial information consists principally of performing analytical procedures and making inquires of persons responsible for

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15 Contemporaneous time records indicate that Merkley and Price charged time to the HSOA engagement during the periods KMJ conducted its reviews and audit. As such, it appears Merkley and Price participated in KMJ's reviews and audit but failed to document work performed as required by PCAOB standards.

accounting and financial matters, and other procedures that address significant accounting and disclosure matters relating to the interim financial information to be reported (*See PCAOB Standards and Related Rules*, AU §§ 722.07 and 722.15). "The accountant should apply analytical procedures to the interim financial information to identify and provide a basis for inquiry about the relationships and individual items that appear to be unusual and that may indicate a material misstatement" (*See PCAOB Standards and Related Rules*, AU § 722.16). In applying analytical procedures and making inquires, the accountant should consider plausible relationships between both financial and relevant nonfinancial information, inquire about unusual or complex situations, significant transactions occurring or recognized in the last several days of the interim period, and the status of uncorrected misstatements identified during the previous audit and interim review (*See PCAOB Standards and Related Rules*, AU §§ 722.16 and 722.18). Additionally, the accountant should obtain evidence that the reported financial information agrees with or reconciles with the accounting records (*See PCAOB Standards and Related Rules*, AU § 722.18). Additionally, PCAOB Auditing Standard No. 3 applies to reviews of interim financial information and establishes requirements for the extent of documentation that an auditor should prepare and retain.

37. Although KMJ performed certain analytical procedures and made some inquiries, Merkley and Price failed to develop expectations based on plausible relationships and exercise professional skepticism in inquiring about unusual and significant transactions occurring at quarter end and the status of uncorrected misstatements identified during prior periods. In certain reviews, Merkley and Price relied on analytical review comparisons that yielded no meaningful relationships.[16] At other times, Merkley and Price failed to recognize or appropriately respond to implausible relationships and unusual, significant transactions occurring at quarter-end, each of which represented fictitious revenue recorded by HSOA management.[17] For at least the first quarter 2006 review, neither Merkley nor Price confirmed that the financial statements included in HSOA's first quarter 2006 Form 10-Q agreed to financial information reviewed by KMJ. Lastly, after discovering a likely error in recording year-end 2004 EBITDA bonuses, neither Merkley nor Price ensured that HSOA accounted for year-end EBITDA bonuses in accordance with GAAP or

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16 For instance, on a work paper prepared by Price and reviewed by Merkley in connection with its March 31, 2006 review, Price compared annualized first quarter 2006 results to 2005 results multiplied by three, not four, for a subsidiary acquired on September 27, 2005. Also, on another work paper reviewed by Merkley in connection with its March 31, 2006 review, the preparer compared annualized first quarter 2006 results to unadjusted 2005 results for a subsidiary that began operations in the fourth quarter of 2005.

17 For example, Price noted a large unusual transaction constituting significantly all of HSOA's largest subsidiary's revenue in the first quarter 2007 but accepted management's representation regarding the transaction despite multiple inconsistencies and management's conflicting statements about the transaction and HSOA's accounting. Price relied on management's representations that the amounts recorded as revenue had been billed by HSOA and were based on work by HSOA, even though he knew that such amounts were recorded via journal entries and not through the subsidiary's normal billing systems. Additionally, KMJ's work papers document that advances from a third party lender were recorded as liabilities by HSOA, when in fact they ultimately recognized such amounts as revenue. In connection with KMJ's second quarter 2007 review, Price similarly failed to obtain an understanding of the purported transactions.

consistently with management's representations. Additionally, Merkley and Price failed to ensure that KMJ's reviews were documented in accordance with PCAOB Auditing Standard No. 3, as evidenced by the lack of review on most work papers and no evidence of a partner review.

<u>Failure to Issue Accurate Audit Reports</u>

38. PCAOB standards require that the auditor's report contain an opinion on the financial statements taken as a whole and contain a clear indication of the character of the auditor's work (*See PCAOB Standards and Related Rules*, AU § 508.04). The auditor can determine that he is able to issue an audit report containing an unqualified opinion only if he has conducted his audit in accordance with PCAOB standards and the financial statements have been prepared in conformity with GAAP (*See PCAOB Standards and Related Rules*, AU §§ 508.08 and 508.14).

39. Merkley acted unreasonably in rendering audit reports containing unqualified opinions. Merkley approved KMJ's issuance of audit reports on HSOA's financial statements even though he should have known that KMJ's audits had not been conducted in accordance with PCAOB standards and that HSOA's financial statements did not present fairly, in all material respects, HSOA's financial position, operating results, and cash flows in conformity with GAAP.

E. VIOLATIONS

<u>Merkley Was a Cause of HSOA's Violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 13a-1 and 13a-13 Thereunder</u>

40. Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder require issuers with securities registered under Section 12 of the Exchange Act to file quarterly and annual reports with the Commission and to keep this information current. The obligation to file such reports embodies the requirement that they be true and correct. *See, e.g., SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1165 (D.C. Cir. 1978). HSOA violated Section 13(a) of the Exchange Act and Rules 13a-1, and 13a-13, by filing Forms 10-KSB and 10-QSB (for 2004 and 2005) and Forms 10-K and 10-Q (for 2006 and the first and second quarters of 2007) that materially misrepresented HSOA's revenues and earnings. Merkley signed audit reports indicating that KMJ's audits of HSOA's 2004, 2005, and 2006 financial statements had been conducted in accordance with the standards of the PCAOB, and that the financial statements were presented fairly in conformity with GAAP, despite numerous inconsistencies and evidence to the contrary, including misrepresentations by HSOA's management. Similarly, Merkley supervised KMJ's reviews of HSOA's 2005 and 2006 interim financial statements, which he improperly represented had been conducted in accordance with PCAOB standards. By his actions, Merkley was a cause of HSOA filing false and misleading annual and quarterly reports with the Commission that misrepresented HSOA's financial results. Accordingly, Merkley was a cause of HSOA's violations of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder.

41. Section 13(b)(2)(A) of the Exchange Act requires registrants under Section 12 of the Exchange Act to make and keep books, records, and accounts that accurately and fairly reflect

the transactions and dispositions of their assets. HSOA violated Section 13(b)(2)(A) by recording and reporting revenue from fictitious projects, overstating revenue earned from real projects, and artificially inflating net income by improperly deferring bonus expense. As discussed above, Merkley's actions were a cause of HSOA's books and records to inaccurately reflect transactions, thereby causing HSOA's violations of Section 13(b)(2)(A) of the Exchange Act.

Rule 2-02 of Regulation S-X

42. Rule 2-02(b)(1) of Regulation S-X requires an accountant's report to state "whether the audit was made in accordance with generally accepted auditing standards." "[R]eferences in Commission rules and staff guidance and in the federal securities laws to GAAS or to specific standards under GAAS, as they relate to issuers, should be understood to mean the standards of the PCAOB plus any applicable rules of the Commission." (*See SEC Release No. 34-49708 (May 14, 2004)*). Thus, an auditor violates Regulation S-X Rule 2-02(b)(1) if it issues a report stating that it had conducted its audit in accordance with PCAOB standards when it had not. *See In re Andrew Sims, CPA*, Rel. No.34-59584, AAER No. 2950 (Mar. 17, 2009).

43. KMJ issued audit reports on HSOA's 2005 and 2006 financial statements stating that it had conducted its audits in accordance with PCAOB standards. KMJ's audits, however, were not conducted in accordance with PCAOB standards, in part due to Merkley's failures to plan, supervise assistants, document procedures performed, and obtain sufficient competent evidence to serve as a basis for KMJ's audit opinions. Merkley should have known that KMJ had not documented its 2005 audit in accordance with PCAOB Auditing Standard No. 3, *Audit Documentation*, should have known KMJ had not obtained sufficient competent evidential matter that HSOA's 2005 and 2006 bonuses were presented in conformity with GAAP, and should have known KMJ had not obtained sufficient competent evidential matter that HSOA's 2006 revenues and cost of revenues were presented in conformity with GAAP at the dates he approved KMJ's issuance of audit reports on HSOA's 2005 and 2006 financial statements. Accordingly, Merkley caused KMJ's violations of Rule 2-02(b)(1).

Rule 102(e) and Section 4C of the Exchange Act

44. Rule 102(e)(1)(ii) of the Commission's Rules of Practice and Section 4C of the Exchange Act authorize the Commission to censure or deny, temporarily or permanently, the privilege of appearing or practicing before the Commission to accountants who are found to have engaged in improper professional conduct. Under Rule 102(e)(1)(iv), the term "improper professional conduct" means, in part, "repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission."

45. Merkley's and Price's actions during the engagements were unreasonable and failed to conform to applicable professional standards. Merkley and Price failed to (i) obtain sufficient competent evidential matter regarding bonuses, revenues, and cost of revenues with respect to KMJ's 2004, 2005, and 2006 audit engagements; (ii) comply with PCAOB Auditing Standard No. 3; (iii) adequately plan the audit and properly supervise assistants in connection with the 2006

engagement; and (iv) conduct reviews of interim financial information in accordance with PCAOB standards and rules. Additionally, Merkley caused KMJ to issue inaccurate audit reports in that he should have known that KMJ's unqualified audit reports were false because they incorrectly represented that the audits were conducted in accordance with PCAOB standards and that HSOA's financial statements were prepared in conformity with GAAP. Based on Merkley's violations of applicable professional standards, Merkley was a cause of HSOA issuing misstated financial statements. This conduct supports an action against Merkley and Price under Rules 102(e)(1)(ii) and 102(e)(1)(iv)(B)(2) of the Rules of Practice.

F. FINDINGS

Based on the foregoing, the Commission finds that KMJ, Merkley and Price engaged in improper professional conduct pursuant to Rules 102(e)(1)(ii) and 102(e)(1)(iv)(B)(2) of the Commission's Rules of Practice and Section 4C of the Exchange Act. Additionally, the Commission finds that Merkley was a cause of HSOA's violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act, and Rules 13a-1 and 13a-13 promulgated thereunder and caused KMJ's violation of Regulation S-X Rule 2-02(b)(1).

G. UNDERTAKINGS

KMJ undertakes the following:

1. Acceptance of New Public Company Audit Clients. The goal of this undertaking is to provide adequate time for KMJ to implement the undertakings concerning auditing and professional development matters described below and implement such other adjustments to its audit practice required by the suspension of Merkley and Price from appearing or practicing before the Commission. KMJ undertakes that, following the issuance of this Order, it will not accept new engagements for public company audits prior to the later of March 31, 2011, or the date that KMJ certifies in writing compliance with each of the undertakings in the form described in paragraph 5, below (the "Certificate of Compliance"). A public company audit is defined as an engagement to audit the financial statements of an "issuer" as that term is defined in Section 3(a)(8) of the Securities Exchange Act of 1934.

2. Auditing Matters. The goal of this undertaking is to require KMJ to engage in an internal review of its existing policies and procedures concerning compliance with the relevant professional, regulatory and firm requirements with respect to public company audit engagements. Prior to December 31, 2010, KMJ shall revise as may be necessary, and then engage in steps to implement and enforce, such policies and procedures so as to provide reasonable assurance that KMJ will comply with its obligations under professional, regulatory and firm requirements with respect to public company audit engagements. KMJ shall review its policies and procedures concerning:

   a. Identification and monitoring of high risk engagements, including policies covering mandatory procedures for high risk engagements. Additionally, KMJ shall designate a partner within the firm responsible for risk management, including, but not limited to, client acceptance and continuance procedures.

b. Completion of planning prior to the commencement of audit fieldwork. Such policies and procedures shall provide reasonable assurance that, prior to the commencement of any significant audit procedures:

   (i) Work papers identifying significant audit areas, documenting risks of material misstatements, and planned extent of testing are finalized and reviewed and approved by the engagement partner, and, when appropriate, the engagement quality reviewer; and

   (ii) Written audit programs are tailored to address identified risks of material misstatements and specify in reasonable detail the procedures expected to be performed to accomplish the objectives of the audit, specify the dollar amount of audit scopes to be used to select items to be tested, specify the expected extent of testing, and a requirement that the reason for any deviation is documented.

c. Audit Sampling. KMJ shall implement such policies and procedures to ensure that it documents its judgments as to the use of statistical or nonstatistical audit sampling methods, identifies relevant populations, identifies expected audit coverage, determines appropriate sample size, selects sample items in such a way that the items selected are representative of the population, tests sample selections, evaluates results, and projects identified errors to the entire population.

d. Consultations. KMJ shall implement enhanced consultation procedures and documentation requirements regarding unusual accounting, auditing, or financial reporting issues. Such procedures shall also include procedures for external firm consultations regarding accounting, auditing, or financial reporting issues not resolved by the audit team, engagement quality reviewer, and, if applicable, the internal consultation process.

e. Documentation. KMJ shall implement enhanced documentation procedures to provide reasonable assurance that KMJ complies with Auditing Standard No. 3, *Audit Documentation*, on each of its public company audit engagements. Such procedures shall emphasize that documentation must be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached and require that any additions made after the documentation date[18] must identify the date the

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[18] Auditing Standard No. 3, paragraph 15, states, "A complete and final set of audit documentation should be assembled for retention as of a date not more than 45 days after the report release date (documentation completion date). If a report is not issued in connection with an engagement, then the documentation completion date should not be more than 45 days from the date that fieldwork was substantially completed. If the auditor was unable to complete the engagement, then the documentation completion date should not be more than 45 days from the date the engagement ceased."

information was added, the name of the person who prepared the additional documentation, and the reason for adding it. Additionally, KMJ shall adopt a policy making it mandatory that engagement partners on public company audit engagements review each audit area designated as having a significant risk of material misstatement (whether due to fraud or error) to ensure compliance with both PCAOB standards and related rules and firm policies and procedures.

f. Detection and Reporting of Illegal Client Activity (Section 10A Compliance). KMJ shall make such revisions as may be necessary in order to adopt, implement and enforce written policies and procedures providing reasonable assurance that KMJ complies with Section 10A of the Securities Exchange Act of 1934, as amended, including without limitation, for each audit subject to Section 10A, procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts, and to comply with all requirements under the standards of the Commission, the PCAOB, and Section 10A to evaluate and report suspected illegal acts.

g. Engagement Quality Control. KMJ shall undertake a review of its existing procedures to provide reasonable assurance that it complies with the PCAOB's Auditing Standard No. 7, *Engagement Quality Review*.

3. Professional Development. The goal of this undertaking is to require KMJ to establish, implement, and enforce written policies and procedures designed to provide reasonable assurance that KMJ's professionals serving public company audit clients participate in professional development activities in accordance with firm guidelines, in subjects that are relevant to their responsibilities and will contribute to their technical training and proficiency as an auditor. Within 90 days of this Order, KMJ will evaluate its existing professional development policy and shall make such revisions as may be necessary in order to adopt, implement, and enforce written policies and procedures to provide that professionals serving public company audit clients participate in professional development activities in accordance with firm guidelines, in subjects that are relevant to their responsibilities and will contribute to their technical training and proficiency as an auditor. Additionally, prior to December 31, 2010, KMJ will require each audit professional serving public company audit clients to undergo:

a. A Minimum of 16 Hours of Audit-Related Training. The audit-related training requirement shall cover topics including, but not limited to: (1) assessing risks of material misstatements and developing responsive audit plans, (2) determining and documenting appropriate sampling methods and sample sizes, selecting samples, and evaluating and documenting results; (3) audit documentation; and (4) obtaining and evaluating sufficient competent evidential matter, including corroboration of management's representations. The audit-related training requirement may be fulfilled by participating in or completing course(s) conducted by or offered by the American Institute of Certified Public Accountants (AICPA) or another comparable organization.

b. A Minimum of 8 Hours of Fraud-Detection Training. KMJ shall ensure that audit professionals assigned to public company engagements undergo fraud detection training conducted by the Association of Certified Fraud Examiners or another comparable organization. The training will include techniques in detecting and responding to possible fraud by audit clients or by employees, officers or directors of audit clients.

4. Cooperation. KMJ agrees that KMJ (including its partners, principals, officers, agents and employees) shall cooperate fully with the Commission with respect to any matter relating to the Commission's investigation of HSOA or its current or former officers, directors or employees, including but not limited to any litigation or other proceeding related to or resulting from that investigation, including litigation in *SEC v. Home Solutions of America, Inc., et al*, Civil No. 3:09-cv-02269-N (N.D.Tx.). Such cooperation shall include, but is not limited to, upon reasonable notice, and without subpoena:

   a. Producing any document, record, or other tangible evidence reasonably requested by Commission staff in connection with the Commission's investigation, litigation or other proceedings;
   b. Providing all information reasonably requested by Commission staff in connection with the Commission's investigation; and
   c. Using its best efforts to secure the attendance and truthful statements or testimony of any KMJ partner, principal, officer, agent, or employee, excluding any such person who is a party to litigation with the Commission, at any meeting, interview, testimony, deposition, trial, or other legal proceeding reasonably requested by the Commission staff.

5. Certification of Compliance. KMJ shall certify, in writing, compliance with the undertakings set forth above. The certification shall identify the undertakings, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and KMJ agrees to provide such evidence. The certification and supporting material shall be submitted to David Peavler, Assistant Director, Fort Worth Regional Office or his successor, with copies to the Office of Chief Counsel of the Enforcement Division and to the PCAOB, Director of Registration and Inspection, no later than March 31, 2011.

IV.

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

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

KMJ

A. KMJ is hereby censured pursuant to Rules 102(e)(1)(ii) and 102(e)(1)(iv)(B)(2) of the Commission's Rules of Practice and Section 4C of the Exchange Act.

Merkley

B. Merkley shall cease and desist from committing or causing any violations and any future violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act, Rules 13a-1 and 13a-13, thereunder, and Regulation S-X Rule 2-02(b)(1).

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

D. After three years from the date of this order, Merkley 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 Merkley's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he/she practices before the Commission in this capacity; and/or

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

(a) Merkley, or the public accounting firm with which he is associated, is registered with the PCAOB in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

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

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

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

E. The Commission will consider an application by Merkley 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 Merkley's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

Price

F. Price is denied the privilege of appearing or practicing before the Commission as an accountant.

G. After two years from the date of this order, Price 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 Price's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he/she practices before the Commission in this capacity; and/or

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

(a) Price, or the public accounting firm with which he is associated, is registered with the PCAOB in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

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

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

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

H. The Commission will consider an application by Price 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 Price's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro
not participating

SECURITIES AND EXCHANGE COMMISSION
Washington D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 62898 / September 13, 2010

Admin. Proc. File No. 3-13701

In the Matter of the Application of

LESLIE A. AROUH

For Review of Action Taken by the

Financial Industry Regulatory Authority, Inc.

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION – REVIEW OF DENIAL OF MEMBERSHIP CONTINUANCE APPLICATION

A registered securities association denied a member firm's application to retain its membership if it employed an individual who, because of a 2004 bar order, was subject to statutory disqualification. *Held*, the review proceeding is *dismissed*.

APPEARANCES:

James M. Kaplan and *William Zeena, Jr.*, of Kaplan Zeena LLP, for *Leslie A. Arouh*.

Marc Menchel, Alan Lawhead, Andrew Love, and *Michael J. Garawski*, for the Financial Industry Regulatory Authority, Inc.

Appeal filed: November 25, 2009
Last brief received: February 25, 2010

I.

The Financial Industry Regulatory Authority, Inc. ("FINRA") denied an application (the "Application") by Raymond James & Associates, Inc. ("Raymond James" or the "Firm") to remain a FINRA member if it permits Leslie A. Arouh to associate with it as a general securities representative.[1] Arouh is subject to statutory disqualification based on a Commission order issued December 20, 2004, which barred him from associating with any broker or dealer, subject to a right to reapply after two years (the "Bar Order").[2] FINRA found that Arouh associated with two broker-dealer firms while the Bar Order was in effect and that the Firm's proposed supervisory plan was inadequate. Concluding that Arouh's proposed association with the Firm would create an unreasonable risk of harm to investors and the markets, FINRA denied the Application. We base our findings on an independent review of the record.

II.

A. Background

Arouh entered the securities industry in 1994. In December 1997, he became associated with First Union Capital Markets Corp. ("First Union"), a registered broker-dealer, as a salesperson of investment-grade corporate bonds. In early April 1998, he participated in a prearranged adjusted trading scheme in which First Union first lost money by buying certain bonds at above-market prices and reselling them at below-market prices, then made up for its losses by selling additional bonds at inflated prices that bore no relationship to supply and demand.[3] First Union investigated the transactions almost immediately, suspended Arouh on April 8, and terminated his employment on May 6, 1998.[4]

In June 1998, Arouh became associated with Raymond James, a FINRA member firm, as an institutional fixed income salesperson. While working at Raymond James, Arouh met Alan

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1 On July 26, 2007, the Commission approved a proposed rule change filed by the National Association of Securities Dealers, Inc. ("NASD") to amend NASD's Restated Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority, Inc., or FINRA, in connection with the consolidation of NASD and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange. *See* Securities Exchange Act Rel. No. 56146 (July 26, 2007), 91 SEC Docket 517, 517 (SR-NASD-2077-053). Because FINRA's review of the Application occurred after the consolidation, references to FINRA will include references to NASD.

2 *Leslie A. Arouh*, 57 S.E.C. 1099 (2004). The Commission also ordered Arouh to pay a $110,000 civil money penalty and to cease and desist from committing or causing any future violations of Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q, Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j, and Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5. *See also infra* note 31 and accompanying text (identifying statutory and regulatory bases for disqualification).

3 *Id.* at 1101-09.

4 *Id.* at 1109.

Weiner and Scott Budner. Together, Weiner and Budner owned one hundred percent of two registered broker-dealer firms, STG Secure Trading Group, Inc. ("STG Inc.") and STG Secure Trading Group LLC ("STG LLC") (together, the "STG entities" or "STG").[5] Weiner and Budner were also officers of the STG entities.

STG, which offered a trading platform for equity day traders, occupied office space across the hall from Arouh's desk at Raymond James. Weiner wanted to take STG public and continue to expand its securities business, and in fall 2004, he proposed that Arouh join STG to help him develop a bond business.

In the meantime, the Commission had instituted proceedings against Arouh based on the 1998 adjusted trading scheme,[6] and in December 2004, the Commission found that Arouh, while working at First Union, "participated, with scienter, in [a] fraudulent adjusted trading scheme in willful violation of Securities Act Section 17(a), Exchange Act Section 10(b), and Exchange Act Rule 10b-5."[7] The scheme, the Commission found, involved hundreds of millions of dollars of trades and exposed both First Union and customers of the trading partner to substantial losses.[8] Based on this misconduct, on December 20, 2004, the Commission found it in the public interest to issue the Bar Order.[9] On January 3, 2005, Arouh filed a motion for reconsideration with the Commission, and began considering how he could continue working in the securities industry despite the bar. He asked an attorney for advice about what activities would be permissible if the Commission denied his motion, but the record contains no details about either his request or the oral advice he received in response.

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[5] The Central Registration Depository ("CRD"), available on FINRA's web site, shows that STG Inc. was registered with NASD and STG LLC was a member of the Philadelphia Stock Exchange. Pursuant to Rule 323 of our Rules of Practice, 17 C.F.R. § 201.323, we take official notice of this information. *See Douglas J. Toth*, Exchange Act Rel. No. 58074 (July 1, 2008), 93 SEC Docket 7380, 7381 n.3 (taking official notice of "basic information" found on CRD), *petition denied*, 319 Fed. App'x 184 (3d Cir. 2009) (unpublished).

[6] *Leslie A. Arouh*, Exchange Act Rel. No. 46450 (Sept. 3, 2002).

[7] *Arouh*, 57 S.E.C. at 1118. The Commission explained: "Adjusted trading constitutes a scheme to defraud in violation of Exchange Act Section 10(b) and Rule 10b-5 thereunder. Adjusted trading is a practice in which a person sells a security above the prevailing market price and purchases another security from the buyer of the first security at a corresponding price above the prevailing market price." *Id.* at 1111 (citations omitted).

[8] *Id.* at 1119-20.

[9] *Id.* at 1020-21.

B. Arouh's Relationship with STG and Raymond James's Membership Continuance Application

1. Arouh's Relationship with STG

In January 2005, Arouh founded two companies, New Horizons LLC ("New Horizons") and Sanctuary Management Consultants LLC ("Sanctuary") (together, the "Companies"). On behalf of the Companies, Arouh signed two consulting agreements with STG (the "Consulting Agreements"). The Consulting Agreements stated that Arouh would provide "recruiting, hiring and pre and post-hiring training of sales, marketing and operational personnel to enable [STG] to establish and operate a fixed income trading department," as well as recruitment and training services in other areas on request, "management consulting services," and "investment advisory and asset management advice."

The Consulting Agreements provided for Arouh to receive a total of $75,000 in signing bonuses upon execution, plus total annual base compensation of $600,000. If STG did at least $600,000 of bond business in a year, Arouh would receive a bonus of at least $600,000.[10] Arouh would participate in a performance-based bonus pool, and he would be entitled to acquire a twelve percent ownership interest in the stock of a holding company that was to acquire STG.

On February 25, 2005, the Commission denied Arouh's motion for reconsideration,[11] and the Bar Order became final. Arouh terminated his employment with Raymond James, but he did not move out of the office he had been using.[12] Raymond James relocated several employees who had been in the space around Arouh, and STG, which at that time had a staff of five people,

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[10] Arouh explained that his annual bonus was to be twenty percent of STG's profits, with a guaranteed minimum of $600,000: "[I]f [STG] made five million and [Weiner] owed me a million, the bonus would be a million instead of six hundred thousand."

[11] *Leslie A. Arouh*, Exchange Act Release No. 51254 (Feb. 25, 2005), 84 SEC Docket 3652. Arouh filed an appeal in the United States Court of Appeals for the District of Columbia Circuit, but subsequently abandoned it.

[12] Arouh testified that "we," i.e., STG, bought the office furniture he had been using from Raymond James and subleased the space, with the understanding that STG would deduct the cost of the sublease from his salary. Arouh testified that STG also paid for maintenance of plants in his office, and for Bloomberg terminals for himself and his assistant. Arouh testified that he had to walk into the area that STG subleased from Raymond James, but that his office "was separate, apart, locked and was different [from Raymond James's] office."

moved into the vacated space.[13] Arouh began providing services to STG, and in March 2005, he received the $75,000 signing bonus as provided in the Consulting Agreements.[14]

Once at STG, Arouh began trying to develop STG's bond business. He successfully recruited three bond traders and stayed in close contact with them once they started working at STG. At STG, the traders' desks were so close to Arouh's that he could "yell out" questions to them. Arouh talked with the bond traders "all the time," sometimes asking whether they were making money in the market, or whether they were long or short. Arouh testified, "[The traders'] success would make a difference in the amount of money that I would ultimately make. I was always interested in knowing whether they were making a lot of money or losing a lot of money." He also asked one of the traders to send him messages about what was going on in the market. When a bond trader complained to Arouh that he was not able to trade the positions he had expected, he asked Arouh to intercede with management and request higher position limits. Arouh brought these concerns to Weiner and Budner.[15] The trader, concerned about whether STG would meet payroll, also asked Arouh to make sure he got paid. Arouh talked to Weiner, and the traders were paid.[16]

Arouh did more for STG's bond business than merely recruit and work with traders. He also took the lead in explaining the bond business to third parties. Arouh testified that, in a meeting with a clearing firm, "I basically described the [bond] business because I knew about that more than either [Weiner or Budner] did." He also testified that when Weiner tried to borrow money for STG, "I would often go and explain what the bond business was because Alan didn't know."

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13 This staff consisted of Weiner, Budner, a compliance officer, an individual who handled back office matters and general administrative duties, and a receptionist.

14 There is some evidence that Arouh began performing services to STG before the Bar Order became final. Arouh insists, however, that he did not provide services to STG until late February.

The services Arouh provided to STG are relevant only if they show that he associated with STG while the bar was in effect. Keeping in mind Arouh's assertions about the timing of his relationship with STG, we find that Arouh provided most if not all of his services to STG between February 25 and mid-April 2005. Moreover, we find no qualitative difference between services provided before and after February 25.

15 Although Arouh testified that Weiner was "responsive" to him when he raised these concerns, the record is unclear as to whether the requests for higher position limits were granted.

16 Arouh testified that the trader who solicited his assistance thought Arouh had influence over Weiner, although Arouh denied having had such influence.

Arouh's role at STG was not limited to the bond area.[17] At Weiner's request, Arouh attended numerous committee meetings, including meetings of STG's management, executive, and sales and business committees, and he participated "on a regular basis" in discussions with STG about "issues that . . . related to managing the company." These discussions dealt with ongoing concerns such as office morale and STG's lack of a professional infrastructure. They also addressed plans for STG's future, such as how to expand STG's business and make it more profitable; whether STG should open more offices in New York, and if so who should be hired to open them; and the implications that acquiring a small brokerage firm would have on STG's fixed income business. Arouh also helped to recruit a branch manager for a newly created position on the equity side of STG's business.

Arouh testified that STG "asked me for input often and I gave it to them." He advised STG management about firm structure and staffing, recommending that STG hire a compliance officer and assign responsibility for STG's fixed income business and equity business. Arouh also reported to STG management on problems STG had with a market maker in New York that he was trying to resolve.

Arouh made several trips on behalf of STG. He traveled to New York with Weiner "a couple of times" to interview salespeople in connection with a possible acquisition by STG, then made recommendations to Weiner and Budner about whether they should proceed. Arouh traveled to Texas so that he could explain to a clearing firm the type of business that STG's bond group would be doing. On this trip, Arouh was introduced to a potential STG customer "[a]s a consultant to STG but more a partner in the business."[18] Additionally, Arouh went with Weiner to New York to try to borrow money for STG from Weiner's friends. Weiner repeatedly asked Arouh to lend him money to improve STG's net capital position.[19] At one point, Arouh gave Weiner $100,000, which was later returned to him after he helped Weiner arrange a $200,000 bank loan.

Arouh was also involved with compliance matters at STG. Arouh attended compliance meetings and was in frequent contact with STG's compliance officer, who kept him informed and

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17 Arouh testified that "[b]usiness development was the most important function I had . . . from the equity side, from the bond side, [and] from the investment banking side." None of Arouh's business development efforts came to fruition during his involvement with STG.

18 Arouh testified that, although he was introduced as a partner, "it was very clear to everyone that I wasn't a partner, that I couldn't be a partner" because of the Bar Order. However, Arouh testified that the potential customer "didn't know the difference" between Arouh, Weiner, and Budner with respect to discussing STG business, apparently viewing the three as equally suitable sources of information.

19 Arouh testified that Weiner asked him for such a loan at least twenty times between February 2005 and April 2005.

sought his input.[20] The compliance officer involved Arouh in efforts to retain a consultant to prepare a compliance manual, and asked Arouh to keep him informed "of all relevant issues and particularly those related to compliance."

In late February, STG's compliance officer expressed concern to Weiner and Arouh about whether about Arouh's relationship with STG complied with the Bar Order. Weiner and Arouh responded that they had a legal opinion that the relationship was compliant, and that they would provide him with a copy.[21] As of March 18, however, the compliance officer was still concerned about the relationship, and he again asked Arouh to show him a legal opinion.

Arouh obtained two letters from counsel, dated March 28, 2005 and April 4, 2005, that discussed the permissible scope of his involvement with STG in light of the Bar Order. Each letter discussed the possibility that Arouh could avoid the "association" contemplated in Exchange Act Section 3(a)(18)[22] by acting as an independent contractor. The March 28 letter stated that Arouh might be able to "interact[] with STG" without associating by using "a separate entity providing recruitment and/or training services for broker/dealer salespersons." By maintaining a separate entity, the letter suggested, Arouh might "superficially avoid" many of the problems that otherwise might arise. The letter further stated that Arouh might be able "to receive compensation from the broker/dealers or through contracts with parties you recruit and/or train whereby the recruits remit a percentage of their commissions," an arrangement the letter said was often used by staffing agencies, and one that "involves no direct contact between you and the broker/dealers, let alone control by either party," and therefore would apparently not involve association between Arouh and broker/dealers.

The April 4 letter expanded the description of services that Arouh could provide as an independent contractor, but omitted the language stating that Arouh might be able to receive compensation based on the commissions of persons he recruited. That letter stated that Arouh

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20 For example, the compliance officer updated Arouh about the development of a new compliance manual, sent him a series of memoranda about compliance "reorganization" efforts, discussed with Arouh and Weiner STG's closing of a "joint back office," copied Arouh on an e-mail informing Weiner that Weiner needed to qualify as a general securities principal, and asked Arouh to attend a meeting to discuss STG's response to an NASD request for information and another meeting to create a business plan and a corporate organizational chart.

21 Weiner told the compliance officer that he had obtained three opinions.

22 15 U.S.C. § 78c(a)(18). Under Section 3(a)(18), a "person associated with a broker or dealer" is defined as "any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer." *Id.* There is a limited exception, not relevant here, for persons whose functions are "solely clerical or ministerial." *Id.*

could perhaps provide "consulting services – for example, with regard to mergers and acquisitions, strategic alliances and growth planning" in addition to "the recruitment and/or training of salespersons" without becoming associated with STG. The letter reiterated that maintaining a separate entity might help Arouh avoid violating the Bar Order. The letter reached the same conclusion as the March 28 letter: due to the lack of direct contact and control, the arrangement "does not appear to involve association, by you with a broker/dealer."

Each letter concluded with a cautionary statement that counsel could not provide Arouh "with definite advice on most points" and advised him, "[I]t is very important that you consult with us prior to engaging in any activity that might be construed as involving association with a broker/dealer."

On April 5, 2005, staff of FINRA's predecessor, NASD, interviewed Arouh in connection with an investigation into STG.[23] Shortly thereafter, on April 11, 2005, a law firm representing Sanctuary sent a letter to NASD's Florida District Office, setting forth the firm's conclusion that Arouh had complied with the Bar Order at all material times, and that Arouh had avoided "association" with STG. The letter stated that Arouh's services were limited to "providing consulting services with regard to mergers and acquisitions, strategic alliances, growth planning and recruitment/training of salespersons," and concluded that, "[a]s none of these activities constitute an 'association' with a broker/dealer pursuant to [Exchange Act Section 3(a)(18)], Arouh's activities with and for STG do not violate the terms of the Bar Order."

By late March or early April, Arouh concluded that STG lacked the capital resources to develop the bond trading business it had envisioned. Moreover, STG had not been paying him as specified in the Consulting Agreements.[24] In April 2005, Arouh ended the relationship with STG.[25] Since then, he has been involved in the real estate industry.

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23 The record does not reveal what prompted the investigation.

24 STG's ledger shows that Arouh and the Companies were paid $3,453.10 in February 2005; $80,000 in March 2005; and $4,511.69 in April 2005. The first payment was made on February 3, and the last on April 18. In a declaration submitted after the hearing, Arouh stated that the February payments "were not compensation for services rendered but instead [were] more likely payments for items [he] furnished to STG, such as tickets for basketball games and other events." He further represented that, aside from the $75,000 signing bonus, the other payments in March and April were either expense reimbursements or advances against expenses.

25 A letter from STG to NASD staff, dated May 12, 2005, states that the relationship between STG and Arouh "ha[d] been set aside until all regulatory matters have been handled."

2. The Membership Continuation Application

In March 2008, Raymond James applied to FINRA for consent to continue as a FINRA member if Arouh became an associated person.[26] Raymond James has been a member of FINRA and its predecessor, NASD, since 1964. At the time of its application, Raymond James had 186 offices of supervisory jurisdiction and sixty-five branch offices, with 947 principals and more than 2,600 registered representatives.

The Application provided that Arouh would be employed as a Senior Vice President, Taxable Fixed Income Sales, in the Firm's home office, but would spend twenty percent of his time traveling. Arouh would handle accounts for institutional clients and would not trade for proprietary accounts or retail accounts other than personal and/or family accounts.

The Firm proposed that Arouh would be supervised by William Specht, Senior Vice President and National Sales Manager, who supervised both the Taxable Fixed Income Institutional Sales Department in the Firm's home office and the Firm's off-site Institutional Fixed Income offices. Specht and Arouh would both work in the Firm's home office, with Arouh sitting next to Specht at the institutional desk, except when either was traveling on business.

The proposed supervisory plan called for Specht, "[c]onsistent with normal firm supervisory procedures," to review and approve Arouh's new account agreements, daily transactions with customers, daily cancels and corrects, and all incoming or outgoing hard copy correspondence. The plan also called for Specht to review emails to and from Arouh "in accordance with firm policy." Because all transactions at the Firm had to be executed by traders, Arouh would not be able to input or record trades without obtaining the approval of the trader executing the trade.

Although much of the Firm's supervision of Arouh would be indistinguishable from that of Firm employees generally, the proposed supervisory plan noted that Arouh's physical proximity to Specht would enable Specht to hear Arouh's conversations. Specht emphasized that he would be personally responsible for reviewing Arouh's trading activity. He further testified that, although the proposed supervisory plan called for only two years of weekly monitoring of Arouh's trades, the Firm would be willing to exercise heightened supervision for the entire time that Arouh was associated with the Firm.

Specht's job required him to travel an average of two to four days each month. Specht reviewed each day's transactions even when he was out of the office. When Specht was away, either James Sickling, manager of the institutional taxable trading desk, or Fred Hoskin, the head of taxable fixed income at the Firm, was generally in the office. Specht testified that Sickling,

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[26] FINRA's By-Laws allow a member firm to request relief from ineligibility to associate with a disqualified person on behalf of the prospective associated person. *See* FINRA By-Laws, Art. III, § 3(d).

like Specht, worked on the trading floor and would therefore hear what Arouh was doing, but that Hoskin had a private office and would not be sitting on the floor with Arouh. The proposed supervisory plan did not assign responsibility for monitoring Arouh in Specht's absence to either Sickling or Hoskin, nor did it explain who would supervise Arouh if Specht, Sickling, and Hoskin were all away at the same time. The plan did not say whether additional measures would be implemented if Hoskin were supervising, to compensate for Hoskin's lesser proximity to Arouh.

C. FINRA Denies Application

FINRA denied Raymond James's application. FINRA found that Arouh acted as a principal of STG and was required to be registered as such. Therefore, FINRA found, Arouh was associated with STG in violation of the Bar Order, and this association violated both Article III, Section 3 of the NASD By-Laws and Section 15(b)(6)(B)(i) of the Exchange Act.[27] FINRA concluded that Arouh's association with STG constituted intervening misconduct that occurred after his statutorily disqualifying event.

In evaluating the seriousness of Arouh's misconduct, FINRA found that Arouh's violation of the Bar Order was reckless in that he, knowing that the Commission had imposed the bar to protect investors and the markets, nonetheless "constructed businesses and contracts that specifically aimed to circumvent the Bar Order, flouting not only its text but also its intent." FINRA further found that Arouh's misconduct resulted in at least $75,000 in monetary gain to Arouh, with the potential for much more, that it lasted a significant period of time, and that it ended not because Arouh acknowledged wrongdoing, but because he was not being paid. FINRA rejected Arouh's argument that he relied on legal advice that his involvement with STG was permitted, and concluded that Arouh's intervening misconduct was "a serious, and possibly egregious, violation [that] shows that he remains a serious threat to the public and the markets."

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[27] Article III, Section 3(a), provided, at the relevant time, that "[n]o person shall become associated with a member . . . if such person is or becomes subject to a disqualification." Section 15(b)(6)(B)(i), 15 U.S.C. § 78*o*(b)(6)(B)(i), provides that "[i]t shall be unlawful . . . [f]or any person as to whom [a Commission bar order] is in effect, without the consent of the Commission, willfully to become, or to be, associated with a broker or dealer in contravention of such order."

FINRA also found that Arouh had associated with STG because (1) he was contractually entitled to receive transaction-based compensation in connection with his activities for STG, although he was not registered as a broker-dealer; and (2) his work as an intermediary in support of STG's potential acquisition of another broker-dealer required him to be separately registered as a broker-dealer, but he was not. Because we base our determination that Arouh was associated with STG on our finding that he acted as a principal, we need not (and do not) reach these alternative bases of decision.

FINRA found that Raymond James did not have a disciplinary history that raised concerns. But it found that the Firm's proposed supervisory plan for Arouh was inadequate, in that it lacked sufficient elements and details to ensure that the Firm would prevent and detect possible misconduct by Arouh. FINRA concluded that Arouh's proposed association with the Firm would create an unreasonable risk of harm to investors and the markets. It accordingly denied the Firm's application. This appeal followed.

III.

Exchange Act Section 19(f) governs our review of this appeal.[28] In general, Section 19(f) requires us to dismiss such an appeal if we find that (1) the specific grounds on which FINRA based its denial of the Firm's membership continuance application exist in fact, (2) FINRA's action was in accordance with its rules, and (3) FINRA's rules are, and were applied in a manner, consistent with the purposes of the Exchange Act.[29] The burden is on the applicant to show that it is in the public interest to permit the requested employment despite the disqualification.[30]

A. Whether the grounds upon which FINRA based its decision exist in fact

As a result of the Bar Order, Arouh became subject to statutory disqualification under the Securities Exchange Act of 1934 and FINRA's By-Laws.[31] As a statutorily disqualified person, Arouh became ineligible to associate with a FINRA member firm without FINRA's consent.[32] FINRA denied Raymond James's application, finding that Arouh committed intervening misconduct by associating with two broker-dealers while the Bar Order was in effect and that the Firm's proposed supervisory plan was inadequate. We consider each of these findings in turn.

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28 15 U.S.C. § 78s(f).

29 *Id.*; *see, e.g.*, *Frank Kufrovich*, 55 S.E.C. 616, 623 (2002); *William J. Haberman*, 53 S.E.C. 1024, 1027 (1998), *aff'd*, 205 F.3d 1345 (8th Cir. 2000) (Table). Even if these criteria were satisfied, however, Section 19(f) would require us to sustain the appeal if we found that FINRA's action imposed an undue burden on competition. 15 U.S.C. § 78s(f). Arouh does not claim, and the record does not support a finding, that FINRA's actions imposed such a burden.

30 *E.g.*, *Gershon Tannenbaum*, 50 S.E.C. 1138, 1140 (1992); *M.J. Coen*, 47 S.E.C. 558, 561 (1981).

31 *See* Exchange Act Section 3(a)(39)(A), 15 U.S.C. § 78c(a)(39)(A); FINRA By-Laws, Art. III, § 4.

32 FINRA By-Laws, Art. III, § 3(d).

1. Intervening Misconduct

Arouh does not dispute, as FINRA found, (1) that Arouh was subject to a Commission order that barred him from associating with any broker or dealer, subject to a right to reapply after two years; (2) that the Bar Order became final after Arouh's motion to reconsider was denied on February 25, 2005; (3) that Arouh became subject to statutory disqualification as a result of the bar; and (4) that Arouh provided services to STG pursuant to the Consulting Agreements while the Bar Order was in effect. Arouh does, however, dispute FINRA's finding that by providing these services, he became associated with STG within the meaning of Exchange Act Section 3(a)(18) or under the FINRA By-Laws.[33] After reviewing the record in this matter, we find that Arouh was associated with STG because he acted as a principal while subject to the Bar Order.

All persons engaged in the investment banking or securities business of FINRA member firms who are to function as principals are required to register[34] and are considered associated persons.[35] Individuals who "are actively engaged in the management of the member's investment banking or securities business, including supervision, solicitation, conduct of business or the training of persons associated with a member for any of these functions," are principals, whatever their title may be.[36]

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[33] Arouh does not dispute that, if he willfully associated with STG, this association violated the Bar Order.

[34] NASD Rule 1021(a).

[35] NASD Notice to Members 05-48 (July 2005) ("[I]n general, parties conducting activities or functions that require registration under NASD rules will be considered associated persons of the member."). Such parties are not considered associated persons if the service provider is separately registered as a broker-dealer and the arrangements in question are contemplated by NASD rules, Municipal Securities Rulemaking Board rules, or applicable federal securities laws or regulations, *id.*, but Arouh does not contend, and the record does not show, that this exception applies to him.

[36] *See, e.g., Dennis Todd Lloyd Gordon*, Exchange Act Rel. No. 37655 (Apr. 11, 2008), 93 SEC Docket 5089, 5100-01 (finding that individual who, "although not holding an official managerial title [at the firm], nonetheless filled a management role" was required to register as a principal); *Richard F. Kresge*, Exchange Act Rel. No. 55988 (June 29, 2007), 90 SEC Docket 3072, 3092-93 (finding that individual who held no official managerial title, but who was "actively engaged in the management" of the firm's securities business, should have been registered as a principal); *Kirk A. Knapp*, 51 S.E.C. 115, 129 (1992) (finding that individual who "exercis[ed] or attempt[ed] to exercise managerial control" over firm's affairs was acting as a principal although he no longer held the title of president or director); *Samuel A. Sardinia*, 46

(continued...)

Hired at a time when STG had only five employees, Arouh took the lead in developing STG's bond business. He was effectively the head of the bond group, as well as its public face. Arouh repeatedly explained the anticipated business of STG's bond group to third parties because he "knew about that more than [Weiner or Budner] did." Arouh successfully recruited three bond traders for STG. Once the traders were on board, Arouh kept in close contact with them, talking to them "all the time" and functioning as an intermediary to bring their concerns to the attention of STG's management. He admitted that the traders' "success" would affect his compensation. Arouh's leadership in this important area of STG's business is persuasive evidence that he was acting as a principal.[37]

Beyond his position at the forefront of STG's bond business, Arouh was extensively involved in STG's management generally. Arouh testified that "[b]usiness development was the most important function I had . . . from the equity side, from the bond side, [and] from the investment banking side." He participated in key committees; reviewed STG's business plan; discussed strategy, office morale, profitability, and business expansion with STG management; and tried to resolve problems STG was having with a market maker. STG sought Arouh's input about the firm's structure and staffing, and Arouh responded by advising STG about positions to fill and the distribution of responsibilities. He helped recruit a branch manager for STG's equity business and interviewed salespeople in connection with a possible acquisition, making recommendations about whether they should be hired. STG's compliance officer asked Arouh to attend meetings and to provide input on compliance-related matters, and he involved Arouh in efforts to retain a consultant to prepare a compliance manual. Arouh's involvement in organizing the firm's affairs, planning for its future, and dealing with personnel matters further manifests the active engagement in firm management that defines a principal.[38]

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[36] (...continued)
S.E.C. 337, 343 (1976) (finding that individual who "actively participated in management decisions" was a principal even after he gave up titles of president and director).

[37] *Cf. Kresge*, 90 SEC Docket at 3091-92 (finding that individual who initiated contact about and negotiated terms of opening a branch office, was often present at the branch office, played a substantial role in the finances of the branch office, was actively involved in hiring personnel for the branch office, participated in meetings at the branch office, and acted as a leader of the personnel who initially opened the branch office, was acting as a principal).

[38] *See, e.g.*, *Gordon*, 93 SEC Docket at 5100-02 (finding that individual who, among other things, "devoted a substantial amount of time and attention" to firm, took responsibility "for a wide range of issues related to the conduct of [the firm's] business and the tenure and conduct of its employees," sought to open branch offices and recruit individual brokers, and interviewed potential candidates was a principal); *Kresge*, 90 SEC Docket at 3092-93 (finding that individual who, among other things, "often was present" in the office, "made himself present" during compliance meetings, and was actively involved in hiring branch manager and registered

(continued...)

Arouh was strongly identified with STG, both in his own mind and in the perceptions of third parties. He traveled on STG's behalf with varied goals: interviewing potential hires, explaining STG's bond business, and assisting Weiner in his efforts to borrow money. A potential customer of STG viewed Weiner, Budner, and Arouh as equally suited to discussing STG's business. Arouh was introduced as "a consultant to STG but more a partner" in the firm, and his use of "we" in referring to STG indicates an alignment of interest with the firm. Arouh worked in what was effectively an STG office suite, so close to STG employees that he could overhear them talking and call out questions to them. STG provided his office space and related amenities.[39] These indicia of identification with STG also support our determination that Arouh acted as a principal.[40]

Arouh argues that he did not act as a principal, rephrasing his contention that he was not actively involved in STG's securities business in several ways. For example, Arouh asserts that he was not involved in the day-to-day conduct of STG's securities business and the implementation of corporate policies that relate to that business. We find, however, as set forth in detail above, that he was quite engaged with the day-to-day management of STG's business. Arouh also argues that his participation in STG meetings and committees does not warrant a finding that he associated with the firm, relying on NASD Notice to Members 99-49, which states that "[a]n outside director's participation in board and committee meetings, during which corporate policies may be developed or adopted, would not by itself rise to the level of being actively engaged in a [firm's] management."[41] But Arouh did far more than just attend meetings, and our determination that he acted as a principal is based on his entire course of conduct. Additionally, Arouh contends

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38 (...continued)
representatives was a principal); *Sardinia*, 46 S.E.C. at 343 (finding that individual who, among other things, spent a "substantial amount of time in connection with the affairs of the firm" and "actively participated in management decisions to an extent clearly exceeding that of a mere accountant," was a principal); *cf. Juan Carlos Schidlowski*, 48 S.E.C. 507, 510 (1986) (finding that individual who was given "very broad responsibility," including setting up and helping to administer firms' accounting, operations, and bond departments, firm's financial reporting, and firm's liaison with NASD and Commission, was a principal).

39 FINRA did not credit Arouh's assertions that he effectively paid rent for his office space because STG's payments on the lease were part of his agreed-upon compensation. No documentary evidence supports Arouh's assertion, which we also reject.

40 *See Gordon*, 93 SEC Docket at 5101 (finding that (1) speaking of firm's actions in terms of what "we" had done and (2) having third parties view individual as in a position to act for the firm provided additional evidence of principal status); *Sardinia*, 46 S.E.C. at 342 (occupying office in firm's suite and paying no rent because rent was offset against commissions generated by securities activities supported determination that individual was a principal).

41 NASD Notice to Members 99-49, 1999 NASD LEXIS 24, at *2 (June 1999).

that he "never participated in the activities of STG's trading desk, never placed any trades, recommended trades or solicited trades[,] . . . never reviewed STG's trading records, order tickets, or any other record that reflected STG's trading activity." But individuals who do not perform the trading-related tasks Arouh enumerates may still be required to register as principals.[42] Thus, we find that none of these arguments relieves Arouh of the obligation to register as a principal.

Arouh further argues that he was not a principal because he did not control STG within the meaning of Exchange Act Section 3(a)(18). He argues that he could merely advise and consult on firm business, not direct or cause the direction of STG's management or policies, and that STG management was free to accept or reject his advice. We have held, however, that "the fact that one is consulted about firm affairs may 'illustrate[] . . . influence in the management of the firm whether or not the views articulated prevail.'"[43] With respect to STG's bond business in particular, Weiner and Budner had strong incentives to follow Arouh's guidance, because Arouh, in his own assessment, "knew more about the business than [they] did."

Arouh argues that he was not a principal because he did not fall into one of the five categories enumerated in NASD Rule 1021(b) (sole proprietors, officers, partners, managers of offices of supervisory jurisdiction, and directors of corporations). He argues that he avoided the requirement to register as a principal by styling himself as a consultant or independent contractor. He further argues that, under Florida law, he was not a partner in STG because the record does not show that he agreed to share in STG's losses.

We reject these related arguments. The decisive factor is what Arouh did for STG, i.e., actively engaged in the management of its securities business, not what he was called.[44] FINRA has informed its members that "[a] registration determination does not depend on the individual's title, but rather on the functions that he or she performs."[45] Arouh's acknowledgment that he was "more a partner" than a consultant reflects the closeness of Arouh's affiliation with STG, whether

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[42] *Cf. Gordon*, 93 SEC Docket at 5101 (rejecting argument that "functions not involved in the chain of the securities transaction do not require registration as a principal").

[43] *Gordon*, 93 SEC Docket at 5102 (quoting *Sardinia*, 46 S.E.C. at 343).

[44] *See supra* note 36; *see also, e.g., Books & Records Requirements for Brokers & Dealers Under the Securities Exchange Act of 1934*, Exchange Act Rel. No. 44992 (Nov. 2, 2001), 76 SEC Docket 433, 435 ("The Commission interprets the term associated person to include any independent contractor, consultant, franchisee, or other person providing services to a broker-dealer equivalent to those services provided by the persons specifically referenced in the statute." (footnote omitted)).

[45] NASD Notice to Members 99-49, 1999 NASD LEXIS 24, at *4.

or not he met the legal definition of a partner, and in any event, our determination that Arouh acted as a principal of STG is not based on a finding that he was a partner in STG.

Arouh argues that he maintained a distinction between his office and STG's offices; he occupied Suite 120, but STG occupied Suite 150.[46] But STG bond traders sat so close to Arouh that he could listen to them and exchange comments with them. In any event, the sharing of office space and the subsidy of Arouh's office space and related expenses by STG are only two of many factors that contribute to our determination that Arouh was required to register as a principal.[47]

We find that FINRA correctly concluded that Arouh acted as a principal of STG and therefore was associated with STG within the meaning of Exchange Act Section 3(a)(18) and FINRA By-Laws while the Bar Order was in effect.[48]

2. Supervisory Plan

We now turn our attention to Raymond James's proposed supervisory plan. Much of what the plan required is no different from the supervision the Firm afforded to all employees: review and approval of new account agreements, daily transactions with customers, daily cancels and corrects, incoming or outgoing hard copy correspondence, and emails to and from Arouh. The inclusion of these elements in the plan does not indicate the "stringent supervision" required when a firm employees a statutorily disqualified individual.[49] Additionally, the plan lacks detail: it does not explain how Specht would conduct his reviews, or what records would be kept of them. Nor

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[46] Arouh also asserts that he and STG did not share telephone lines.

[47] *Cf. Gordon*, 93 SEC Docket at 5102 (noting that Commission bases determination that registration as a principal is required on "all of the relevant facts and circumstances," and finding that a combination of functions may require that someone register as a principal, even if none of the functions, viewed in isolation, would have done so). Because our analysis depends on all the facts and circumstances, the absence of various factors found to support a determination that an individual acted as a principal in other cases does not preclude our finding that Arouh acted as a principal with respect to STG.

[48] Because Arouh's status as a principal establishes that he was an associated person, we need not address whether the record additionally shows that Arouh was an associated person either because he expected to receive transaction-based compensation or because he served as an intermediary in STG's potential acquisition of another broker-dealer. *See supra* note 27.

[49] *See, e.g.*, *Haberman*, 53 S.E.C. at 1031 ("We require . . . stringent supervision for a person subject to a statutory disqualification."); *Kufrovich*, 55 S.E.C at 629 (rejecting a proposed supervisory plan as lacking "a key component – stringent supervision").

does it explain how Specht would handle customer complaints, or what he would do if he detected exceptions.

The plan is further flawed because it lacks adequate provisions about supervision while either Arouh or Specht is traveling. It makes no special provisions for Arouh's supervision when he is away from the office and neither Specht, nor Sickling, nor Hoskin is able to hear his conversations or keep an eye on him. Although Specht testified that either Sickling or Hoskin was "generally" in the office when Specht was away, the plan does not say how supervisory responsibilities are to be allocated as between Sickling and Hoskin, nor does it say who is to assume supervisory responsibility if both Sickling and Hoskin are away. Moreover, although Hoskin would not be sitting on the trading floor with Arouh as Specht or Sickling would, the plan does not provide additional measures to compensate for this lack of proximity. The plan thus lacks sufficient elements and detail to demonstrate that the Firm would prevent and detect possible misconduct by Arouh.

Because of the seriousness of Arouh's intervening misconduct and the deficiencies in Raymond James's supervisory plan, we find that the grounds on which FINRA based its decision to deny the membership continuation application exist in fact.

B. Whether FINRA's Denial of the Application Was in Accordance with Its Rules

We also find that FINRA's denial of the application was in accordance with FINRA's rules, which provide for the denial of a firm's application to continue in membership if the firm employs a statutorily disqualified person. FINRA conducted an eligibility hearing in accordance with its rules, during which it afforded Arouh and the Firm an opportunity to be heard.[50]

Arouh argues that Member Regulation raised the argument that his relationship with STG constituted intervening misconduct that would warrant denial of the application for the first time at the hearing, and that Arouh was severely prejudiced because he had no opportunity to prepare a defense. Member Regulation briefly described Arouh's relationship with STG in its recommendation regarding the application, which was sent to Arouh's counsel several weeks before the hearing, although at that time it characterized the relationship as an aggravating

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[50] *See* FINRA By-Laws, Art. 3, § 3(d) (stating that FINRA "may conduct such inquiry or investigation into the relevant facts and circumstances as it, in its discretion, considers necessary to its determination" of whether to approve a membership continuation application); *see also* FINRA Code of Procedure, Rules 9520-25 (setting forth parameters of eligibility proceedings).

FINRA is in the process of developing a collection of consolidated rules. The first phase of these consolidated rules became effective on December 15, 2008. *See FINRA Regulatory Notice 08-57* (Oct. 2008). Because Raymond James filed its application before December 15, 2008, however, the NASD Rule 9520 series was applicable.

circumstance rather than intervening misconduct.[51] After the hearing, the panel asked the parties to supplement the record (1) by filing documentary evidence "demonstrating the specific timing" of any payments by STG to the Companies pursuant to the Consulting Agreements, (2) by clarifying, "with declarations, documentary evidence, stipulations, and/or citations to the record," when Arouh began and ceased providing services to STG, and (3) by filing briefs that addressed the question "whether Arouh was an 'associated person' of STG . . . and therefore violated the SEC's December 20, 2004 order," with particular respect to "the conduct of Arouh and the provisions of the Consulting Agreements that governed the compensatory structure of that relationship." In response, Arouh submitted an affidavit and documentary evidence pertaining to the timing of consulting services provided to STG and the receipt of payments from STG. He also submitted a brief arguing that the services he provided pursuant to the Consulting Agreements did not render him an "associated person" of STG. Under the circumstances, we find that the panel gave Arouh the opportunity to prepare a defense to the intervening misconduct allegation and that Arouh was not prejudiced.

Arouh argues that certain documents introduced by Member Regulation as attachments to a post-hearing brief are "nothing more than hearsay and statements of third parties."[52] We have repeatedly held, however, that hearsay is admissible in administrative proceedings, and we evaluate such evidence based on its probative value, its reliability, and the fairness of its use.[53] Although Arouh broadly objects that the documents are hearsay, he makes no specific arguments as to their reliability or probative value. Because Member Regulation submitted the documents after the hearing, the panel gave Arouh an opportunity to submit a declaration addressing issues

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[51] In its recommendation, Member Regulation identified as intervening misconduct only Arouh's failure to comply with the Commission's December 20, 2004 order to pay a $110,000 civil penalty until January 2007, after the Commission had filed a complaint seeking an order requiring Arouh to comply. FINRA did not base its decision as to the Application on this ground.

[52] These include an assortment of STG internal e-mails, the personal compliance log of STG's compliance officer for the period from February 14, 2005 to March 28, 2005, and a memorandum from STG's compliance officer to "All Committee Members."

[53] *E.g., Harry Gliksman*, 54 S.E.C. 471, 480 (1999), *aff'd*, 24 Fed. App'x 702 (9th Cir. 2001) (unpublished).

raised by the documents, and he in fact submitted such a declaration.[54] For these reasons, we reject Arouh's argument that the documents should not be considered.

Arouh also argues that Member Regulation acted unfairly in introducing, as an attachment to its post-hearing brief, a transcript of his off-the-record ("OTR") testimony taken in 2005. FINRA staff took Arouh's testimony in connection with NASD's 2005 investigation of STG, and Arouh had not previously reviewed it. Under NASD rules, witnesses such as Arouh do not routinely receive transcripts of their testimony, although they may do so upon written request of counsel, unless there is good cause to deny the request.[55] Arouh does not argue, and the record does not show, that his counsel submitted a request for the transcript. Moreover, the hearing panel allowed Arouh to address issues raised by the transcript by either seeking to re-open the hearing or (as he chose) by submitting declaration. Under these circumstances, we reject his argument that the use of the transcript is unfair.[56]

C. Whether FINRA's Rules Are, and Were Applied in a Manner Consistent with, the Exchange Act

Under the Exchange Act, FINRA may deny a firm's application for continuation in membership if it determines that the association of the statutorily disqualified person would be inconsistent with the public interest and the protection of investors.[57] For FINRA's denial of an

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[54] Arouh had objected to Member Regulation's submission of these materials after the hearing, arguing that "[i]ntroducing these Exhibits this late in the proceedings evidences either Member Reg's intent to unfairly surprise Arouh and thereby deprive him of his right to present a defense or indicates Member Reg's failure to conduct a diligent inquiry into the evidence they intended to use." The hearing panel stated that it was "troubled by Member Regulation's post-hearing submission of exhibits," but it denied Arouh's motion to strike the exhibits, stating that "[i]nclusion, rather than exclusion, of all relevant evidence is preferred, and it is clear that the newly proposed evidence may have some relevance to the 'associated person' issue." In order to ensure fairness, however, the hearing panel allowed Arouh to either file a motion for an additional hearing, or serve documentary evidence, including declarations, on Member Regulation and FINRA's Office of General Counsel. Arouh chose to submit the declaration.

[55] NASD Rule 8410(f). Rule 8410, like NASD's Rule 9520 series, became part of the FINRA consolidated rulebook after Raymond James filed its application. *See supra* note 50 (discussing development of consolidated rules).

[56] We also note that Arouh relies on the transcript in his briefs to the Commission.

[57] Section 15A(g)(2) of the Exchange Act, 15 U.S.C. §78*o*-3(g)(2); *see also* FINRA By-Laws, Art. 3, § 3(d) (providing that FINRA Board may approve continuation in membership (continued...)

application to be consistent with the Exchange Act, FINRA must "'independently [evaluate the] application, based upon the totality of the circumstances, and . . . explain the bases for its conclusion.'"[58] In cases like Arouh's, where a statutorily disqualified person has applied for permission to associate after a sanction of specified duration has run its course, we have held that it would be inconsistent with the remedial purposes of the Exchange Act and unfair to deny the application solely on the basis of the misconduct that led to the original sanction.[59] The application may be denied, however, if there is new information "reflecting adversely on [the applicant's] ability to function in his proposed employment in a manner consonant with the public interest."[60]

FINRA based its denial of the application on new information – Arouh's association with STG in violation of the Bar Order. FINRA found that Arouh's association with STG was "a serious, and possibly egregious, violation that shows that he remains a serious threat to the public and the markets, and warrants the denial of [the] application." FINRA based this conclusion on its findings that Arouh acted recklessly by seeking to remain involved in the securities industry while the Bar Order was in effect, that his misconduct continued for approximately two months, and that his association with STG resulted in at least $75,000 in monetary gain, with the potential for more. FINRA also found Raymond James's supervisory plan inadequate because it lacked sufficient detail to ensure that the Firm would prevent and detect possible misconduct by Arouh.

We have consistently recognized that, in order to ensure protection of investors, a self-regulatory organization ("SRO") such as FINRA "may demand a high level of integrity from securities professionals."[61] We have also afforded FINRA discretion in determining whether persons subject to statutory disqualification should be permitted to associate with a member firm.[62] As we have previously stated, we consider violation of a bar order very serious

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57 (...continued)
if Board determines that such approval is consistent with public interest and protection of investors); *cf. Haberman*, 53 S.E.C. at 1027 n.7 ("NASD may, in its discretion, approve association with a statutorily disqualified person only if the NASD determines that such approval is consistent with the public interest and the protection of investors.").

58 *Timothy P. Pedregon*, Exchange Act Rel. No. 61791 (Mar. 26, 2010), 98 SEC Docket 26802, 26811 (quoting *Kufrovich*, 55 S.E.C. at 625).

59 *Paul Edward van Dusen*, 47 S.E.C. 668, 671 (1981).

60 *Id.*

61 *Kufrovich*, 55 S.E.C. at 627.

62 *E.g.*, *Am. Inv. Servs.*, 54 S.E.C. 1265, 1271 & n.16 (2001); *Halpert & Co.*, 50
(continued...)

misconduct.[63] We agree with FINRA that the seriousness of Arouh's misconduct militates against allowing the Application.

We also find that the deficiencies in Raymond James's supervisory plan counsel against allowing the Application. In many respects, the plan simply describes the Firm's normal supervisory procedures. It lacks details as to how even those procedures would be implemented. Moreover, the lack of specific supervisory coverage when Specht or Arouh is out of the office is a serious flaw. As we have previously recognized, "a supervisory plan lacks the necessary intensive scrutiny when the supervisor will not be in close, physical proximity to the statutorily disqualified person."[64] We therefore find that, in denying the Application, FINRA applied its rules in a manner consistent with the Exchange Act.

Arouh argues that even if he was associated with STG, his actions did not violate Section 15(b)(6) of the Exchange Act because his conduct was not willful. It is well established that a person acted "willfully" within the meaning of Section 15(b)(6) if he or she intended to commit the act that constituted the violation, whether or not he or she intended to violate the securities laws.[65] Arouh does not deny that he intended to perform the services for STG described above, and thus we find his conduct to be willful.

Arouh contends that he "conducted a reasonable and diligent investigation into the scope of the Bar Order" and "conducted a reasonable inquiry and relied on the advice of counsel." He argues that this reliance constitutes at least a mitigating, if not an exonerating, factor.

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62 (...continued)
S.E.C. 420, 422 (1990).

63 *Kirk A. Knapp*, 50 S.E.C. 858, 864 (1992) (finding that majority owner of an NASD member firm engaged in "very serious misconduct" when he, among other things, "flouted the NASD's bar by exercising a managerial role in the firm"); *cf. David C. Ho*, Exchange Act Rel. No. 54481 (Sept. 22, 2006), 88 SEC Docket 3194, 3203 (affirming sanctions imposed by Chicago Board Options Exchange, Inc. ("CBOE"), in part because of individual's "disregard for CBOE's disciplinary authority in violating his suspension").

64 *Timothy H. Emerson, Jr.*, Exchange Act Rel. No. 60328 (July 17, 2009), 96 SEC Docket 18882, 18890; *see also Kufrovich*, 55 S.E.C. at 628-29 (finding supervisory plan inadequate where, among other factors, supervisor would not be physically present in close proximity to statutorily disqualified individual during all working days); *Haberman*, 53 S.E.C. at 1031-32 (finding supervisory plan inadequate where, among other factors, supervisor's travel schedule and firm's usual way of conducting business would result in insufficient contact between supervisor and statutorily disqualified individual).

65 *See, e.g., John D. Audifferen*, Exchange Act Rel. No. 58230 (July 25, 2008), 93 SEC Docket 8129, 8138; *Wonsover v. SEC*, 205 F.3d 408, 413 (D.C. Cir. 2000).

In the context of disciplinary proceedings, we have held that to successfully assert reliance on the advice of counsel, a respondent must establish "that the respondent made full disclosure to counsel, appropriately sought to obtain relevant legal advice, obtained it, and then reasonably relied on the advice."[66] The advice must be based on full and complete disclosure,[67] and the respondent asserting reliance must produce "'actual advice from an actual lawyer.'"[68] Applying these standards, we find that Arouh failed to establish reasonable reliance on competent legal advice.

Arouh asked counsel for an opinion about "the scope of his future permissible activities in the event the Commission refused to consider its decision" in or around early January 2005, while he was still associated with Raymond James.[69] The attorney informed Arouh orally about his findings. However, there is not enough evidence about either the disclosure Arouh made, or the oral advice he obtained, to establish that Arouh relied on that advice.

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[66] *Howard Brett Berger*, Exchange Act Rel. No. 58950 (Nov. 14, 2008), 94 SEC Docket 11615, 11630.

[67] *Id.*; *see also Hal S. Herman*, 55 S.E.C. 395, 403 (2001) (finding no reliance on advice of counsel where respondent could not establish that he made full disclosure to counsel); *accord Dolphin & Bradbury, Inc. v. SEC*, 512 F.3d 634, 642 (D.C. Cir. 2008) ("'Reliance on advice of counsel will not be available to the defendant if he failed to disclose all relevant facts to the attorney.'") (quoting Douglas W. Hawes & Thomas J. Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases,* 62 Va. L. Rev. 1, 29 (1976)).

[68] *Berger*, 94 SEC Docket at 11631 (quoting *SEC v. McNamee*, 481 F.3d 451, 456 (7th Cir. 2007); *accord Eugene T. Ichinose*, 47 S.E.C. 393, 395 (1980) (finding that respondent could not rely on advice of counsel where record did not "show with any specificity what advice he may have received" from counsel).

[69] Arouh seeks to introduce new evidence in the form of law firm billing records for January 2005, with an accompanying sworn statement of counsel. The billing records show that Arouh's attorney spent one hour on "[a]nalysis of consulting agreements" on January 21, 2005 and one hour on "[r]eceipt and review and analysis of contracts review of comments from STG's counsel" on January 27, 2005. The billing records do not show what Arouh told counsel or what advice counsel gave to Arouh.

Rule 452 of our Rules of Practice, 17 C.F.R. § 201.452, allows us to accept additional evidence if (1) it is material and (2) there were reasonable grounds for failure to adduced such evidence previously. We find that Arouh did not have reasonable grounds for having failed to introduce this evidence at an earlier stage of this proceeding, but we nevertheless admit it as an exercise of discretion.

Nor do the letters from counsel dated March 28 and April 4, 2005 prove that Arouh reasonably relied on advice of counsel. First, the letters were written after Arouh had been providing services to STG for more than a month.[70] They do not establish that Arouh reasonably relied on the advice of counsel during the period before they were written. In addition, neither letter shows that Arouh completely disclosed to counsel the services he provided to STG. The March 28 letter mentions only the provision of "recruitment and/or training services for broker/dealer salespersons," services that Arouh was to provide pursuant to the Consulting Agreement with STG Inc. The letter is silent as to the broader array of management consulting, investment advisory, and asset management services enumerated in the Consulting Agreement with STG LLC. The April 4 letter contains a more expansive list of services that might be permitted, stating that "providing consulting services – for example, with regard to mergers and acquisitions, strategic alliances and growth planning," did not appear to involve "association" within the meaning of Section 3(a)(18),[71] but it does not indicate that Arouh disclosed the full extent of his contemplated activity. Neither letter indicates that Arouh disclosed to counsel the services he had already provided to STG; neither letter mentions the Consulting Agreements.

Both the March 28 letter and the April 4 letter advised Arouh that some activities might be permissible. However, each letter cautioned Arouh that the letter contained only a "broad overview of the limitations imposed by the Bar Order, and possible opportunities for your engagement with STG," and warned that Arouh should not simply rely on the letter without further inquiry:

> [T]he lack of clarity in the statutes and case law on this subject does not allow us to provide you with definitive advice on most points. Therefore, it is very important that you consult with us prior to engaging in any activity (other than those specifically discussed

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[70] Although the log maintained by STG's compliance officer shows that, as of February 24, 2005, Weiner "claim[ed] to have gotten three opinions" stating that Arouh's relationship with STG was "compliant," none of these are in the record, and as of March 18, 2005, the compliance officer had still not seen any of them.

A January 30, 2008 letter to a FINRA Deputy Regional Chief Counsel stated that Arouh's attorney prepared the March 28, 2005 letter in response to Arouh's request that he document his oral advice. To the extent the March 28, 2005 letter reflects the advice Arouh received in January 2005, that advice was not specific enough for Arouh reasonably to rely on it going forward with the services he provided to STG, as discussed below.

[71] Both letters provided advice as to activities that Arouh should avoid; the April 4 letter also provided a list of activities that Arouh was "clearly not permitted to engage in."

above) that may be construed as involving association with broker/dealers so that we can re-examine the authorities in light of specific proposed fact situations.[72]

Arouh failed to show that he brought such specific fact situations to the attention of counsel, or received advice that his involvement in those situations would not constitute association. In light of these facts, we find that Arouh could not have reasonably relied on the advice of counsel when he provided the services at issue to STG.

Arouh argues that, by his attorney's letter of April 11, 2005, he disclosed his activities in connection with STG to FINRA's predecessor, NASD, and that he thereafter reasonably relied on the lack of any response in assuming that NASD found his activities unobjectionable. "We have repeatedly held that members and their associated persons 'cannot shift their burden of compliance to the NASD.'"[73] Moreover, the letter notifying NASD of Arouh's involvement with STG was written only a few weeks before the end of the two-month period at issue. Arouh's alleged reliance on the lack of a response could have no bearing on his conduct between February 25 and April 11. Additionally, the April 11 letter contains only general descriptions of Arouh's activities: it does not mention his leadership in developing STG's fixed income business, his recruitment of traders, his travel on behalf of STG, or his interviewing of and recommendations about potential new hires and acquisition targets. Any implicit approval would therefore have been too general to establish that FINRA had no objection to Arouh's conduct.

* * *

We find that FINRA's basis for denying Raymond James's application to continue in membership with Arouh as Senior Vice President, Taxable Fixed Income Sales, exists in fact, and

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[72] The quoted passage is from the April 4 letter; the language in the March 28 letter is similar.

[73] *Hans Beerbaum*, Exchange Act Rel. No. 55731 (May 9, 2007), 90 SEC Docket 1863, 1871 n.22 (quoting *B.R. Stickle & Co.*, 51 S.E.C. 1022, 1025 (1994)); *see also, e.g., Kirk A. Knapp*, 50 S.E.C. at 862 n.15 (holding that president of brokerage firm "cannot shift his responsibility for compliance with regulatory requirements to . . . the NASD" (citing *Steven C. Pruette*, 46 S.E.C. 1138, 1141 (1978))); *cf. Apex Fin. Corp.*, 47 S.E.C. 265, 267 (1980) (holding that broker-dealer "cannot shift its responsibility for compliance . . . to regulatory authorities" (citations omitted)).

In February 2008, in response to an inquiry from Arouh's counsel, FINRA's Department of Enforcement advised that it would not take any action against Arouh at that time for his 2005 conduct with respect to STG. That decision was an exercise of prosecutorial discretion and did not constitute a determination as to whether Arouh was associated with STG in 2005 while the Bar Order was in effect or whether any subsequent attempt to associate with a member firm was in the public interest.

that FINRA acted fairly and in accordance with its rules, which are and were applied in a manner consistent with the purposes of the Exchange Act.[74] Arouh engaged in serious intervening misconduct by associating with STG while the Bar Order was in effect. Faced with a Commission order intended to protect the investing public and the markets, Arouh sought to avoid its impact by styling himself as a "consultant," avoiding the formal titles that would have marked him as a principal. He actively involved himself in the management of STG, hoping to match the remuneration he had enjoyed in prior positions in the securities industry and to someday acquire an ownership interest in STG's holding company. He received a $75,000 signing bonus, and he maintained the relationship with STG for approximately two months, abandoning it only when he was not paid as promised. By disregarding the terms of the Bar Order, Arouh put his personal interests above those of the investing public.

We find that Raymond James's proposed supervisory plan was inadequate because it lacked sufficient elements and details to ensure that the Firm would prevent and detect possible misconduct by Arouh. The plan contains few details about the proposed reviews, and it fails to provide adequately for in-person supervision of Arouh when either Arouh or Specht is traveling.

For these reasons, we conclude that Arouh's proposed association with Raymond James would pose an unreasonable risk of harm to investors and the markets. We further conclude that Arouh has not established that it is in the public interest to permit his re-entry into the securities industry as Senior Vice President, Fixed Income Sales at Raymond James. We therefore dismiss this review proceeding. An appropriate order will issue.[75]

By the Commission (Commissioners CASEY, WALTER, AGUILAR and PAREDES); Chairman SHAPIRO not participating.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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[74] We also find that FINRA's action imposed no undue burden on competition. *See supra* note 29 and accompanying text (discussing requirements of Exchange Act Section 19(f), 15 U.S.C. § 78s(f)).

[75] We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 62898 / September 13, 2010

Admin. Proc. File No. 3-13701

In the Matter of the Application of

LESLIE A. AROUH

For Review of Action Taken by the

Financial Industry Regulatory Authority, Inc.

ORDER DISMISSING REVIEW PROCEEDING

On the basis of the Commission's opinion issued this day, it is

ORDERED that the application for review filed by Leslie A. Arouh be, and it hereby is, dismissed.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro not participating

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 62894 / September 13, 2010

Admin. Proc. File No. 3-13782

In the Matter of the Application of

WIND ENERGY AMERICA INC.
c/o Robert O. Knutson
Wind Energy America Inc.
9372 Creekwood Dr.
Eden Prairie, Minnesota 55347

For Review of Action Taken by

Financial Industry Regulatory Authority, Inc.

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION – REMOVAL FROM QUOTATION ON THE OTC BULLETIN BOARD

Failure to Meet Continued Quotation Requirements

Registered securities association removed issuer's securities from quotation because the issuer failed to timely file a required annual or quarterly report three times within two years. *Held*, the application for review is *dismissed*.

APPEARANCES:

Robert O. Knutson, for Wind Energy America Inc.

Marc Menchel, *Alan Lawhead*, *Gary J. Dernelle*, and *Andrew J. Love*, for Financial Industry Regulatory Authority, Inc.

Appeal filed: February 16, 2010
Last brief received: June 1, 2010

37 of 82

I.

Wind Energy America Inc. ("Wind Energy" or the "Company"), an issuer formerly quoted on the OTC Bulletin Board Service ("OTCBB"),[1] appeals the decision of Financial Industry Regulatory Authority, Inc. ("FINRA") to remove Wind Energy's securities from quotation on the OTCBB. FINRA determined that Wind Energy's securities were ineligible for OTCBB quotation pursuant to FINRA OTC Bulletin Board Service Rule 6530 ("Rule 6530") because the Company failed to timely file a required annual or quarterly report three times in two years.[2] We base our findings on an independent review of the record.

II.

The facts are largely undisputed. Wind Energy is a Minnesota-based corporation that focuses on developing wind energy production. Wind Energy's common stock is registered with the Commission under Section 12(g) of the Securities Exchange Act of 1934.[3] Exchange Act Section 13(a) requires every issuer of a security registered pursuant to Section 12 to file periodic and other reports with the Commission containing such information as the Commission's rules prescribe.[4] Pursuant to Exchange Act Section 13(a), the Commission has promulgated Rules 13a-1 and 13a-13, which require issuers to file annual and quarterly reports with the Commission.[5]

During the period at issue, Wind Energy's securities were quoted on the OTCBB. Under Rule 6530, OTCBB-quoted companies must timely file their annual and quarterly reports with the Commission as a condition of continued OTCBB quotation. Rule 6530(e) provides that an issuer that is delinquent in its reporting obligations three times during a two-year period will be denied OTCBB quotation for one year.

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[1] The OTCBB is an electronic quotation system that displays real-time quotes, last-sale prices, and volume information for many over-the-counter securities not listed on The Nasdaq Stock Market or a national securities exchange. U.S. Securities and Exchange Commission, OTC Bulletin Board (OTCBB), *available at* http://www.sec.gov/answers/otcbb.htm (last visited June 16, 2010).

[2] As part of the effort to consolidate and reorganize the rules of the National Association of Securities Dealers, Inc. ("NASD") and New York Stock Exchange ("NYSE") into one FINRA rulebook, NASD Rule 6530 (which is otherwise unchanged) is now codified as FINRA Rule 6530.

[3] 15 U.S.C. § 78*l*(g).

[4] 15 U.S.C. § 78m(a).

[5] 17 C.F.R. §§ 240.13a-1 and 13a-13; *see also Navistar Int'l Corp.*, Securities Exchange Act Rel. No. 56769 (Nov. 8, 2007), 91 SEC Docket 3131, 3132.

Wind Energy submitted its Form 10-Q quarterly report for the period ending March 31, 2008 (the "2008 quarterly report") pursuant to Exchange Act Rule 12b-25, which extends the filing deadline for a quarterly report to "no later than the fifth calendar day following the prescribed due date."[6] As a result, Wind Energy's 2008 quarterly report was due on May 20, 2008. Wind Energy electronically submitted the 2008 quarterly report to the Commission on May 20, 2008 at 6:26 p.m. Eastern Time. On May 28, 2008, FINRA OTCBB staff sent a delinquency notification to Wind Energy stating that Rule 13(a)[7] of Regulation S-T provides that electronic filings submitted after 5:30 p.m. Eastern Time shall be deemed filed as of the next business day. Because Wind Energy filed its report at 6:26 p.m. Eastern Time, the Commission deemed it filed on May 21, 2008, the day after it was due. The May 28, 2008 notification stated that Wind Energy filed the report late and warned that "[a]ny OTCBB issuer that is delinquent in its reporting obligations three times in a 24-month period . . . is ineligible for quotation on the OTCBB for a period of one year."

Wind Energy failed to file its Form 10-K annual report for the period ending June 30, 2008 (the "2008 annual report") with the Commission by the October 14, 2008 filing deadline. On October 15, 2008, FINRA OTCBB staff sent a delinquency notification to Wind Energy informing the Company of this second delinquency. The notification reminded Wind Energy of the possible consequences of delinquent reporting and stated that Wind Energy had been delinquent twice in the previous two years. Wind Energy eventually filed the 2008 annual report on November 4, 2008.

Wind Energy failed to file its Form 10-K annual report for the period ending June 30, 2009 (the "2009 annual report") with the Commission by the October 13, 2009 filing deadline. On October 14, 2009, FINRA OTCBB staff sent a notification to the Company pursuant to Rule 6530(f)(1) stating that the Company had been delinquent in its reporting obligations three times in the prior two years and that its securities would be removed from OTCBB quotation. The notification also informed Wind Energy that it could request a hearing to appeal the staff's determination of the delinquency.

On October 21, 2009, Wind Energy timely requested a hearing by the FINRA Office of Hearing Officers to appeal FINRA's determination that Wind Energy was not in compliance with Rule 6530(e). On November 16, 2009, a Hearing Officer conducted a telephonic hearing in which FINRA and Wind Energy participated. During the hearing, Wind Energy did not dispute that it filed the three reports at issue late, including the 2008 quarterly report. One day after the hearing, however, the Company filed a pleading titled "post-hearing motion for relief," claiming that it submitted the 2008 quarterly report on time. The Hearing Officer rejected the motion as untimely filed.

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[6] 17 C.F.R. § 240.12b-25.

[7] 17 C.F.R. § 232.13(a).

On January 4, 2010, the Hearing Officer issued her decision. Although the Hearing Officer had rejected Wind Energy's "post-hearing motion for relief" as untimely, she considered and rejected the Company's argument that it timely filed the 2008 quarterly report. The Hearing Officer determined that Wind Energy filed the 2008 quarterly report late based on the provisions of Rule 13(a) of Regulation S-T and therefore found "no dispute that [Wind Energy] ha[d] been delinquent in its reporting obligations three times in a 24-month period" in violation of Rule 6530(e). The Hearing Officer concluded that Wind Energy was ineligible for continued OTCBB quotation and ordered that the Company's securities be removed from the OTCBB. FINRA's National Adjudicatory Council ("NAC") Review Subcommittee did not call the Hearing Officer's decision for review.[8] This appeal followed.

III.

Our review of FINRA's removal of Wind Energy's securities from the OTCBB is governed by Exchange Act Section 19(f).[9] Under Section 19(f), we must dismiss Wind Energy's appeal if we determine that (1) the specific grounds on which the removal from the OTCBB is based exist in fact, (2) the removal is in accordance with the applicable FINRA rules, and (3) those rules are, and were applied in a manner, consistent with the purposes of the Exchange Act.[10] We believe that FINRA acted in accordance with Section 19(f) when it removed Wind Energy's securities from quotation on the OTCBB.

A. Specific Grounds Exist in Fact

Under Rule 6530, OTCBB-quoted companies must timely file their annual and quarterly reports with the Commission as a condition of continued OTCBB quotation. Rule 6530(e) provides that an issuer that is delinquent in its reporting obligations three times during a two-year period will be denied OTCBB quotation for one year. FINRA adopted Rule 6530(e) to address

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[8] FINRA Rule 9750 provides that, if the NAC Review Subcommittee does not call for further review of the matter, the Hearing Officer's decision shall constitute final FINRA action.

[9] 15 U.S.C. § 78s(f). Wind Energy has not alleged, and the record does not suggest, that FINRA's action "imposes any burden on competition not necessary or appropriate in furtherance of the purposes of" the Exchange Act. *See id.*

[10] *Id.*; *see also Navistar*, 91 SEC Docket at 3138; *Fog Cutter Capital Group, Inc.*, 58 S.E.C. 1049, 1056-57 (2005), *petition denied*, 474 F.3d 822 (D.C. Cir. 2007); *Outsource Int'l, Inc.*, 55 S.E.C. 382, 390-91 (2001).

high levels of non-compliance and recidivism with respect to filing requirements.[11] Rule 6530(e) is "designed to foster the timeliness of disclosures available to the public by OTCBB issuers" and properly includes measures to exclude those issuers that only "occasionally and inadvertently fail to comply with their reporting obligations."[12]

It is undisputed that Wind Energy failed to file timely the 2008 and 2009 annual reports. Wind Energy objects only to the finding that it did not timely file the 2008 quarterly report. The Company submitted the 2008 quarterly report pursuant to Exchange Act Rule 12b-25, which extends the filing deadline for a quarterly report to "no later than the fifth calendar day following the prescribed due date." Wind Energy contends that because it filed the report at 6:26 p.m. Eastern Time on May 20, 2008, the calendar day it was due under the Rule 12b-25 extension, the report was not late. The Company argues that FINRA erred when it found the 2008 quarterly report to be untimely filed under the terms of Regulation S-T and that in so doing, FINRA effectively altered the Commission's rules establishing periodic reporting deadlines.

Wind Energy argues that "FINRA cannot create or impose a different filing date requirement than that of the SEC," but Rule 13(a) of Regulation S-T, not a FINRA regulation, imposes the 5:30 p.m. Eastern Time filing deadline. Wind Energy was an electronic filer of its periodic reports and, therefore, was subject to the requirements of Regulation S-T. Rule 13(a) of Regulation S-T provides that all electronic filings submitted by direct transmission after 5:30 p.m. Eastern Time will be deemed filed as of the next business day.[13] Wind Energy submitted the 2008 quarterly report at 6:26 p.m. Eastern Time on May 20, 2008. Pursuant to Regulation S-T, the Commission therefore deemed the report filed as of May 21, 2008, rendering the filing one day late.

Contrary to Wind Energy's claim, the use of the phrase "calendar day" in Rule 12b-25 is meant to distinguish a calendar day from a business day for purposes of calculating the extended

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[11] *Order Approving Proposed Rule Change to Limit the Eligibility for Quotation on the OTCBB of the Securities of an Issuer That Is Repeatedly Delinquent in Its Periodic Reporting Obligations*, Exchange Act Rel. No. 52786 (Nov. 23, 2005), 70 Fed. Reg. 70907, 70909 ("Rule 6530 Order"). Nasdaq reported that it had identified over 3,000 instances of delinquent or otherwise incomplete filings by 1,806 OTCBB issuers. *Id.* at 70908.

[12] *Id.* at 70909.

[13] 17 C.F.R § 232.13(a). Similarly, the EDGAR Filer Manual provides, "If you begin direct transmission of a live submission after 5:30 p.m. Eastern time and the submission is accepted, it will have a filing date as of 6:00 a.m. the next business day." EDGAR Filer Manual, Volume II: "EDGAR Filing," Version 14 § 11.1 (April 2010), *available at* http://www.sec.gov/info/edgar/edgarfm-vol2-v14.pdf.

filing date permitted under the Rule, not to change the requirements of Regulation S-T.[14] As the preamble to Regulation 12B specifically states:

> This regulation should be read in conjunction with Regulation S-T . . . which governs the preparation and submission of documents in electronic format. Many provisions relating to the preparation and submission of documents in paper format contained in this regulation are superseded by the provisions of Regulation S-T for documents required to be filed in electronic format.[15]

On this basis, we find that Wind Energy was delinquent in filing the 2008 quarterly report. Therefore, the specific grounds exist in fact for FINRA to remove Wind Energy's securities from quotation on the OTCBB pursuant to Rule 6530(e).[16]

B. The Removal from the OTCBB Is in Accordance with FINRA Rules

We also find that FINRA's removal of Wind Energy's securities from the OTCBB is in accordance with FINRA rules. Rule 6530(e) prohibits a FINRA member from quoting a security when the issuer of that security has failed to timely file a complete required annual or quarterly report three times in two years. Wind Energy was delinquent in filing three periodic reports in two years. Thus, FINRA OTCBB staff properly concluded that Wind Energy failed to satisfy the OTCBB eligibility requirements set forth in Rule 6530(e). FINRA OTCBB staff notified Wind Energy of this determination pursuant to Rule 6530(f)(1), and the Hearing Officer subsequently granted Wind Energy's request for review of the decision pursuant to Rule 6530(f)(2). Following the hearing, the Hearing Officer affirmed FINRA OTCBB staff's determination and ordered the

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14 Under Exchange Act Rule 12b-25, issuers are required to notify the Commission of their inability to file a periodic report, along with supporting reasons, by filing a Form 12b-25 "no later than one business day after the due date" for such report. 17 C.F.R. § 240.12b-25(a); *see* 17 C.F.R. § 249.322 (Form 12b-25). Filing a Form 12b-25 in accordance with the rule provides an automatic extension of fifteen calendar days for filing a Form 10-K or Form 10-KSB and five calendar days for filing a Form 10-Q or Form 10-QSB. 17 C.F.R. § 240.12b- 25(b).

15 17 C.F.R. § 240.12b; *see also Rulemaking for EDGAR System*, Exchange Act Rel. No. 31905 (Feb. 23, 1993), 53 SEC Docket 1798, 1852 (announcing the addition of the preamble to Regulation 12B); Rule 10 of Regulation S-T, 17 C.F.R. § 232.10.

16 *Cf. e.g.*, *SC&T Int'l, Inc.*, 54 S.E.C. 320, 325 (1999) (determining that specific grounds for delisting existed in fact where company failed to file its quarterly and annual reports in a timely manner).

removal of Wind Energy's securities from the OTCBB.[17] Because the NAC Review Subcommittee did not call for further review, the Hearing Officer's decision constituted FINRA's final action under Rule 9750.

Wind Energy claims that it did not receive the delinquency notifications for the 2008 quarterly report and 2008 annual report until after the hearing. During the hearing, however, a member of FINRA's staff testified that these two notifications were sent to Wind Energy, and Wind Energy did not dispute this claim.[18] In any event, Rule 6530(f)(1) requires FINRA to send a notification to an issuer, "[u]pon determining that an issuer's security would be ineligible for quotation under this Rule." This requirement is "reasonably designed to inform issuers" of the consequences of their delinquencies.[19] FINRA complied with this requirement when it sent the October 14, 2009 notification. Moreover, there is no evidence that Wind Energy suffered any prejudice even if it did not receive the first two notifications. The reporting requirements of the Exchange Act "are clear and unequivocal, and they are satisfied only by the filing of complete, accurate and timely reports."[20] Wind Energy failed to meet these requirements three times in a two-year period, and on this basis FINRA removed Wind Energy's securities from quotation on the OTCBB.

Wind Energy claims that the Hearing Officer unfairly rejected Wind Energy's memorandum arguing that the Company submitted the 2008 quarterly report on time. The Hearing Officer rejected the memorandum because it was filed late but nevertheless addressed the argument in her decision. Moreover, our *de novo* review permits us to review the entire record, and we have considered and rejected Wind Energy's argument here. We conclude that the removal of Wind Energy's securities from the OTCBB accorded with FINRA rules.

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[17] *See* Rule 6530(f)(2) (providing that the hearing officer "will consider only the issues of whether the issuer's security is then eligible for quotation" and "whether the issuer filed a complete report by the applicable due date taking into account any extensions pursuant to" Exchange Act Rule 12b-25, and "shall not have the discretion to grant any extensions of time for ineligible securities to become eligible").

[18] FINRA staff stated that there had been "a successful delivery" of the notifications because FINRA "had not received any notifications back in the mail."

[19] *Order Granting Approval to Proposed Rule Change Relating to Amendments to NASD Rule 6530 to Clarify the Review Process for OTCBB Eligibility Determinations*, Exchange Act Rel. No. 54028 (June 28, 2006), 71 Fed. Reg. 36847, 36848.

[20] *SEC v. IMC Int'l, Inc.*, 384 F. Supp. 889, 893 (N.D. Texas), *aff'd*, 505 F.2d 733 (5th Cir. 1974).

C. The Rule Is, and Was Applied in a Manner, Consistent with the Exchange Act

Exchange Act Section 2 provides that securities transactions are "affected with a national public interest," making it necessary that issuers file appropriate reports in order to "insure the maintenance of fair and honest markets in such transactions."[21] As a result, we have recognized that "the availability of current financial information is critical to the proper operation of the financial markets."[22] We have held that "the failure 'to provide timely reports and adequate financial information [is] offensive to the central purpose of the periodic reporting system Congress established through the Exchange Act.'"[23]

Rule 6530 is consistent with Exchange Act Section 15A because it protects investors and the public interest by requiring issuers quoted on the OTCBB to file reports containing current financial information with the Commission or appropriate regulatory agency.[24] When the Commission approved Rule 6530, it found that, by precluding issuers who failed to meet their reporting requirements on numerous occasions from OTCBB quotation, Rule 6530 was designed to protect investors and the public interest.[25] We find that the FINRA rule is, and was applied in a manner, consistent with the purposes of the Exchange Act.

Wind Energy argues that FINRA's actions were unfair and inequitable in a number of ways. For example, Wind Energy argues that the Exchange Act's reporting requirements are "onerous" and make it "almost impossible for small SEC reporting companies to even exist." However, given the importance of current financial information to the proper operation of the financial markets, investors are "entitled to assume" that reporting companies, regardless of their size, will comply "promptly" with their obligations under the Exchange Act.[26]

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21 15 U.S.C. § 78b.

22 *Navistar*, 91 SEC Docket at 3143; *see also SC&T*, 54 S.E.C. at 326 ("Requiring public companies to file appropriate reports ensures the maintenance of fair and honest markets in securities.").

23 *Navistar*, 91 SEC Docket at 3143 (quoting *SEC v. Beisinger Indus. Corp.*, 421 F. Supp. 691, 695 (D. Mass. 1976), *aff'd*, 552 F.2d 15 (1st Cir. 1977)).

24 *Order Granting Approval of Proposed Rule Change Relating to Microcap Initiatives – Amendments to NASD Rules 6530 and 6540*, Exchange Act Rel. No. 40878 (Jan. 8, 1999), 64 Fed. Reg. 1255, 1257. Specifically, the Commission believes that Rule 6530 is consistent with the requirements of Section 15A(b)(6) and (11).

25 *Rule 6530 Order* at 70909.

26 *SC&T*, 54 S.E.C. at 326.

Wind Energy claims that it was unaware of the "three-strike" provision of Rule 6530(e) and the filing deadline provided by Regulation S-T. Wind Energy's ignorance of these rules, however, does not excuse its obligation to comply with them.[27] Moreover, the notifications that FINRA OTCBB staff sent to Wind Energy following the Company's delinquent filings of the 2008 quarterly report and 2008 annual report each stated the applicable Rule 6530 and Regulation S-T filing requirements.

Wind Energy asserts that its "auditors needed more time to satisfy comments from the SEC Staff Accountants regarding valuations of certain wind energy purchases" in connection with the Company's preparation of its 2008 and 2009 annual reports. Wind Energy contends that the two annual reports "would have been on time if [the Company] hadn't been concerned with responding correctly on such SEC accounting comments." Public companies are encouraged to consult with Commission staff on accounting concerns or questions, and responding to staff comments is a routine part of this process.[28] But it is Wind Energy's obligation under Exchange Act Section 13(a) and Exchange Act Rules 13a-1 and 13a-13 to ensure that its periodic reports are filed accurately, completely, and on time.[29]

Wind Energy argues that FINRA's decision makes it difficult for the Company to raise capital and will cause the Company and its existing investors irreparable harm. However, the mere "fact that a security is delisted does not necessarily result in irreparable harm to the issuer because its securities may continue to trade in other markets."[30] Here, despite being removed from quotation on the OTCBB, Wind Energy's securities will still be eligible for quotation in the Pink OTC Markets.[31] Moreover, under Rule 6530(e)(2), Wind Energy can seek reinstatement on

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27 *Cf. Guang Lu*, Exchange Act Rel. No. 51047 (Jan. 14, 2005), 84 SEC Docket 2639, 2646 n.16 (citing *Gilbert M. Hair*, 51 S.E.C. 374, 378 (1993)) (holding that "ignorance of NASD rules does not excuse an associated person from compliance with those rules"), *aff'd*, 179 Fed. Appx. 702 (D.C. Cir. 2006).

28 *See, e.g.*, Guidance for Consulting on Accounting Matters with the Office of the Chief Accountant, *available at* http://www.sec.gov/info/accountants/ocasubguidance.htm (last visited August 18, 2010).

29 *See Impax Labs., Inc.*, Exchange Act Rel. No. 57684 (May 23, 2008), 93 SEC Docket 6241, 6255.

30 *Navistar Int'l Corp.*, Exchange Act Rel. No. 55304 (Feb. 13, 2007) (order denying stay), 89 SEC Docket 3384, 3392 (citing *JD Am. Workwear, Inc.*, Exchange Act Rel. No. 43283 (Sept. 12, 2000), 73 SEC Docket 748, 753-54).

31 Pink OTC Markets, formerly known as Pink Sheets, operates Pink Quote, an electronic quotation system that displays quotes from broker-dealers for many over-the-counter

(continued...)

the OTCBB after it achieves compliance with the Commission's reporting requirements for one year. We recognize that existing Wind Energy shareholders may be disadvantaged by the removal of the Company's securities from OTCBB quotation, but this is outweighed by the public interest in Wind Energy's compliance with the disclosure requirements, so that both existing and prospective investors on the OTCBB will have current information about the Company.[32]

We find that a factual basis exists to remove Wind Energy's securities from quotation on the OTCBB; that FINRA acted in accordance with its applicable rules in removing Wind Energy's securities; and that those rules are, and were applied in a manner, consistent with the purposes of the Exchange Act. Accordingly, we dismiss this review proceeding.

An appropriate order will issue.[33]

By the Commission (Commissioners CASEY, WALTER, AGUILAR, and PAREDES); Chairman SCHAPIRO not participating.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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31 (...continued)
securities. *See* U.S. Securities and Exchange Commission, Pink Sheets, *available at* http://www.sec.gov/answers/pink.htm (last visited June 16, 2010).

32 *See Navistar Order*, 89 SEC Docket at 3392-93 (citing *JD Am. Workwear*, 73 SEC Docket at 754).

33 We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 62894 / September 13, 2010

Admin. Proc. File No. 3-13782

In the Matter of the Application of

WIND ENERGY AMERICA INC.
c/o Robert O. Knutson
Wind Energy America Inc.
9372 Creekwood Dr.
Eden Prairie, Minnesota 55347

For Review of Action Taken by

Financial Industry Regulatory Authority, Inc.

ORDER DISMISSING APPLICATION FOR REVIEW OF ACTION OF REGISTERED SECURITIES ASSOCIATION

On the basis of the Commission's opinion issued this day, it is

ORDERED that the application for review of action taken by Financial Industry Regulatory Authority, Inc. against Wind Energy America Inc. be, and it hereby is, dismissed.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62903 / September 14, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14045

In the Matter of **Anything2ship, Inc.,** **Aquaculture Resources Management, Inc.,** **Arcadia Investments, Inc.,** **Armitec, Inc.,** **Arrow Capital Group, Inc.,** **August Financial Holding Co., Inc., and** **AW Computer Systems, Inc.,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Anything2ship, Inc., Aquaculture Resources Management, Inc., Arcadia Investments, Inc., Armitec, Inc., Arrow Capital Group, Inc., August Financial Holding Co., Inc., and AW Computer Systems, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Anything2ship, Inc. (CIK No. 1078610) is a void Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Anything2ship 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 November 30, 2002, which reported a total loss of $91,780 for the prior three months.

2. Aquaculture Resources Management, Inc. (CIK No. 1094339) is a dissolved Florida corporation located in Palm Beach, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Aquaculture is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended April 30, 2001, which reported a net loss of $3,063 for the prior nine months.

3. Arcadia Investments, Inc. (CIK No. 1101094) is a dissolved Wyoming corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Arcadia 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 $19,853 for the prior six months.

4. Armitec, Inc. (CIK No. 723619) is a void Delaware corporation located in Smyrna, Georgia with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Armitec 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 $239,479 for the prior three months. As of September 8, 2010, the company's stock (symbol "AMTI") was traded on the over-the-counter markets.

5. Arrow Capital Group, Inc. (CIK No. 1097763) is a permanently revoked Nevada corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Arrow Capital is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 2001, which reported a net loss of $2,611 for the prior six months.

6. August Financial Holding Co., Inc. (CIK No. 835176) is a dissolved Nevada corporation located in Boston, Massachusetts with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). August Financial 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, 2003, which reported a net loss of $312,374 for the prior six months. On December 22, 2003, the company announced the winding-up of its business. As of September 8, 2010, the company's stock (symbol "AFHI") was traded on the over-the-counter markets.

7. AW Computer Systems, Inc. (CIK No. 319037) is a New Jersey corporation located in Mount Laurel, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). AW Computer 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, 1998, which reported a net loss of $839,666 for the prior nine months. On May 5, 1998, the company filed a Chapter 7 petition in the U.S. Bankruptcy Court for the District of New Jersey, which was terminated on September 25, 2002.

B. DELINQUENT PERIODIC FILINGS

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

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

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

III.

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

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

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62904 / September 14, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14046

In the Matter of	
Electric Mail Co., Inc. (n/k/a Lero Gold Corp.), Electronic Publishing Technology Corp., Elkhorn Gold Mining Corp., Ememberdirect, Inc., Emerald Homes, Ltd., Encore Wireless, Inc., and Entreport Corp., **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Electric Mail Co., Inc. (n/k/a Lero Gold Corp.), Electronic Publishing Technology Corp., Elkhorn Gold Mining Corp., Ememberdirect, Inc., Emerald Homes, Ltd., Encore Wireless, Inc., and Entreport Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Electric Mail Co., Inc. (n/k/a Lero Gold Corp.) (CIK No. 1058058) is a British Columbia corporation located in Burnaby, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g).

Electric Mail 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 $1,426,493 (Canadian) for the prior twelve months.

2. Electronic Publishing Technology Corp. (CIK No. 277471) is a Colorado corporation located in Torrance, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Electronic Publishing Technology is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended March 31, 1994, which reported a net loss of $64,905 for the prior nine months.

3. Elkhorn Gold Mining Corp. (CIK No. 1070249) is a British Columbia corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Elkhorn Gold Mining is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed an amended Form 20-F registration statement on November 4, 1999, which reported a net loss of over $2.8 million (Canadian) for the year ended July 31, 1998.

4. Ememberdirect, Inc. (CIK No. 318523) is a void Delaware corporation located in San Francisco, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Ememberdirect 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 July 31, 2000, which reported a net loss of $1,768,000 for the prior three months.

5. Emerald Homes, Ltd. (CIK No. 806627) is a cancelled Delaware corporation located in Coarsegold, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Emerald Homes 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, 1993.

6. Encore Wireless, Inc. (CIK No. 1093568) is a permanently revoked Nevada corporation located in Westlake Village, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Encore Wireless 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 $800,389 for the prior three months. As of September 8, 2010, the company's stock (symbol "ENCW") was traded on the over-the-counter markets.

7. Entreport Corp. (CIK No. 1092494) is a dissolved Florida corporation located in Carlsbad, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Entreport 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 $160,195 for the prior three months. As of September 8, 2010, the company's stock (symbol "EPCN") 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, 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. 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.

10. 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 hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
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. 62905 / September 14, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14047

In the Matter of Speed of Thought Trading Corp. (f/k/a Emperor Penguin, Inc.), Sports/Entertainment Group, Inc., Standard Automotive Corp., Starmet Corp., Stearman Enterprises, Inc., Streamline.com, Inc., and Supradur Companies, Inc., Respondents.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Speed of Thought Trading Corp. (f/k/a Emperor Penguin, Inc.), Sports/Entertainment Group, Inc., Standard Automotive Corp., Starmet Corp., Stearman Enterprises, Inc., Streamline.com, Inc., and Supradur Companies, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Speed of Thought Trading Corp. (f/k/a Emperor Penguin, Inc.) (CIK No. 1122348) is a dissolved New York corporation located in Plainview, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Speed of Thought is delinquent in its periodic filings with the Commission,

having not filed any periodic reports since it filed a Form 10-SB registration statement on October 4, 2000, which reported a net loss of $20,000 for the period from August 14 to September 30, 2000.

2. Sports/Entertainment Group, Inc. (CIK No. 814254) is a void Delaware corporation located in Millburn, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Sports/Entertainment Group 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 November 30, 1994, which reported a net loss of $566,643 for the prior nine months.

3. Standard Automotive Corp. (CIK No. 1043505) is a void Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Standard Automotive 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, 2001, which reported a net loss of over $42.4 million for the prior nine months. As of September 8, 2010, the company's stock (symbol "SAUC") was traded on the over-the-counter markets.

4. Starmet Corp. (CIK No. 276331) is a dissolved Massachusetts corporation located in Concord, Massachusetts with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Starmet 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 2, 2000, which reported a net loss of $310,000 for the prior three months. As of September 8, 2010, the company's stock (symbol "STMT") was traded on the over-the-counter markets.

5. Stearman Enterprises, Inc. (CIK No. 1097395) is a void Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Stearman 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 July 31, 2001, which reported a net loss of $500 for the prior twelve months.

6. Streamline.com, Inc. (CIK No. 1042091) is a void Delaware corporation located in Westwood, Massachusetts with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Streamline.com 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 1, 2000, which reported a net loss of over $5.9 million for the prior three months. As of September 8, 2010, the company's stock (symbol "SLNE") was traded on the over-the-counter markets.

7. Supradur Companies, Inc. (CIK No. 95618) is a void Delaware corporation located in Rye, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Supradur is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for

the period ended October 2, 1994, which reported a net loss of over $2.8 million for the prior nine months.

B. DELINQUENT PERIODIC FILINGS

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

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

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

III.

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

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

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

- Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement

- Auditing Standard No. 14, Evaluating Audit Results

- Auditing Standard No. 15, Audit Evidence

(collectively referred to as the "Risk Assessment Standards"); and amendment to the Board's interim auditing standards (collectively, "the proposed rules "). The text of the Risk Assessment Standards and amendments to the Board's interim auditing standards are set out below.

Auditing Standard No. 8

Audit Risk

Introduction

1. This standard discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit[1/] or an audit of financial statements only.

[1/] When the auditor is performing an integrated audit of financial statements and internal control over financial reporting, the requirements in Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, also apply. However, the risks of material misstatement of the financial statements are the same for both the audit of financial statements and the audit of internal control over financial reporting.

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-62919; File No. PCAOB-2010-01)

September 14, 2010

Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), notice is hereby given that on September 14, 2010, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission") the proposed rules described in Items I and II below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rules from interested persons.

I. Board's Statement of the Terms of Substance of the Proposed Rules

On August 5, 2010, the Board adopted the following eight auditing standards:

- Auditing Standard No. 8, Audit Risk
- Auditing Standard No. 9, Audit Planning
- Auditing Standard No. 10, Supervision of the Audit Engagement
- Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit
- Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement

- Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement

- Auditing Standard No. 14, Evaluating Audit Results

- Auditing Standard No. 15, Audit Evidence

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Auditing Standard No. 8

Audit Risk

Introduction

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[1/] When the auditor is performing an integrated audit of financial statements and internal control over financial reporting, the requirements in Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, also apply. However, the risks of material misstatement of the financial statements are the same for both the audit of financial statements and the audit of internal control over financial reporting.

Objective

2. The objective of the auditor is to conduct the audit of financial statements in a manner that reduces audit risk to an appropriately low level.

Audit Risk

3. To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement[2/] due to error or fraud. Reasonable assurance[3/] is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.

4. In an audit of financial statements, audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, i.e., the financial statements are not presented fairly in conformity with the applicable financial reporting framework. Audit risk is a function of the risk of material misstatement and detection risk.

2/ Misstatement is defined in Appendix A of Auditing Standard No. 14, Evaluating Audit Results.

3/ See AU sec. 110, Responsibilities and Functions of the Independent Auditor, and paragraph .10 of AU sec. 230, Due Professional Care in the Performance of Work, for a further discussion of reasonable assurance.

Note: The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

Risk of Material Misstatement

5. The risk of material misstatement refers to the risk that the financial statements are materially misstated. Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, indicates that the auditor should assess the risks of material misstatement at two levels: (1) at the financial statement level and (2) at the assertion[4/] level.[5/]

6. Risks of material misstatement at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of material misstatement at the financial statement level may be especially relevant to the auditor's consideration of the risk of material misstatement due to fraud. For example, an ineffective control environment, a lack of sufficient capital to continue operations, and declining conditions affecting the company's industry might create pressures or opportunities for management to manipulate the financial statements, leading to higher risk of material misstatement.

[4/] See Auditing Standard No. 15, Audit Evidence, for a description of financial statement assertions.

[5/] Paragraph 59 of Auditing Standard No. 12.

7. Risk of material misstatement at the assertion level consists of the following components:

a. Inherent risk, which refers to the susceptibility of an assertion to a misstatement, due to error or fraud, that could be material, individually or in combination with other misstatements, before consideration of any related controls.

b. Control risk, which is the risk that a misstatement due to error or fraud that could occur in an assertion and that could be material, individually or in combination with other misstatements, will not be prevented or detected on a timely basis by the company's internal control. Control risk is a function of the effectiveness of the design and operation of internal control.

8. Inherent risk and control risk are related to the company, its environment, and its internal control, and the auditor assesses those risks based on evidence he or she obtains. The auditor assesses inherent risk using information obtained from performing risk assessment procedures and considering the characteristics of the accounts and disclosures in the financial statements.[6/] The auditor assesses control risk using evidence obtained

[6/] Paragraph 59.a. of Auditing Standard No. 12.

from tests of controls (if the auditor plans to rely on those controls to assess control risk at less than maximum) and from other sources.[7/]

Detection Risk

9. In an audit of financial statements, detection risk is the risk that the procedures performed by the auditor will not detect a misstatement that exists and that could be material, individually or in combination with other misstatements. Detection risk is affected by (1) the effectiveness of the substantive procedures and (2) their application by the auditor, i.e., whether the procedures were performed with due professional care.

10. The auditor uses the assessed risk of material misstatement to determine the appropriate level of detection risk for a financial statement assertion. The higher the risk of material misstatement, the lower the level of detection risk needs to be in order to reduce audit risk to an appropriately low level.

11. The auditor reduces the level of detection risk through the nature, timing, and extent of the substantive procedures performed. As the appropriate level of detection risk decreases, the evidence from substantive procedures that the auditor should obtain increases.[8/]

[7/] Paragraphs 32-34 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

[8/] Paragraph 37 of Auditing Standard No. 13.

Auditing Standard No. 9

Audit Planning

Introduction

1. This standard establishes requirements regarding planning an audit.

Objective

2. The objective of the auditor is to plan the audit so that the audit is conducted effectively.

Responsibility of the Engagement Partner for Planning

3. The **engagement partner**[9/] is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for planning the audit and may seek assistance from appropriate engagement team members in fulfilling this responsibility. Engagement team members who assist the engagement partner with audit planning also should comply with the relevant requirements in this standard.

Planning an Audit

4. The auditor should properly plan the audit. This standard describes the auditor's

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[9/] Terms defined in Appendix A, Definitions, are set in **boldface type** the first time they appear.

responsibilities for properly planning the audit.[10/]

5. Planning the audit includes establishing the overall audit strategy for the engagement and developing an audit plan, which includes, in particular, planned risk assessment procedures and planned responses to the risks of material misstatement. Planning is not a discrete phase of an audit but, rather, a continual and iterative process that might begin shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit.

Preliminary Engagement Activities

6. The auditor should perform the following activities at the beginning of the audit:

a. Perform procedures regarding the continuance of the client relationship and the specific audit engagement,[11/]

b. Determine compliance with independence and ethics requirements, and

> Note: The determination of compliance with independence and ethics requirements is not limited to

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[10/] The term, "auditor," as used in this standard, encompasses both the engagement partner and the engagement team members who assist the engagement partner in planning the audit.

[11/] Paragraphs .14-.16 of QC sec. 20, System of Quality Control for a CPA Firm's Accounting and Auditing Practice. AU sec. 161, The Relationship of Generally Accepted Auditing Standards to Quality Control Standards, explains how the quality control standards relate to the conduct of audits.

preliminary engagement activities and should be reevaluated with changes in circumstances.

c. Establish an understanding with the client regarding the services to be performed on the engagement.[12/]

Planning Activities

7. The nature and extent of planning activities that are necessary depend on the size and complexity of the company, the auditor's previous experience with the company, and changes in circumstances that occur during the audit. When developing the audit strategy and audit plan, as discussed in paragraphs 8-10, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures:

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;

[12/] AU sec. 310, Appointment of the Independent Auditor.

- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;

- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;

- The auditor's preliminary judgments about materiality,[13] risk, and, in integrated audits, other factors relating to the determination of material weaknesses;

- Control deficiencies previously communicated to the audit committee[14] or management;

- Legal or regulatory matters of which the company is aware;

- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;

- Preliminary judgments about the effectiveness of internal control over financial reporting;

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[13] Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit.

[14] If no audit committee exists, all references to the audit committee in this standard apply to the entire board of directors of the company. See 15 U.S.C. §§ 78c(a)58 and 7201(a)(3).

- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;

- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and

- The relative complexity of the company's operations.

  Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

Audit Strategy

8. The auditor should establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan.

9. In establishing the overall audit strategy, the auditor should take into account:

a. The reporting objectives of the engagement and the nature of the communications required by PCAOB standards,[15/]

b. The factors that are significant in directing the activities of the engagement team,[16/]

c. The results of preliminary engagement activities[17/] and the auditor's evaluation of the important matters in accordance with paragraph 7 of this standard, and

d. The nature, timing, and extent of resources necessary to perform the engagement.[18/]

[15/] See, e.g., AU sec. 310 and AU sec. 380, Communication With Audit Committees. Also, various laws or regulations require other matters to be communicated. (See, e.g., Rule 2-07 of Regulation S-X, 17 CFR 210.2-07; and Rule 10A-3 under the Securities Exchange Act of 1934, 17 CFR 240.10A-3.) The requirements of this standard do not modify communications required by those other laws or regulations.

[16/] See, e.g., paragraph 6 of Auditing Standard No. 10, Supervision of the Audit Engagement.

[17/] Paragraph 6 of this standard.

[18/] See, e.g., paragraph .06 of AU sec. 230, Due Professional Care in the Performance of Work, paragraph 16 of this standard, and paragraph 5.a. of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

Audit Plan

10. The auditor should develop and document an audit plan that includes a description of:

a. The planned nature, timing, and extent of the risk assessment procedures;[19]

b. The planned nature, timing, and extent of tests of controls and substantive procedures;[20] and

c. Other planned audit procedures required to be performed so that the engagement complies with PCAOB standards.

Multi-location Engagements

11. In an audit of the financial statements of a company with operations in multiple locations or business units,[21] the auditor should determine the extent to which audit procedures should be performed at selected locations or business units to obtain sufficient

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[19] Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

[20] Auditing Standard No. 13 and Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

[21] The term "business units" includes subsidiaries, divisions, branches, components, or investments.

appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. This includes determining the locations or business units at which to perform audit procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual locations or business units. The auditor should assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit.

12. Factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures include:

a. The nature and amount of assets, liabilities, and transactions executed at the location or business unit, including, e.g., significant transactions executed at the location or business unit that are outside the normal course of business for the company, or that otherwise appear to be unusual given the auditor's understanding of the company and its environment;[22/]

[22/] Paragraph .66 of AU sec. 316, Consideration of Fraud in a Financial Statement Audit.

b. The materiality of the location or business unit;[23]

c. The specific risks associated with the location or business unit that present a reasonable possibility[24] of material misstatement to the company's consolidated financial statements;

d. Whether the risks of material misstatement associated with the location or business unit apply to other locations or business units such that, in combination, they present a reasonable possibility of material misstatement to the company's consolidated financial statements;

e. The degree of centralization of records or information processing;

f. The effectiveness of the control environment, particularly with respect to management's control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or business unit; and

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[23] Paragraph 10 of Auditing Standard No. 11 describes the consideration of materiality in planning and performing audit procedures at an individual location or business unit.

[24] There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

g. The frequency, timing, and scope of monitoring activities by the company or others at the location or business unit.

> Note: When performing an audit of internal control over financial reporting, refer to Appendix B, Special Topics, of Auditing Standard No. 5[25/] for considerations when a company has multiple locations or business units.

13. In determining the locations or business units at which to perform audit procedures, the auditor may take into account relevant activities performed by internal audit, as described in AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements, or others, as described in Auditing Standard No. 5. AU sec. 322 and Auditing Standard No. 5 establish requirements regarding using the work of internal audit and others, respectively.

14. AU sec. 543, Part of Audit Performed by Other Independent Auditors, describes the auditor's responsibilities regarding using the work and reports of other independent auditors who audit the financial statements of one or more of the locations or business units that are included in the consolidated financial statements.[26/] In those situations, the

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25/ Paragraphs B10-B16 of Auditing Standard No. 5.

26/ For integrated audits, see also paragraphs C8-C11 of Auditing Standard No. 5.

auditor should perform the procedures in paragraphs 11-13 of this standard to determine the locations or business units at which audit procedures should be performed.

Changes During the Course of the Audit

15. The auditor should modify the overall audit strategy and the audit plan as necessary if circumstances change significantly during the course of the audit, including changes due to a revised assessment of the risks of material misstatement or the discovery of a previously unidentified risk of material misstatement.

Persons with Specialized Skill or Knowledge

16. The auditor should determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

17. If a person with specialized skill or knowledge employed or engaged by the auditor participates in the audit, the auditor should have sufficient knowledge of the subject matter to be addressed by such a person to enable the auditor to:

a. Communicate the objectives of that person's work;

b. Determine whether that person's procedures meet the auditor's objectives; and

c. Evaluate the results of that person's procedures as they relate to the nature, timing, and extent of other planned audit procedures and the effects on the auditor's report.

Additional Considerations in Initial Audits

18. The auditor should undertake the following activities before starting an initial audit:

a. Perform procedures regarding the acceptance of the client relationship and the specific audit engagement; and

b. Communicate with the predecessor auditor in situations in which there has been a change of auditors in accordance with AU sec. 315, Communications Between Predecessor and Successor Auditors.

19. The purpose and objective of planning the audit are the same for an initial audit or a recurring audit engagement. However, for an initial audit, the auditor should determine the additional planning activities necessary to establish an appropriate audit strategy and audit plan, including determining the audit procedures necessary to obtain sufficient appropriate audit evidence regarding the opening balances.[27/]

[27/] See also paragraph 3 of Auditing Standard No. 6, Evaluating Consistency of Financial Statements.

<u>APPENDIX A</u> – Definition

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Engagement partner – The member of the engagement team with primary responsibility for the audit.

Auditing Standard No. 10

<u>Supervision of the Audit Engagement</u>

<u>Introduction</u>

1. This standard establishes requirements regarding supervision of the audit engagement, including supervising the work of engagement team members.

<u>Objective</u>

2. The objective of the auditor is to supervise the audit engagement, including supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached.

Responsibility of the Engagement Partner for Supervision

3. The **engagement partner**[28/] is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for proper supervision of the work of engagement team members and for compliance with PCAOB standards, including standards regarding using the work of specialists,[29/] other auditors,[30/] internal auditors,[31/] and others who are involved in testing controls.[32/] Paragraphs 5-6 of this standard describe the nature and extent of supervisory activities necessary for proper supervision of engagement team members.[33/]

4. The engagement partner may seek assistance from appropriate engagement team members in fulfilling his or her responsibilities pursuant to this standard. Engagement team members who assist the engagement partner with supervision of the work of other

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28/ Terms defined in Appendix A, Definitions, are set in **boldface type** the first time they appear.

29/ AU sec. 336, Using the Work of a Specialist.

30/ AU sec. 543, Part of Audit Performed by Other Independent Auditors.

31/ AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.

32/ Paragraphs 16-19 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

33/ See also paragraph .06 of AU sec. 230, Due Professional Care in the Performance of Work.

engagement team members also should comply with the requirements in this standard with respect to the supervisory responsibilities assigned to them.

Supervision of Engagement Team Members

5. The engagement partner and, as applicable, other engagement team members performing supervisory activities, should:

a. Inform engagement team members of their responsibilities,[34/] including:

(1) The objectives of the procedures that they are to perform;

(2) The nature, timing, and extent of procedures they are to perform; and

(3) Matters that could affect the procedures to be performed or the evaluation of the results of those procedures, including relevant aspects of the company, its environment, and its internal control over financial reporting,[35/] and possible accounting and auditing issues;

34/ AU sec. 230.06 and paragraph 5 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement, establish requirements regarding the appropriate assignment of engagement team members.

35/ Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, describes the auditor's responsibilities for obtaining an understanding of the company, its environment, and its internal control over financial reporting.

b. Direct engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities so they can evaluate those issues and determine that appropriate actions are taken in accordance with PCAOB standards;[36/]

> Note: In applying due professional care in accordance with AU sec. 230, each engagement team member has a responsibility to bring to the attention of appropriate persons, disagreements or concerns the engagement team member might have with respect to accounting and auditing issues that he or she believes are of significance to the financial statements or the auditor's report regardless of how those disagreements or concerns may have arisen.

c. Review the work of engagement team members to evaluate whether:

(1) The work was performed and documented;

(2) The objectives of the procedures were achieved; and

[36/] See, e.g., paragraph 15 of Auditing Standard No. 9, Audit Planning, paragraph 74 of Auditing Standard No. 12, and paragraphs 20-23 and 35-36 of Auditing Standard No. 14, Evaluating Audit Results.

(3) The results of the work support the conclusions reached.[37/]

6. To determine the extent of supervision necessary for engagement team members to perform their work as directed and form appropriate conclusions, the engagement partner and other engagement team members performing supervisory activities should take into account:

a. The nature of the company, including its size and complexity;[38/]

b. The nature of the assigned work for each engagement team member, including:

(1) The procedures to be performed, and

(2) The controls or accounts and disclosures to be tested;

c. The risks of material misstatement; and

d. The knowledge, skill, and ability of each engagement team member.[39/]

Note: In accordance with the requirements of paragraph 5 of Auditing Standard No. 13, The Auditor's Responses to

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37/ Auditing Standard No. 14 describes the auditor's responsibilities for evaluating the results of the audit, and Auditing Standard No. 3, Audit Documentation, establishes requirements regarding audit documentation.

38/ Paragraph 10 of Auditing Standard No. 12.

39/ See also paragraph 5.a. of Auditing Standard No. 13 and AU sec. 230.06.

the Risks of Material Misstatement, the extent of supervision of engagement team members should be commensurate with the risks of material misstatement.[40/]

APPENDIX A – **Definition**

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Engagement partner – The member of the engagement team with primary responsibility for the audit.

Auditing Standard No. 11

Consideration of Materiality in Planning and Performing an Audit

Introduction

1. This standard establishes requirements regarding the auditor's consideration of materiality in planning and performing an audit.[41/]

Materiality in the Context of an Audit

[40/] Paragraph 5.b. of Auditing Standard No. 13 indicates that the extent of supervision of engagement team members is part of the auditor's overall responses to the risks of material misstatement.

[41/] Auditing Standard No. 14 establishes requirements regarding the auditor's consideration of materiality in evaluating audit results.

2. In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the ...fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[42/] As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him ...."[43/]

3. To obtain reasonable assurance about whether the financial statements are free of material misstatement, the auditor should plan and perform audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial statements. This includes being alert while planning and performing audit procedures for misstatements that could be material due to quantitative or qualitative factors. Also, the evaluation of uncorrected misstatements in accordance with Auditing Standard No. 14, Evaluating Audit Results, requires consideration of both qualitative and quantitative factors.[44/] However, it ordinarily is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors.

42/ TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

43/ TSC Industries, 426 U.S. at 450.

44/ Appendix B of Auditing Standard No. 14.

4. For integrated audits, Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, states, "In planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements."[45/]

Objective

5. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing audit procedures.

Considering Materiality in Planning and Performing an Audit

Establishing a Materiality Level for the Financial Statements as a Whole

6. To plan the nature, timing, and extent of audit procedures, the auditor should establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This includes consideration of the company's earnings and other relevant factors. To determine the nature, timing, and extent of audit procedures, the materiality level for the financial statements as a whole needs to be expressed as a specified amount.

45/ Paragraph 20 of Auditing Standard No. 5.

Note: If financial statements for the audit period are not available, the auditor may establish an initial materiality level based on estimated or preliminary financial statement amounts. In those situations, the auditor should take into account the effects of known or expected changes in the company's financial statements, including significant transactions or adjustments that are expected to be reflected in the financial statements at the end of the period.

Establishing Materiality Levels for Particular Accounts or Disclosures

7. The auditor should evaluate whether, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. If so, the auditor should establish separate materiality levels for those accounts or disclosures to plan the nature, timing, and extent of audit procedures for those accounts or disclosures.

Note: Lesser amounts of misstatements could influence the judgment of a reasonable investor because of qualitative factors, e.g., because of the sensitivity of circumstances surrounding misstatements, such as conflicts of interest in related party transactions.

Determining Tolerable Misstatement

8. The auditor should determine the amount or amounts of tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level. The auditor should determine tolerable misstatement at an amount or amounts that reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the financial statements. Accordingly, tolerable misstatement should be less than the materiality level for the financial statements as a whole and, if applicable, the materiality level or levels for particular accounts or disclosures.

9. In determining tolerable misstatement and planning and performing audit procedures, the auditor should take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods.

Considerations for Multi-location Engagements

10. For purposes of the audit of the consolidated financial statements of a company with multiple locations or business units, the auditor should determine tolerable misstatement for the individual locations or business units at an amount that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the consolidated financial statements.

Accordingly, tolerable misstatement at an individual location should be less than the materiality level for the financial statements as a whole.

<u>Considerations as the Audit Progresses</u>

11. The auditor should reevaluate the established materiality level or levels and tolerable misstatement when, because of changes in the particular circumstances or additional information that comes to the auditor's attention, there is a substantial likelihood that misstatements of amounts that differ significantly from the materiality level or levels that were established initially would influence the judgment of a reasonable investor. Situations in which changes in circumstances or additional information that comes to the auditor's attention would require such reevaluation include:

a. The materiality level or levels and tolerable misstatement were established initially based on estimated or preliminary financial statement amounts that differ significantly from actual amounts.

b. Events or changes in conditions occurring after the materiality level or levels and tolerable misstatement were established initially are likely to affect investors' perceptions about the company's financial position, results of operations, or cash flows.

Note: Examples of such events or changes in conditions include (1) changes in laws, regulations, or the applicable financial reporting framework that affect investors' expectations about the measurement or disclosure of certain items and (2) significant new contractual arrangements that draw attention to a particular aspect of a company's business that is separately disclosed in the financial statements.

12. If the auditor's reevaluation results in a lower amount for the materiality level or levels or tolerable misstatement than initially established by the auditor, the auditor should (1) evaluate the effect, if any, of the lower amount or amounts on his or her risk assessments and audit procedures and (2) modify the nature, timing, and extent of audit procedures as necessary to obtain sufficient appropriate audit evidence.

Note: The reevaluation of the materiality level or levels and tolerable misstatement is also relevant to the auditor's evaluation of uncorrected misstatements in accordance with Auditing Standard No. 14.[46/]

[46/] Paragraph 17 of Auditing Standard No. 14.

Auditing Standard No. 12

Identifying and Assessing Risks of Material Misstatement

Introduction

1. This standard establishes requirements regarding the process of identifying and assessing risks of material misstatement[47/] of the financial statements.

2. Paragraphs 4-58 of this standard discuss the auditor's responsibilities for performing **risk assessment procedures**.[48/] Paragraphs 59-73 of this standard discuss identifying and assessing the risks of material misstatement using information obtained from performing risk assessment procedures.

Objective

3. The objective of the auditor is to identify and appropriately assess the risks of material misstatement, thereby providing a basis for designing and implementing responses to the risks of material misstatement.

Performing Risk Assessment Procedures

4. The auditor should perform risk assessment procedures that are sufficient to provide

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47/ Paragraphs 5-8 of Auditing Standard No. 8, Audit Risk.

48/ Terms defined in Appendix A, Definitions, are set in **boldface type** the first time they appear.

a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud,[49/] and designing further audit procedures.[50/]

5. Risks of material misstatement can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting. For example, external or company-specific factors can affect the judgments involved in determining accounting estimates or create pressures to manipulate the financial statements to achieve certain financial targets. Also, risks of material misstatement may relate to, e.g., personnel who lack the necessary financial reporting competencies, information systems that fail to accurately capture business transactions, or financial reporting processes that are not adequately aligned with the requirements in the applicable financial reporting framework. Thus, the audit procedures that are necessary to identify and appropriately assess the risks of material misstatement include consideration of both external factors and company-specific factors. This standard discusses the following risk assessment procedures:

[49/] AU sec. 316, Consideration of Fraud in a Financial Statement Audit, discusses fraud, its characteristics, and the types of misstatements due to fraud that are relevant to the audit, i.e., misstatements arising from fraudulent financial reporting and misstatements arising from asset misappropriation.

[50/] Auditing Standard No. 15, Audit Evidence, describes further audit procedures as consisting of tests of controls and substantive procedures.

a. Obtaining an understanding of the company and its environment (paragraphs 7-17);

b. Obtaining an understanding of internal control over financial reporting (paragraphs 18-40);

c. Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company (paragraphs 41-45);

d. Performing analytical procedures (paragraphs 46-48);

e. Conducting a discussion among engagement team members regarding the risks of material misstatement (paragraphs 49-53); and

f. Inquiring of the audit committee, management, and others within the company about the risks of material misstatement (paragraphs 54-58).

> Note: This standard describes an approach to identifying and assessing risks of material misstatement that begins at the financial statement level and with the auditor's overall understanding of the company and its environment and

works down to the significant accounts and disclosures and their relevant assertions.[51/]

6. In an integrated audit, the risks of material misstatement of the financial statements are the same for both the audit of internal control over financial reporting and the audit of financial statements. The auditor's risk assessment procedures should apply to both the audit of internal control over financial reporting and the audit of financial statements.

Obtaining an Understanding of the Company and Its Environment

7. The auditor should obtain an understanding of the company and its environment ("understanding of the company") to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement. Obtaining an understanding of the company includes understanding:

a. Relevant industry, regulatory, and other external factors;

b. The nature of the company;

c. The company's selection and application of accounting principles, including related disclosures;

[51/] Paragraph 11 of Auditing Standard No. 15 discusses financial statement assertions.

d. The **company's objectives and strategies** and those related **business risks** that might reasonably be expected to result in risks of material misstatement; and

e. The company's measurement and analysis of its financial performance.

8. In obtaining an understanding of the company, the auditor should evaluate whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement.

Industry, Regulatory, and Other External Factors

9. Obtaining an understanding of relevant industry, regulatory, and other external factors encompasses industry factors, including the competitive environment and technological developments; the regulatory environment, including the applicable financial reporting framework[52/] and the legal and political environment;[53/] and external factors, including general economic conditions.

Nature of the Company

10. Obtaining an understanding of the nature of the company includes understanding:

52/ The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

53/ AU sec. 317, Illegal Acts by Clients, discusses the auditor's consideration of laws and regulations relevant to the audit.

- The company's organizational structure and management personnel;
- The sources of funding of the company's operations and investment activities, including the company's capital structure, noncapital funding (e.g., subordinated debt or dependencies on supplier financing), and other debt instruments;
- The company's significant investments, including equity method investments, joint ventures, and variable interest entities;
- The company's operating characteristics, including its size and complexity;

  Note: The size and complexity of a company might affect the risks of misstatement and how the company addresses those risks.
- The sources of the company's earnings, including the relative profitability of key products and services; and
- Key supplier and customer relationships.

  Note: The auditor should take into account the information gathered while obtaining an understanding of the nature of the company when determining the existence of related parties in accordance with AU sec. 334, Related Parties.

11. As part of obtaining an understanding of the company as required by paragraph 7, the auditor should consider performing the following procedures and the extent to which the procedures should be performed:

- Reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and, in an integrated audit, the effectiveness of the company's internal control over financial reporting, e.g., company-issued press releases, company-prepared presentation materials for analysts or investor groups, and analyst reports;

- Observing or reading transcripts of earnings calls and, to the extent publicly available, other meetings with investors or rating agencies;

- Obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses; and

- Obtaining information about trading activity in the company's securities and holdings in the company's securities by significant holders to identify potentially significant unusual developments (e.g., from Forms 3, 4, 5, 13D, and 13G).

Selection and Application of Accounting Principles, Including Related Disclosures

12. As part of obtaining an understanding of the company's selection and application of accounting principles, including related disclosures, the auditor should evaluate whether the company's selection and application of accounting principles are appropriate for its business and consistent with the applicable financial reporting framework and accounting principles used in the relevant industry. Also, to identify and assess risks of material misstatement related to omitted, incomplete, or inaccurate disclosures, the auditor should develop expectations about the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework.

13. The following matters, if present, are relevant to the necessary understanding of the company's selection and application of accounting principles, including related disclosures:

- Significant changes in the company's accounting principles, financial reporting policies, or disclosures and the reasons for such changes;
- The financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting principles;

- The accounts or disclosures for which judgment is used in the application of significant accounting principles, especially in determining management's estimates and assumptions;
- The effect of significant accounting principles in controversial or emerging areas for which there is a lack of authoritative guidance or consensus;
- The methods the company uses to account for significant and unusual transactions; and
- Financial reporting standards and laws and regulations that are new to the company, including when and how the company will adopt such requirements.

Company Objectives, Strategies, and Related Business Risks

14. The purpose of obtaining an understanding of the company's objectives, strategies, and related business risks is to identify business risks that could reasonably be expected to result in material misstatement of the financial statements.

> Note: Some relevant business risks might be identified through other risk assessment procedures, such as obtaining an understanding of the nature of the company and understanding industry, regulatory, and other external factors.

15. The following are examples of situations in which business risks might result in material misstatement of the financial statements:

- Industry developments (a potential related business risk might be, e.g., that the company does not have the personnel or expertise to deal with the changes in the industry.)
- New products and services (a potential related business risk might be, e.g., that the new product or service will not be successful.)
- Use of information technology ("IT") (a potential related business risk might be, e.g., that systems and processes are incompatible.)
- New accounting requirements (a potential related business risk might be, e.g., incomplete or improper implementation of a new accounting requirement.)
- Expansion of the business (a potential related business risk might be, e.g., that the demand for the company's products or services has not been accurately estimated.)
- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, e.g., incomplete or improper implementation of the strategy.)

- Current and prospective financing requirements (a potential related business risk might be, e.g., the loss of financing due to the company's inability to meet financing requirements.)

- Regulatory requirements (a potential related business risk might be, e.g., that there is increased legal exposure.)

Note: Business risks could affect risks of material misstatement at the financial statement level, which would affect many accounts and disclosures in the financial statements. For example, a company's loss of financing or declining conditions affecting the company's industry could affect its ability to settle its obligations when due. This, in turn, could affect the risks of material misstatement related to, e.g., the classification of long-term liabilities or valuation of long-term assets, or it could result in substantial doubt about the company's ability to continue as a going concern. Other business risks could affect the risks of material misstatement for particular accounts, disclosures, or assertions. For example, an unsuccessful new product or service or failed business expansion might affect the risks of material misstatement related to the valuation of inventory and other related assets.

Company Performance Measures

16. The purpose of obtaining an understanding of the company's performance measures is to identify performance measures, whether external or internal, that affect the risks of material misstatement.

17. The following are examples of performance measures that might affect the risks of material misstatement:

- Measures that form the basis for contractual commitments or incentive compensation arrangements;
- Measures used by external parties, such as analysts and rating agencies, to review the company's performance; and
- Measures the company uses to monitor its operations that highlight unexpected results or trends that prompt management to investigate their cause and take corrective action, including correction of misstatements.

Note: The first two examples represent performance measures that can affect the risks of material misstatement by creating incentives or pressures for management of the company to manipulate certain accounts or disclosures to achieve certain performance targets (or conceal a failure to achieve those targets). The third example represents performance measures that management might use to monitor risks affecting the financial statements.

Note: Smaller companies might have less formal processes to measure and review financial performance. In such cases, the auditor might identify relevant performance measures by considering the information that the company uses to manage the business.

Obtaining an Understanding of Internal Control Over Financial Reporting

18. The auditor should obtain a sufficient understanding of each component[54/] of internal control over financial reporting ("understanding of internal control") to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.

19. The nature, timing, and extent of procedures that are necessary to obtain an understanding of internal control depend on the size and complexity of the company;[55/]

54/ Paragraphs 21-22 of this standard discuss components of internal control over financial reporting.

55/ Paragraph 13 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements, states, "The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its control objectives. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks."

the auditor's existing knowledge of the company's internal control over financial reporting; the nature of the company's controls, including the company's use of IT; the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting.

Note: The auditor also might obtain an understanding of certain controls that are not part of internal control over financial reporting, e.g., controls over the completeness and accuracy of operating or other nonfinancial information used as audit evidence.[56/]

20. Obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.

Note: Procedures the auditor performs to obtain evidence about design effectiveness include inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs, as described in paragraphs 37-38, that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Note: Determining whether a control has been implemented means determining whether the control exists and whether the company is using

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56/ Paragraph 10 of Auditing Standard No. 15.

it. The procedures to determine whether a control has been implemented may be performed in connection with the evaluation of its design. Procedures performed to determine whether a control has been implemented include inquiry of appropriate personnel, in combination with observation of the application of controls or inspection of documentation. Walkthroughs, as described in paragraphs 37-38, that include these procedures ordinarily are sufficient to determine whether a control has been implemented.

21. Internal control over financial reporting can be described as consisting of the following components:[57/]

- The control environment,
- The company's risk assessment process,
- Information and communication,
- Control activities, and
- Monitoring of controls.

57/ Different internal control frameworks use different terms and approaches to describe the components of internal control over financial reporting.

22. Management might use an internal control framework with components that differ from the components identified in the preceding paragraph when establishing and maintaining the company's internal control over financial reporting. In evaluating the design of controls and determining whether they have been implemented in an audit of financial statements only, the auditor may use the framework used by management or another suitable, recognized framework.[58/] For integrated audits, Auditing Standard No. 5, states, "The auditor should use the same suitable, recognized control framework to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting."[59/] If the auditor uses a suitable, recognized internal control framework with components that differ from those listed in the preceding paragraph, the auditor should adapt the requirements in paragraphs 23-36 of this standard to conform to the components in the framework used.

Control Environment

23. The auditor should obtain an understanding of the company's control environment, including the policies and actions of management, the board, and the audit committee concerning the company's control environment.

58/ See Securities Exchange Act Release No. 34-47986 (June 5, 2003) for a description of the characteristics of a suitable, recognized framework.

59/ Paragraph 5 of Auditing Standard No. 5.

24. Obtaining an understanding of the control environment includes assessing:

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

  Note: In an audit of financial statements only, this assessment may be based on the evidence obtained in understanding the control environment, in accordance with paragraph 23, and the other relevant knowledge possessed by the auditor. In an integrated audit of financial statements and internal control over financial reporting, Auditing Standard No. 5[60/] describes the auditor's responsibility for evaluating the control environment.

25. If the auditor identifies a control deficiency[61/] in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor, as discussed in paragraphs 65-66 of this standard.

60/ Paragraph 25 of Auditing Standard No. 5.

61/ Paragraph A3 of Auditing Standard No. 5.

The Company's Risk Assessment Process

26. The auditor should obtain an understanding of management's process for:

a. Identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud ("fraud risks");

b. Assessing the likelihood and significance of misstatements resulting from those risks; and

c. Deciding about actions to address those risks.

27. Obtaining an understanding of the company's risk assessment process includes obtaining an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.

Information and Communication

28. Information System Relevant to Financial Reporting. The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including:

a. The classes of transactions in the company's operations that are significant to the financial statements;

b. The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, processed, recorded, and reported;

c. The related accounting records, supporting information, and specific accounts in the financial statements that are used to initiate, authorize, process, and record transactions;

d. How the information system captures events and conditions, other than transactions,[62/] that are significant to the financial statements; and

e. The period-end financial reporting process.

> Note: Appendix B discusses additional considerations regarding manual and automated systems and controls.

29. The auditor also should obtain an understanding of how IT affects the company's flow of transactions. (See Appendix B.)

> Note: The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the approach used to identify significant accounts and disclosures and their relevant assertions and,

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[62/] Examples of such events and conditions include depreciation and amortization and conditions affecting the recoverability of assets.

when applicable, to select the controls to test, as well as to assess risk and allocate audit effort.

30. A company's business processes are the activities designed to:

a. Develop, purchase, produce, sell and distribute a company's products or services;

b. Record information, including accounting and financial reporting information; and

c. Ensure compliance with laws and regulations relevant to the financial statements.

31. Obtaining an understanding of the company's business processes assists the auditor in obtaining an understanding of how transactions are initiated, authorized, processed, and recorded.

32. A company's period-end financial reporting process, as referred to in paragraph 28.e., includes the following:

- Procedures used to enter transaction totals into the general ledger;

- Procedures related to the selection and application of accounting principles;[63/]

- Procedures used to initiate, authorize, record, and process journal entries in the general ledger;

- Procedures used to record recurring and nonrecurring adjustments to the annual financial statements (and quarterly financial statements, if applicable); and

- Procedures for preparing annual financial statements and related disclosures (and quarterly financial statements, if applicable).

33. Communication. The auditor should obtain an understanding of how the company communicates financial reporting roles and responsibilities and significant matters relating to financial reporting to relevant company personnel and others, including:

- Communications between management, the audit committee, and the board of directors; and

- Communications to external parties, including regulatory authorities and shareholders.

63/ Paragraphs 12-13 of this standard.

Control Activities

34. The auditor should obtain an understanding of control activities that is sufficient to assess the factors that affect the risks of material misstatement and to design further audit procedures, as described in paragraph 18 of this standard.[64/] As the auditor obtains an understanding of the other components of internal control over financial reporting, he or she is also likely to obtain knowledge about some control activities. The auditor should use his or her knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control over financial reporting in determining the extent to which it is necessary to devote additional attention to obtaining an understanding of control activities to assess the factors that affect the risks of material misstatement and to design further audit procedures.

> Note: A broader understanding of control activities is needed for relevant assertions for which the auditor plans to rely on controls. Also, in the audit of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit.

64/ Also see paragraph B5 of Appendix B of this standard.

Monitoring of Controls

35. The auditor should obtain an understanding of the major types of activities that the company uses to monitor the effectiveness of its internal control over financial reporting and how the company initiates corrective actions related to its controls.[65/]

36. An understanding of the company's monitoring activities includes understanding the source of the information used in the monitoring activities.

Performing Walkthroughs

37. As discussed in paragraph 20, the auditor may perform walkthroughs as part of obtaining an understanding of internal control over financial reporting. For example, the auditor may perform walkthroughs in connection with understanding the flow of transactions in the information system relevant to financial reporting, evaluating the design of controls relevant to the audit, and determining whether those controls have been implemented. In performing a walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and IT that company personnel use. Walkthrough procedures usually include a combination of

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65/ In some companies, internal auditors or others performing an equivalent function contribute to the monitoring of controls. AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements, establishes requirements regarding the auditor's consideration and use of the work of the internal audit function.

inquiry, observation, inspection of relevant documentation, and re-performance of controls.

> Note: For integrated audits, Auditing Standard No. 5 establishes certain objectives that the auditor should achieve to further understand likely sources of potential misstatements and as part of selecting the controls to test. Auditing Standard No. 5 states that performing walkthroughs will frequently be the most effective way of achieving those objectives.[66/]

38. In performing a walkthrough, at the points at which important processing procedures occur, the auditor questions the company's personnel about their understanding of what is required by the company's prescribed procedures and controls. These probing questions, combined with the other walkthrough procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walkthrough allow the auditor to gain an understanding of the different types of significant transactions handled by the process.

66/ See paragraphs 34-38 of Auditing Standard No. 5.

Relationship of Understanding of Internal Control to Tests of Controls

39. The objective of obtaining an understanding of internal control, as discussed in paragraph 18 of this standard, is different from testing controls for the purpose of assessing control risk[67/] or for the purpose of expressing an opinion on internal control over financial reporting in the audit of internal control over financial reporting.[68/] The auditor may obtain an understanding of internal control concurrently with performing tests of controls if he or she obtains sufficient appropriate evidence to achieve the objectives of both procedures. Also, the auditor should take into account the evidence obtained from understanding internal control when assessing control risk and, in the audit of internal control over financial reporting, forming an opinion about the effectiveness of internal control over financial reporting.

40. Relationship of Understanding of Internal Control to Evaluating Entity-Level Controls in an Audit of Internal Control Over Financial Reporting. Auditing Standard No. 5 states, "The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting."[69/] The procedures performed to obtain an understanding of certain components of internal control in accordance with this standard, e.g., the control

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67/ Paragraphs 16-35 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

68/ Paragraph B1 of Auditing Standard No. 5.

69/ Paragraph 22 of Auditing Standard No. 5.

environment, the company's risk assessment process, information and communication, and monitoring of controls, might provide evidence that is relevant to the auditor's evaluation of entity-level controls.[70/] The auditor should take into account the evidence obtained from understanding internal control when determining the nature, timing, and extent of procedures necessary to support the auditor's conclusions about the effectiveness of entity-level controls in the audit of internal control over financial reporting.

Considering Information from the Client Acceptance and Retention Evaluation, Audit Planning Activities, Past Audits, and Other Engagements

41. Client Acceptance and Retention and Audit Planning Activities. The auditor should evaluate whether information obtained from the client acceptance and retention evaluation process or audit planning activities is relevant to identifying risks of material misstatement. Risks of material misstatement identified during those activities should be assessed as discussed beginning in paragraph 59 of this standard.

42. Past Audits. In subsequent years, the auditor should incorporate knowledge obtained during past audits into the auditor's process for identifying risks of material misstatement, including when identifying significant ongoing matters that affect the risks of material

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[70/] The entity-level controls included in paragraph 24 of Auditing Standard No. 5 include controls related to the control environment; the company's risk assessment process; centralized processing and controls; controls over the period-end financial reporting process; and controls to monitor other controls.

misstatement or determining how changes in the company or its environment affect the risks of material misstatement, as discussed in paragraph 8 of this standard.

43. If the auditor plans to limit the nature, timing, or extent of his or her risk assessment procedures by relying on information from past audits, the auditor should evaluate whether the prior years' information remains relevant and reliable.

44. Other Engagements. When the auditor has performed a review of interim financial information in accordance with AU sec. 722, Interim Financial Information, the auditor should evaluate whether information obtained during the review is relevant to identifying risks of material misstatement in the year-end audit.

45. The auditor should obtain an understanding of the nature of the services that have been performed for the company by the auditor or affiliates of the firm[71/] and should take into account relevant information obtained from those engagements in identifying risks of material misstatement.[72/]

Performing Analytical Procedures

46. The auditor should perform analytical procedures that are designed to:

71/ See PCAOB Rule 3501(a)(i), which defines "affiliate of the accounting firm."

72/ Paragraph 7 of Auditing Standard No. 9, Audit Planning.

a. Enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior year end; and

b. Identify areas that might represent specific risks relevant to the audit, including the existence of unusual transactions and events, and amounts, ratios, and trends that warrant investigation.

47. In applying analytical procedures as risk assessment procedures, the auditor should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including material misstatement due to fraud. Also, when the auditor has performed a review of interim financial information in accordance with AU sec. 722, he or she should take into account the analytical procedures applied in that review when designing and applying analytical procedures as risk assessment procedures.

48. When performing an analytical procedure, the auditor should use his or her understanding of the company to develop expectations about plausible relationships among the data to be used in the procedure.[73/] When comparison of those expectations with relationships derived from recorded amounts yields unusual or unexpected results,

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[73/] Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data.

the auditor should take into account those results in identifying the risks of material misstatement.

Note: Analytical procedures performed as risk assessment procedures often use data that is preliminary or data that is aggregated at a high level, and, in those instances, such analytical procedures are not designed with the level of precision necessary for substantive analytical procedures.

Conducting a Discussion among Engagement Team Members Regarding Risks of Material Misstatement

49. The key engagement team members should discuss (1) the company's selection and application of accounting principles, including related disclosure requirements, and (2) the susceptibility of the company's financial statements to material misstatement due to error or fraud.

Note: The key engagement team members should discuss the potential for material misstatement due to fraud either as part of the discussion regarding risks of material misstatement or in a separate discussion.[74]

Note: As discussed in paragraph 67, the financial statements might be susceptible to misstatement through omission of required disclosures or presentation of inaccurate or incomplete disclosures.

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[74] Paragraphs 52-53 of this standard.

50. Key engagement team members include all engagement team members who have significant engagement responsibilities, including the engagement partner. The manner in which the discussion is conducted depends on the individuals involved and the circumstances of the engagement. For example, if the audit involves more than one location, there could be multiple discussions with team members in differing locations. The engagement partner or other key engagement team members should communicate the important matters from the discussion to engagement team members who are not involved in the discussion.

> Note: If the audit is performed entirely by the engagement partner, that engagement partner, having personally conducted the planning of the audit, is responsible for evaluating the susceptibility of the company's financial statements to material misstatement.

51. Communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change.[75/]

Discussion of the Potential for Material Misstatement Due to Fraud

52. The discussion among the key engagement team members about the potential for material misstatement due to fraud should occur with an attitude that includes a

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75/ See also paragraph 29 of Auditing Standard No. 14, Evaluating Audit Results.

questioning mind, and the key engagement team members should set aside any prior beliefs they might have that management is honest and has integrity. The discussion among the key engagement team members should include:

- An exchange of ideas, or "brainstorming," among the key engagement team members, including the engagement partner, about how and where they believe the company's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the company could be misappropriated, including (a) the susceptibility of the financial statements to material misstatement through related party transactions and (b) how fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures;

- A consideration of the known external and internal factors affecting the company that might (a) create incentives or pressures for management and others to commit fraud, (b) provide the opportunity for fraud to be perpetrated, and (c) indicate a culture or environment that enables management to rationalize committing fraud;

- A consideration of the risk of management override; and

- A consideration of the potential audit responses to the susceptibility of the company's financial statements to material misstatement due to fraud.

53. The auditor should emphasize the following matters to all engagement team members:

- The need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, as described in AU sec. 316;[76/]

- The need to be alert for information or other conditions (such as those matters presented in Appendix C of Auditing Standard No. 14) that might affect the assessment of fraud risks; and

- If information or other conditions indicate that a material misstatement due to fraud might have occurred, the need to probe the issues, acquire additional evidence as necessary, and consult with other team members and, if appropriate, others in the firm including specialists.[77/]

Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement

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76/ AU sec. 316.13.

77/ Paragraphs 20-23 of Auditing Standard No. 14 establish further requirements for evaluating whether misstatements might be indicative of fraud and determining the necessary procedures to be performed in those situations.

54. The auditor should inquire of the audit committee, or equivalent (or its chair), management, the internal audit function, and others within the company who might reasonably be expected to have information that is important to the identification and assessment of risks of material misstatement.

> Note: The auditor's inquiries about risks of material misstatement should include inquiries regarding fraud risks.

55. The auditor should use his or her knowledge of the company and its environment, as well as information from other risk assessment procedures, to determine the nature of the inquiries about risks of material misstatement.

Inquiries Regarding Fraud Risks

56. The auditor's inquiries regarding fraud risks should include the following:

a. Inquiries of management regarding:

   (1) Whether management has knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

   (2) Management's process for identifying and responding to fraud risks in the company, including any specific fraud risks the company has identified or account balances or disclosures for

which a fraud risk is likely to exist, and the nature, extent, and frequency of management's fraud risk assessment process;

(3) Controls that the company has established to address fraud risks the company has identified, or that otherwise help to prevent and detect fraud, including how management monitors those controls;

(4) For a company with multiple locations (a) the nature and extent of monitoring of operating locations or business segments and (b) whether there are particular operating locations or business segments for which a fraud risk might be more likely to exist;

(5) Whether and how management communicates to employees its views on business practices and ethical behavior;

(6) Whether management has received tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program, if such program exists) and, if so, management's responses to such tips and complaints; and

(7) Whether management has reported to the audit committee on how the company's internal control serves to prevent and detect material misstatements due to fraud.

b. Inquiries of the audit committee, or equivalent, or its chair regarding:

(1) The audit committee's views about fraud risks in the company;

(2) Whether the audit committee has knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

(3) Whether the audit committee is aware of tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program, if such program exists) and, if so, the audit committee's responses to such tips and complaints; and

(4) How the audit committee exercises oversight of the company's assessment of fraud risks and the establishment of controls to address fraud risks.

c. If the company has an internal audit function, inquiries of appropriate internal audit personnel regarding:

(1) The internal auditors' views about fraud risks in the company;

(2) Whether the internal auditors have knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

(3) Whether internal auditors have performed procedures to identify or detect fraud during the year, and whether management has satisfactorily responded to the findings resulting from those procedures; and

(4) Whether internal auditors are aware of instances of management override of controls and the nature and circumstances of such overrides.

57. In addition to the inquiries outlined in the preceding paragraph, the auditor should inquire of others within the company about their views regarding fraud risks, including, in particular, whether they have knowledge of fraud, alleged fraud, or suspected fraud. The auditor should identify other individuals within the company to whom inquiries should be directed and determine the extent of such inquiries by considering whether others in the company might have additional knowledge about fraud, alleged fraud, or suspected fraud or might be able to corroborate fraud risks identified in discussions with management or the audit committee. Examples of other individuals within the company to whom inquiries might be directed include:

- Employees with varying levels of authority within the company, including, e.g., company personnel with whom the auditor comes into contact during the course of the audit (a) in obtaining an understanding of internal control, (b) in observing inventory or performing cutoff procedures, or (c) in obtaining explanations for significant differences identified when performing analytical procedures;

- Operating personnel not directly involved in the financial reporting process;
- Employees involved in initiating, recording, or processing complex or unusual transactions, e.g., a sales transaction with multiple elements or a significant related party transaction; and
- In-house legal counsel.

58. When evaluating management's responses to inquiries about fraud risks and determining when it is necessary to corroborate management's responses, the auditor should take into account the fact that management is often in the best position to commit fraud. Also, the auditor should obtain evidence to address inconsistencies in responses to the inquiries.

<u>Identifying and Assessing the Risks of Material Misstatement</u>

59. The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level. In identifying and assessing risks of material misstatement, the auditor should:

a. Identify risks of misstatement using information obtained from performing risk assessment procedures (as discussed in paragraphs 4-58) and considering the characteristics of the accounts and disclosures in the financial statements.

> Note: Factors relevant to identifying fraud risks are discussed in paragraphs 65-69 of this standard.

b. Evaluate whether the identified risks relate pervasively to the financial statements as a whole and potentially affect many assertions.

c. Evaluate the types of potential misstatements that could result from the identified risks and the accounts, disclosures, and assertions that could be affected.

> Note: In identifying and assessing risks at the assertion level, the auditor should evaluate how risks at the financial statement level could affect risks of misstatement at the assertion level.

d. Assess the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statements.

> Note: In assessing the likelihood and magnitude of potential misstatement, the auditor may take into account the planned degree of reliance on controls selected to test.[78/]

e. Identify significant accounts and disclosures[79/] and their relevant assertions[80/] (paragraphs 60-64 of this standard).

> Note: The determination of whether an account or disclosure is significant or whether an assertion is a

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78/ Paragraphs 16-35 of Auditing Standard No. 13.

79/ Paragraph A10 of Auditing Standard No. 5 states:

> An account or disclosure is a significant account or disclosure if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.

80/ Paragraph A9 of Auditing Standard No. 5 states:

> A relevant assertion is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.

relevant assertion is based on inherent risk, without regard to the effect of controls.

f. Determine whether any of the identified and assessed risks of material misstatement are **significant risks** (paragraphs 70-71 of this standard).

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

60. To identify significant accounts and disclosures and their relevant assertions in accordance with paragraph 59.e., the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include:

- Size and composition of the account;
- Susceptibility to misstatement due to error or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- Nature of the account or disclosure;
- Accounting and reporting complexities associated with the account or disclosure;

- Exposure to losses in the account;
- Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;
- Existence of related party transactions in the account; and
- Changes from the prior period in account and disclosure characteristics.

61. As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account or disclosure.

62. The risk factors that the auditor should evaluate in the identification of significant accounts and disclosures and their relevant assertions are the same in the audit of internal control over financial reporting as in the audit of the financial statements; accordingly, significant accounts and disclosures and their relevant assertions are the same for both audits.

> Note: In the financial statement audit, the auditor might perform substantive auditing procedures on financial statement accounts,

disclosures, and assertions that are not determined to be significant accounts and disclosures and relevant assertions.[81/]

63. The components of a potential significant account or disclosure might be subject to significantly differing risks.

64. When a company has multiple locations or business units, the auditor should identify significant accounts and disclosures and their relevant assertions based on the consolidated financial statements.

Factors Relevant to Identifying Fraud Risks

65. The auditor should evaluate whether the information gathered from the risk assessment procedures indicates that one or more fraud risk factors are present and should be taken into account in identifying and assessing fraud risks. Fraud risk factors are events or conditions that indicate (1) an incentive or pressure to perpetrate fraud, (2) an opportunity to carry out the fraud, or (3) an attitude or rationalization that justifies the fraudulent action. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances in which fraud exists. Examples of

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[81/] The auditor might perform substantive auditing procedures because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high or as a means of introducing unpredictability in the procedures performed. See paragraphs 11, 14, and 25 of Auditing Standard No. 14, for further discussion about undetected misstatement. See paragraph 61 of Auditing Standard No. 5 and paragraph 5.c. of Auditing Standard No. 13, for further discussion about the unpredictability of auditing procedures.

fraud risk factors related to fraudulent financial reporting and misappropriation of assets are listed in AU sec. 316.85. These illustrative risk factors are classified based on the three conditions discussed in this paragraph, which generally are present when fraud exists.

> Note: The factors listed in AU sec. 316.85 cover a broad range of situations and are only examples. Accordingly, the auditor might identify additional or different fraud risk factors.

66. All three conditions discussed in the preceding paragraph are not required to be observed or evident to conclude that a fraud risk exists. The auditor might conclude that a fraud risk exists even when only one of these three conditions is present.

67. Consideration of the Risk of Omitted, Incomplete, or Inaccurate Disclosures. The auditor's evaluation of fraud risk factors in accordance with paragraph 65 should include evaluation of how fraud could be perpetrated or concealed by presenting incomplete or inaccurate disclosures or by omitting disclosures that are necessary for the financial statements to be presented fairly in conformity with the applicable financial reporting framework.

68. Presumption of Fraud Risk Involving Improper Revenue Recognition. The auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.

69. Consideration of the Risk of Management Override of Controls. The auditor's identification of fraud risks should include the risk of management override of controls.

> Note: Controls over management override are important to effective internal control over financial reporting for all companies, and may be particularly important at smaller companies because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller companies, the controls that address the risk of management override might be different from those at a larger company. For example, a smaller company might rely on more detailed oversight by the audit committee that focuses on the risk of management override.

Factors Relevant to Identifying Significant Risks

70. To determine whether an identified and assessed risk is a significant risk, the auditor should evaluate whether the risk requires special audit consideration because of the nature of the risk or the likelihood and potential magnitude of misstatement related to the risk.

> Note: The determination of whether a risk of material misstatement is a significant risk is based on inherent risk, without regard to the effect of controls.

71. Factors that should be evaluated in determining which risks are significant risks include:

a. The effect of the quantitative and qualitative risk factors discussed in paragraph 60 on the likelihood and potential magnitude of misstatements;

b. Whether the risk is a fraud risk;

Note: A fraud risk is a significant risk.

c. Whether the risk is related to recent significant economic, accounting, or other developments;

d. The complexity of transactions;

e. Whether the risk involves significant transactions with related parties;

f. The degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

g. Whether the risk involves significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature.

Further Consideration of Controls

72. When the auditor has determined that a significant risk, including a fraud risk, exists, the auditor should evaluate the design of the company's controls that are intended to address fraud risks and other significant risks and determine whether those controls have been implemented, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs 18-40 of this standard.[82]

73. Controls that address fraud risks include (a) specific controls designed to mitigate specific risks of fraud, e.g., controls to address risks of intentional misstatement of specific accounts and (b) controls designed to prevent, deter, and detect fraud, e.g., controls to promote a culture of honesty and ethical behavior.[83] Such controls also include those that address the risk of management override of other controls.

__Revision of Risk Assessment__

74. The auditor's assessment of the risks of material misstatement, including fraud risks, should continue throughout the audit. When the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify

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[82] Auditing Standard No. 13 discusses the auditor's response to fraud risks and other significant risks.

[83] AU sec. 316.88 and paragraph 14 of Auditing Standard No. 5 present examples of controls that address fraud risks.

planned audit procedures or perform additional procedures in response to the revised risk assessments.[84/]

APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Business risks – Risks that result from significant conditions, events, circumstances, actions, or inactions that could adversely affect a company's ability to achieve its objectives and execute its strategies. Business risks also might result from setting inappropriate objectives and strategies or from changes or complexity in the company's operations or management.

A3. Company's objectives and strategies – The overall plans for the company as established by management or the board of directors. Strategies are the approaches by which management intends to achieve its objectives.

A4. Risk assessment procedures – The procedures performed by the auditor to obtain information for identifying and assessing the risks of material misstatement in the financial statements whether due to error or fraud.

> Note: Risk assessment procedures by themselves do not provide sufficient appropriate evidence on which to base an audit opinion.

84/ See also paragraph 46 of Auditing Standard No. 13.

A5. Significant risk – A risk of material misstatement that requires special audit consideration.

<u>APPENDIX B</u> – Consideration of Manual and Automated Systems and Controls

B1. While obtaining an understanding of the company's information system related to financial reporting, the auditor should obtain an understanding of how the company uses information technology ("IT") and how IT affects the financial statements.[85/] The auditor also should obtain an understanding of the extent of manual controls and automated controls used by the company, including the IT general controls that are important to the effective operation of the automated controls. That information should be taken into account in assessing the risks of material misstatement.[86/]

B2. Controls in a manual system might include procedures such as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items.

B3. Alternatively, a company might use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format would replace paper documents. When IT is used to initiate, record, process, and report

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85/ <u>See also</u> AU sec. 324, <u>Service Organizations</u>, if the company uses a service organization for services that are part of the company's internal control over financial reporting.

86/ <u>See also</u> paragraphs 16-17 of Auditing Standard No. 9, <u>Audit Planning</u>.

transactions, the IT systems and programs may include controls related to the relevant assertions of significant accounts and disclosures or may be critical to the effective functioning of manual controls that depend on IT.

B4. The auditor should obtain an understanding of specific risks to a company's internal control over financial reporting resulting from IT. Examples of such risks include:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both;
- Unauthorized access to data that might result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions or inaccurate recording of transactions (particular risks might arise when multiple users access a common database);
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby breaking down segregation of duties;
- Unauthorized changes to data in master files;
- Unauthorized changes to systems or programs;
- Failure to make necessary changes to systems or programs;

- Inappropriate manual intervention; and

- Potential loss of data or inability to access data as required.

B5. In obtaining an understanding of the company's control activities, the auditor should obtain an understanding of how the company has responded to risks arising from IT.

B6. When a company uses manual elements in internal control systems and the auditor plans to rely on, and therefore test, those manual controls, the auditor should design procedures to test the consistency in the application of those manual controls.

Auditing Standard No. 13

The Auditor's Responses to the Risks of Material Misstatement

Introduction

1. This standard establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement.

Objective

2. The objective of the auditor is to address the risks of material misstatement through appropriate overall audit responses and audit procedures.

<u>Responding to the Risks of Material Misstatement</u>

3. To meet the objective in the preceding paragraph, the auditor must design and implement audit responses that address the risks of material misstatement that are identified and assessed in accordance with Auditing Standard No. 12, <u>Identifying and Assessing Risks of Material Misstatement</u>.

4. This standard discusses the following types of audit responses:

   a. Responses that have an overall effect on how the audit is conducted ("overall responses"), as described in paragraphs 5-7; and

   b. Responses involving the nature, timing, and extent of the audit procedures to be performed, as described in paragraphs 8-46.

<u>Overall Responses</u>

5. The auditor should design and implement overall responses to address the assessed risks of material misstatement as follows:

   a. <u>Making appropriate assignments of significant engagement responsibilities</u>. The knowledge, skill, and ability of engagement team members with significant engagement responsibilities should be commensurate with the assessed risks of material misstatement.[87]

b. Providing the extent of supervision that is appropriate for the circumstances, including, in particular, the assessed risks of material misstatement. (See paragraphs 5–6 of Auditing Standard No. 10, Supervision of the Audit Engagement.)

c. Incorporating elements of unpredictability in the selection of audit procedures to be performed. As part of the auditor's response to the assessed risks of material misstatement, including the assessed risks of material misstatement due to fraud ("fraud risks"), the auditor should incorporate an element of unpredictability in the selection of auditing procedures to be performed from year to year. Examples of ways to incorporate an element of unpredictability include:

    (1) Performing audit procedures related to accounts, disclosures, and assertions that would not otherwise be tested based on their amount or the auditor's assessment of risk;

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[87] See also paragraph .06 of AU sec. 230, Due Professional Care in the Performance of Work.

(2) Varying the timing of the audit procedures;

(3) Selecting items for testing that have lower amounts or are otherwise outside customary selection parameters;

(4) Performing audit procedures on an unannounced basis; and

(5) In multi-location audits, varying the location or the nature, timing, and extent of audit procedures at related locations or business units from year to year.[88/]

d. Evaluating the company's selection and application of significant accounting principles. The auditor should evaluate whether the company's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions,[89/] are indicative of bias that could lead to material misstatement of the financial statements.

88/ For integrated audits, paragraphs 61 and B13 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, establish requirements for introducing unpredictability in testing of controls from year to year and in multi-location audits.

89/ Paragraphs 12-13 of Auditing Standard No. 12 discuss the auditor's responsibilities regarding obtaining an understanding of the company's selection and application of accounting principles. See also paragraphs .66-.67 of AU sec. 316, Consideration of Fraud in a Financial Statement Audit, and paragraphs .04 and .06 of AU sec. 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.

Note: Paragraph .11 of AU sec. 380, Communication With Audit Committees, discusses the auditor's judgments about the quality of a company's accounting principles.

6. The auditor also should determine whether it is necessary to make pervasive changes to the nature, timing, or extent of audit procedures to adequately address the assessed risks of material misstatement. Examples of such pervasive changes include modifying the audit strategy to:

a. Increase the substantive testing of the valuation of numerous significant accounts at year end because of significantly deteriorating market conditions, and

b. Obtain more persuasive audit evidence from substantive procedures due to the identification of pervasive weaknesses in the company's control environment.

7. Due professional care requires the auditor to exercise professional skepticism.[90/] Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence. The auditor's responses to the assessed risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating audit

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[90/] AU secs. 230.07-.09.

evidence.[91] Examples of the application of professional skepticism in response to the assessed fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining sufficient appropriate evidence to corroborate management's explanations or representations concerning important matters, such as through third-party confirmation, use of a specialist engaged or employed by the auditor, or examination of documentation from independent sources.

Responses Involving the Nature, Timing, and Extent of Audit Procedures

8. The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.

9. In designing the audit procedures to be performed, the auditor should:

   a. Obtain more persuasive audit evidence the higher the auditor's assessment of risk;

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[91] AU sec. 316.13.

b. Take into account the types of potential misstatements that could result from the identified risks and the likelihood and magnitude of potential misstatement;[92]

c. In an integrated audit, design the testing of controls to accomplish the objectives of both audits simultaneously:

(1) To obtain sufficient evidence to support the auditor's control risk[93] assessments for purposes of the audit of financial statements;[94] and

(2) To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end.

Note: Auditing Standard No. 5 establishes requirements for tests of controls in the audit of internal control over financial reporting.

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[92] For example, potential misstatements regarding disclosures include omission of required disclosures or presentation of inaccurate or incomplete disclosures.

[93] See paragraph 7.b. of Auditing Standard No. 8, Audit Risk, for a definition of control risk.

[94] For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of financial statements only.

10. The audit procedures performed in response to the assessed risks of material misstatement can be classified into two categories: (1) tests of controls and (2) substantive procedures.[95/] Paragraphs 16-35 of this standard discuss tests of controls, and paragraphs 36-46 discuss substantive procedures.

> Note: Paragraphs 16-17 of this standard discuss when tests of controls are necessary in a financial statement audit. Ordinarily, tests of controls are performed for relevant assertions for which the auditor chooses to rely on controls to modify his or her substantive procedures.

Responses to Significant Risks

11. For significant risks, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed risks.

> Note: Auditing Standard No. 12 discusses identification of significant risks[96/] and states that fraud risks are significant risks.

Responses to Fraud Risks

[95/] Substantive procedures consist of (a) tests of details of accounts and disclosures and (b) substantive analytical procedures.

[96/] See paragraph 71 of Auditing Standard No. 12 for factors that the auditor should evaluate in determining which risks are significant risks.

12. The audit procedures that are necessary to address the assessed fraud risks depend upon the types of risks and the relevant assertions that might be affected.

Note: If the auditor identifies deficiencies in controls that are intended to address assessed fraud risks, the auditor should take into account those deficiencies when designing his or her response to those fraud risks.

Note: Auditing Standard No. 5 establishes requirements for addressing assessed fraud risks in the audit of internal control over financial reporting.[97/]

13. Addressing Fraud Risks in the Audit of Financial Statements. In the audit of financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed fraud risks. If the auditor selects certain controls intended to address the assessed fraud risks for testing in accordance with paragraphs 16-17 of this standard, the auditor should perform tests of those controls.

14. The following are examples of ways in which planned audit procedures may be modified to address assessed fraud risks:

a. Changing the nature of audit procedures to obtain evidence that is more reliable or to obtain additional corroborative information;

97/ Paragraphs 14-15 of Auditing Standard No. 5.

b. Changing the timing of audit procedures to be closer to the end of the period or to the points during the period in which fraudulent transactions are more likely to occur; and

c. Changing the extent of the procedures applied to obtain more evidence, e.g., by increasing sample sizes or applying computer-assisted audit techniques to all of the items in an account.

> Note: AU secs. 316.54-.67 provide additional examples of responses to assessed fraud risks relating to fraudulent financial reporting (e.g., revenue recognition, inventory quantities, and management estimates) and misappropriation of assets in the audit of financial statements.

15. Also, AU sec. 316 indicates that the auditor should perform audit procedures to specifically address the risk of management override of controls including:

a. Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud (AU secs. 316.58-.62);

b. Reviewing accounting estimates for biases that could result in material misstatement due to fraud (AU secs. 316.63-.65); and

c. Evaluating the business rationale for significant unusual transactions (AU secs. 316.66-.67).

Testing Controls

Testing Controls in an Audit of Financial Statements

16. Controls to be Tested. If the auditor plans to assess control risk at less than the maximum by relying on controls,[98/] and the nature, timing, and extent of planned substantive procedures are based on that lower assessment, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire **period of reliance.**[99/] However, the auditor is not required to assess control risk at less than the maximum for all relevant assertions and, for a variety of reasons, the auditor may choose not to do so.

17. Also, tests of controls must be performed in the audit of financial statements for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence and when necessary to support the auditor's reliance on the

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98/ Reliance on controls that is supported by sufficient and appropriate audit evidence allows the auditor to assess control risk at less than the maximum, which results in a lower assessed risk of material misstatement. In turn, this allows the auditor to modify the nature, timing, and extent of planned substantive procedures.

99/ Terms defined in Appendix A, Definitions, are set in **boldface type** the first time they appear.

accuracy and completeness of financial information used in performing other audit procedures.[100/]

> Note: When a significant amount of information supporting one or more relevant assertions is electronically initiated, recorded, processed, or reported, it might be impossible to design effective substantive tests that, by themselves, would provide sufficient appropriate evidence regarding the assertions. For such assertions, significant audit evidence may be available only in electronic form. In such cases, the sufficiency and appropriateness of the audit evidence usually depend on the effectiveness of controls over their accuracy and completeness. Furthermore, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, recorded, processed, or reported only in electronic form and appropriate controls are not operating effectively.

18. Evidence about the Effectiveness of Controls in the Audit of Financial Statements. In designing and performing tests of controls for the audit of financial statements, the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The auditor should

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[100/] Paragraph 10 of Auditing Standard No. 15, Audit Evidence, and paragraph .16 of AU sec. 329, Substantive Analytical Procedures.

obtain more persuasive audit evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. The auditor also should obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls, including situations in which substantive procedures alone cannot provide sufficient appropriate audit evidence.

Testing Design Effectiveness

19. The auditor should test the design effectiveness of the controls selected for testing by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect error or fraud that could result in material misstatements in the financial statements.

> Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.

20. Procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.[101/]

Testing Operating Effectiveness

21. The auditor should test the operating effectiveness of a control selected for testing by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

22. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

Obtaining Evidence from Tests of Controls

23. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the nature, timing, and extent of testing

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[101/] Paragraphs 37-38 of Auditing Standard No. 12 discuss performing a walkthrough.

might provide sufficient evidence in relation to the degree of reliance in an audit of financial statements.

> Note: To obtain evidence about whether a control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures.

Nature of Tests of Controls

24. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in the order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and re-performance of a control.

> Note: Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control.

25. The nature of the tests of controls that will provide appropriate evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

Note: A smaller, less complex company or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of activities, inspection of less formal documentation, or re-performance of certain controls, might provide sufficient evidence about whether the control is effective.

Extent of Tests of Controls

26. The more extensively a control is tested, the greater the evidence obtained from that test.

27. Matters that could affect the necessary extent of testing of a control in relation to the degree of reliance on a control include the following:

- The frequency of the performance of the control by the company during the audit period;
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control;
- The expected rate of deviation from a control;
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control;

- The extent to which audit evidence is obtained from tests of other controls related to the assertion;

- The nature of the control, including, in particular, whether it is a manual control or an automated control; and

- For an automated control, the effectiveness of relevant information technology general controls.

> Note: AU sec. 350, Audit Sampling, establishes requirements regarding the use of sampling in tests of controls.

Timing of Tests of Controls

28. The timing of tests of controls relates to when the evidence about the operating effectiveness of the controls is obtained and the period of time to which it applies. Paragraph 16 of this standard indicates that the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire period of reliance.

29. Using Audit Evidence Obtained during an Interim Period. When the auditor obtains evidence about the operating effectiveness of controls as of or through an interim date, he

or she should determine what additional evidence is necessary concerning the operation of the controls for the remaining period of reliance.

30. The additional evidence that is necessary to update the results of testing from an interim date through the remaining period of reliance depends on the following factors:

- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date;

    Note: If there have been significant changes to the control since the interim date, the auditor should obtain evidence about the effectiveness of the new or modified control;

- The inherent risk associated with the related account(s) or assertion(s);

- The specific control tested prior to year end, including the nature of the control and the risk that the control is no longer effective during the remaining period, and the results of the tests of the control;

- The planned degree of reliance on the control;

- The sufficiency of the evidence of effectiveness obtained at an interim date; and

- The length of the remaining period.

31. <u>Using Audit Evidence Obtained in Past Audits</u>. For audits of financial statements, the auditor should obtain evidence during the current year audit about the design and operating effectiveness of controls upon which the auditor relies. When controls on which the auditor plans to rely have been tested in past audits and the auditor plans to use evidence about the effectiveness of those controls that was obtained in prior years, the auditor should take into account the following factors to determine the evidence needed during the current year audit to support the auditor's control risk assessments:

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) or assertion(s);
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether the account has a history of errors;
- The effectiveness of entity-level controls that the auditor has tested, especially controls that monitor other controls;
- The nature of the controls and the frequency with which they operate;

- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);

- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;

- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective);[102/]

- The complexity of the control and the significance of the judgments that must be made in connection with its operation;

- The planned degree of reliance on the control;

- The nature, timing, and extent of procedures performed in past audits;

- The results of the previous years' testing of the control;

[102/] The auditor also may use a benchmarking strategy, when appropriate, for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph B28 of Auditing Standard No. 5.

- Whether there have been changes in the control or the process in which it operates since the previous audit; and

- For integrated audits, the evidence regarding the effectiveness of the controls obtained during the audit of internal control.

Assessing Control Risk

32. The auditor should assess control risk for relevant assertions by evaluating the evidence obtained from all sources, including the auditor's testing of controls for the audit of internal control and the audit of financial statements, misstatements detected during the financial statement audit, and any identified control deficiencies.

33. Control risk should be assessed at the maximum level for relevant assertions (1) for which controls necessary to sufficiently address the assessed risk of material misstatement in those assertions are missing or ineffective or (2) when the auditor has not obtained sufficient appropriate evidence to support a control risk assessment below the maximum level.

34. When deficiencies affecting the controls on which the auditor intends to rely are detected, the auditor should evaluate the severity of the deficiencies and the effect on the auditor's control risk assessments. If the auditor plans to rely on controls relating to an assertion but the controls that the auditor tests are ineffective because of control deficiencies, the auditor should:

a. Perform tests of other controls related to the same assertion as the ineffective controls, or

b. Revise the control risk assessment and modify the planned substantive procedures as necessary in light of the increased assessment of risk.

> Note: Auditing Standard No. 5 establishes requirements for evaluating the severity of a control deficiency and communicating identified control deficiencies to management and the audit committee in an integrated audit. AU sec. 325, Communications About Control Deficiencies in an Audit of Financial Statements, establishes requirements for communicating significant deficiencies and material weaknesses in an audit of financial statements only.

Testing Controls in an Audit of Internal Control

35. Auditing Standard No. 5 states that the objective of the tests of controls in an audit of internal control is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the company's internal control over financial reporting. The auditor's opinion relates to the effectiveness of the company's internal control over financial

reporting as of a point in time and taken as a whole.[103/] Auditing Standard No. 5 establishes requirements regarding the selection of controls to be tested and the necessary nature, timing, and extent of tests of controls in an audit of internal control over financial reporting.

Substantive Procedures

36. The auditor should perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.

37. As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases. The evidence provided by the auditor's substantive procedures depends upon the mix of the nature, timing, and extent of those procedures. Further, for an individual assertion, different combinations of the nature, timing, and extent of testing might provide sufficient appropriate evidence to respond to the assessed risk of material misstatement.

38. Internal control over financial reporting has inherent limitations,[104/] which, in turn, can affect the evidence that is needed from substantive procedures. For example, more evidence from substantive procedures ordinarily is needed for relevant assertions that

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103/ Paragraph B1 of Auditing Standard No. 5.

104/ Paragraph A5 of Auditing Standard No. 5.

have a higher susceptibility to management override or to lapses in judgment or breakdowns resulting from human failures.[105/]

Nature of Substantive Procedures

39. Substantive procedures generally provide persuasive evidence when they are designed and performed to obtain evidence that is relevant and reliable. Also, some types of substantive procedures, by their nature, produce more persuasive evidence than others. Inquiry alone does not provide sufficient appropriate evidence to support a conclusion about a relevant assertion.

> Note: Auditing Standard No. 15 discusses certain types of substantive procedures and the relevance and reliability of audit evidence.

40. Taking into account the types of potential misstatements in the relevant assertions that could result from identified risks, as required by paragraph 9.b., can help the auditor determine the types and combination of substantive audit procedures that are necessary to detect material misstatements in the respective assertions.

41. Substantive Procedures Related to the Period-end Financial Reporting Process. The auditor's substantive procedures must include the following audit procedures related to the period-end financial reporting process:

105/ See, e.g., paragraph .14 of AU sec. 328, Auditing Fair Value Measurements and Disclosures.

a. Reconciling the financial statements with the underlying accounting records; and

b. Examining material adjustments made during the course of preparing the financial statements.

> Note: AU secs. 316.58-.62 establish requirements for examining journal entries and other adjustments for evidence of possible material misstatement due to fraud.

Extent of Substantive Procedures

42. The more extensively a substantive procedure is performed, the greater the evidence obtained from the procedure. The necessary extent of a substantive audit procedure depends on the materiality of the account or disclosure, the assessed risk of material misstatement, and the necessary degree of assurance from the procedure. However, increasing the extent of an audit procedure cannot adequately address an assessed risk of material misstatement unless the evidence to be obtained from the procedure is reliable and relevant.

Timing of Substantive Procedures

43. Performing certain substantive procedures at interim dates may permit early consideration of matters affecting the year-end financial statements, e.g., testing material

transactions involving higher risks of misstatement. However, performing substantive procedures at an interim date without performing procedures at a later date increases the risk that a material misstatement could exist in the year-end financial statements that would not be detected by the auditor. This risk increases as the period between the interim date and year end increases.

44. In determining whether it is appropriate to perform substantive procedures at an interim date, the auditor should take into account the following:

a. The assessed risk of material misstatement, including:

   (1) The auditor's assessment of control risk, as discussed in paragraphs 32-34;

   (2) The existence of conditions or circumstances, if any, that create incentives or pressures on management to misstate the financial statements between the interim test date and the end of the period covered by the financial statements;

   (3) The effects of known or expected changes in the company, its environment, or its internal control over financial reporting during the remaining period;

b. The nature of the substantive procedures;

c. The nature of the account or disclosure and relevant assertion; and

d. The ability of the auditor to perform the necessary audit procedures to cover the remaining period.

45. When substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. Such procedures should include (a) comparing relevant information about the account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual and investigating such amounts and (b) performing audit procedures to test the remaining period.

46. If the auditor obtains evidence that contradicts the evidence on which the original risk assessments were based, including evidence of misstatements that he or she did not expect, the auditor should revise the related risk assessments and modify the planned nature, timing, or extent of substantive procedures covering the remaining period as necessary. Examples of such modifications include extending or repeating at the period end the procedures performed at the interim date.

Dual-purpose Tests

47. In some situations, the auditor might perform a substantive test of a transaction concurrently with a test of a control relevant to that transaction (a "**dual-purpose test**"). In those situations, the auditor should design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested.[106/]

APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Dual-purpose test – Substantive test of a transaction and a test of a control relevant to that transaction that are performed concurrently, e.g., a substantive test of sales transactions performed concurrently with a test of controls over those transactions.

A3. Period of reliance – The period being covered by the company's financial statements, or the portion of that period, for which the auditor plans to rely on controls in order to modify the nature, timing, and extent of planned substantive procedures.

106/ Paragraph .44 of AU sec. 350 discusses applying audit sampling in dual-purpose tests.

Auditing Standard No. 14

Evaluating Audit Results

Introduction

1. This standard establishes requirements regarding the auditor's evaluation of audit results and determination of whether he or she has obtained sufficient appropriate audit evidence.

Objective

2. The objective of the auditor is to evaluate the results of the audit to determine whether the audit evidence obtained is sufficient and appropriate to support the opinion to be expressed in the auditor's report.

Evaluating the Results of the Audit of Financial Statements

3. In forming an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, the auditor should take into account all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.

4. In the audit of financial statements,[107/] the auditor's evaluation of audit results should include evaluation of the following:

a. The results of analytical procedures performed in the overall review of the financial statements ("overall review");

b. **Misstatements** accumulated during the audit, including, in particular, **uncorrected misstatements**;[108/]

c. The qualitative aspects of the company's accounting practices;

d. Conditions identified during the audit that relate to the assessment of the risk of material misstatement due to fraud ("fraud risk");

e. The presentation of the financial statements, including the disclosures; and

f. The sufficiency and appropriateness of the audit evidence obtained.

Performing Analytical Procedures in the Overall Review

5. In the overall review, the auditor should read the financial statements and disclosures and perform analytical procedures to (a) evaluate the auditor's conclusions

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[107/] For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of financial statements only.

[108/] Terms defined in Appendix A, Definitions, are set in **boldface type** the first time they appear.

formed regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement.

6. As part of the overall review, the auditor should evaluate whether:

a. The evidence gathered in response to unusual or unexpected transactions, events, amounts, or relationships previously identified during the audit is sufficient; and

b. Unusual or unexpected transactions, events, amounts, or relationships[109/] indicate risks of material misstatement that were not identified previously, including, in particular, fraud risks.

> Note: If the auditor discovers a previously unidentified risk of material misstatement or concludes that the evidence gathered is not adequate, he or she should modify his or her audit procedures or perform additional procedures as necessary in accordance with paragraph 36 of this standard.

7. The nature and extent of the analytical procedures performed during the overall review may be similar to the analytical procedures performed as risk assessment

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[109/] Paragraphs 46-48 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement and paragraph .03 of AU sec. 329, Substantive Analytical Procedures.

procedures. The auditor should perform analytical procedures relating to revenue through the end of the reporting period.[110/]

8. The auditor should obtain corroboration for management's explanations regarding significant unusual or unexpected transactions, events, amounts, or relationships. If management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail to be useful, the auditor should perform procedures to address the matter.

9. Evaluating Whether Analytical Procedures Indicate a Previously Unrecognized Fraud Risk. Whether an unusual or unexpected transaction, event, amount, or relationship indicates a fraud risk, as discussed in paragraph 6.b., depends on the relevant facts and circumstances, including the nature of the account or relationship among the data used in the analytical procedures. For example, certain unusual or unexpected transactions, events, amounts, or relationships could indicate a fraud risk if a component of the relationship involves accounts and disclosures that management has incentives or pressures to manipulate, e.g., significant unusual or unexpected relationships involving revenue and income.

[110/] Paragraph 47 of Auditing Standard No. 12 contains a requirement to perform analytical procedures relating to revenue as part of the risk assessment procedures.

Accumulating and Evaluating Identified Misstatements

10. Accumulating Identified Misstatements. The auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial.

> Note: "Clearly trivial" is not another expression for "not material." Matters that are clearly trivial will be of a smaller order of magnitude than the materiality level established in accordance with Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit, and will be inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature, or circumstances. When there is any uncertainty about whether one or more items is clearly trivial, the matter is not considered trivial.

11. The auditor may designate an amount below which misstatements are clearly trivial and do not need to be accumulated. In such cases, the amount should be set so that any misstatements below that amount would not be material to the financial statements, individually or in combination with other misstatements, considering the possibility of undetected misstatement.

12. The auditor's accumulation of misstatements should include the auditor's best estimate of the total misstatement in the accounts and disclosures that he or she has tested, not just the amount of misstatements specifically identified. This includes

misstatements related to accounting estimates, as determined in accordance with paragraph 13 of this standard, and projected misstatements from substantive procedures that involve audit sampling, as determined in accordance with AU sec. 350, Audit Sampling.[111/]

13. Misstatements Relating to Accounting Estimates. If the auditor concludes that the amount of an accounting estimate included in the financial statements is unreasonable or was not determined in conformity with the relevant requirements of the applicable financial reporting framework, he or she should treat the difference between that estimate and a reasonable estimate determined in conformity with the applicable accounting principles as a misstatement. If a range of reasonable estimates is supported by sufficient appropriate audit evidence and the recorded estimate is outside of the range of reasonable estimates, the auditor should treat the difference between the recorded accounting estimate and the closest reasonable estimate as a misstatement.

> Note: If an accounting estimate is determined in conformity with the relevant requirements of the applicable financial reporting framework and the amount of the estimate is reasonable, a difference between an estimated amount best supported by the audit evidence and the recorded amount of the accounting estimate ordinarily would not be considered to

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[111/] AU sec. 350.26.

be a misstatement. Paragraph 27 discusses evaluating accounting estimates for bias.

14. Considerations as the Audit Progresses. The auditor should determine whether the overall audit strategy and audit plan need to be modified if:

a. The nature of accumulated misstatements and the circumstances of their occurrence indicate that other misstatements might exist that, in combination with accumulated misstatements, could be material; or

b. The aggregate of misstatements accumulated during the audit approaches the materiality level or levels used in planning and performing the audit.[112/]

> Note: When the aggregate of accumulated misstatements approaches the materiality level or levels used in planning and performing the audit, there likely will be greater than an appropriately low level of risk that possible undetected misstatements, when combined with the aggregate of misstatements accumulated during the audit that remain uncorrected, could be material to the financial statements. If the auditor's assessment of this risk is unacceptably high,

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[112/] Auditing Standard No. 11.

he or she should perform additional audit procedures or determine that management has adjusted the financial statements so that the risk that the financial statements are materially misstated has been reduced to an appropriately low level.

15. The auditor should communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them.

16. If management has examined an account or a disclosure in response to misstatements detected by the auditor and has made corrections to the account or disclosure, the auditor should evaluate management's work to determine whether the corrections have been recorded properly and whether uncorrected misstatements remain.

17. Evaluation of the Effect of Uncorrected Misstatements. The auditor should evaluate whether uncorrected misstatements are material, individually or in combination with other misstatements. In making this evaluation, the auditor should evaluate the misstatements in relation to the specific accounts and disclosures involved and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.[113/] (See Appendix B.)

[113/] If the financial statements contain material misstatements, AU sec. 508, Reports on Audited Financial Statements, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 discusses

Note: In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the ...fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[114/] As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him ...."[115/]

Note: As a result of the interaction of quantitative and qualitative considerations in materiality judgments, uncorrected misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility[116/] that it could lead to a material contingent liability or a material loss of

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situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

114/ TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

115/ TSC Industries, 426 U.S. at 450.

116/ There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

revenue.[117] Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount.

Note: If the reevaluation of the established materiality level or levels, as set forth in Auditing Standard No. 11,[118] results in a lower amount for the materiality level or levels, the auditor should take into account that lower materiality level or levels in the evaluation of uncorrected misstatements.

18. The auditor's evaluation of uncorrected misstatements, as described in paragraph 17 of this standard, should include evaluation of the effects of uncorrected misstatements detected in prior years and misstatements detected in the current year that relate to prior years.

19. The auditor cannot assume that an instance of error or fraud is an isolated occurrence. Therefore, the auditor should evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement. This evaluation is important in determining whether the risk assessments remain appropriate, as discussed in paragraph 36 of this standard.

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[117] AU sec. 317, Illegal Acts by Clients.

[118] Paragraphs 11-12 of Auditing Standard No. 11.

20. Evaluating Whether Misstatements Might Be Indicative of Fraud. The auditor should evaluate whether identified misstatements[119] might be indicative of fraud and, in turn, how they affect the auditor's evaluation of materiality and the related audit responses. As indicated in AU sec. 316, Consideration of Fraud in a Financial Statement Audit, fraud is an intentional act that results in material misstatement of the financial statements.[120]

21. If the auditor believes that a misstatement is or might be intentional, and if the effect on the financial statements could be material or cannot be readily determined, the auditor should perform procedures to obtain additional audit evidence to determine whether fraud has occurred or is likely to have occurred and, if so, its effect on the financial statements and the auditor's report thereon.

22. For misstatements that the auditor believes are or might be intentional, the auditor should evaluate the implications on the integrity of management or employees and the possible effect on other aspects of the audit. If the misstatement involves higher-level management, it might be indicative of a more pervasive problem, such as an issue with the integrity of management, even if the amount of the misstatement is small. In such circumstances, the auditor should reevaluate the assessment of fraud risk and the effect of

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119/ Misstatements include omission and presentation of inaccurate or incomplete disclosures.

120/ AU sec. 316.05.

that assessment on (a) the nature, timing, and extent of the necessary tests of accounts or disclosures and (b) the assessment of the effectiveness of controls. The auditor also should evaluate whether the circumstances or conditions indicate possible collusion involving employees, management, or external parties and, if so, the effect of the collusion on the reliability of evidence obtained.

23. If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, he or she also must determine his or her responsibilities under AU secs. 316.79-.82A, AU sec. 317, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1.

Evaluating the Qualitative Aspects of the Company's Accounting Practices

24. When evaluating whether the financial statements as a whole are free of material misstatement, the auditor should evaluate the qualitative aspects of the company's accounting practices, including potential bias in management's judgments about the amounts and disclosures in the financial statements.

25. The following are examples of forms of management bias:

a. The selective correction of misstatements brought to management's attention during the audit (e.g., correcting misstatements that have the effect of increasing reported earnings but not correcting misstatements that have the effect of decreasing reported earnings).

Note: To evaluate the potential effect of selective correction of misstatements, the auditor should obtain an understanding of the reasons that management decided not to correct misstatements communicated by the auditor in accordance with paragraph 15.

b. The identification by management of additional adjusting entries that offset misstatements accumulated by the auditor. If such adjusting entries are identified, the auditor should perform procedures to determine why the underlying misstatements were not identified previously and evaluate the implications on the integrity of management and the auditor's risk assessments, including fraud risk assessments. The auditor also should perform additional procedures as necessary to address the risk of further undetected misstatement.

c. Bias in the selection and application of accounting principles.[121/]

d. Bias in accounting estimates.[122/]

121/ Paragraph 5.d. of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

122/ Paragraph 27 of this standard.

26. If the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, the auditor should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements. Also, the auditor should evaluate whether the auditor's risk assessments, including, in particular, the assessment of fraud risks, and the related audit responses remain appropriate.

27. Evaluating Bias in Accounting Estimates. The auditor should evaluate whether the difference between estimates best supported by the audit evidence and estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the company's management. If each accounting estimate included in the financial statements was individually reasonable but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase earnings or loss, the auditor should evaluate whether these circumstances indicate potential management bias in the estimates. Bias also can result from the cumulative effect of changes in multiple accounting estimates. If the estimates in the financial statements are grouped at one end of the range of reasonable estimates in the prior year and are grouped at the other end of the range of reasonable estimates in the current year, the auditor should evaluate whether management is using swings in estimates to achieve an expected or desired outcome, e.g., to offset higher or lower than expected earnings.

Note: AU secs. 316.64-.65 establish requirements regarding performing a retrospective review of accounting estimates and evaluating the potential for fraud risks.

Evaluating Conditions Relating to the Assessment of Fraud Risks

28. When evaluating the results of the audit, the auditor should evaluate whether the accumulated results of auditing procedures[123/] and other observations affect the assessment of the fraud risks made throughout the audit and whether the audit procedures need to be modified to respond to those risks. (See Appendix C.)

29. As part of this evaluation, the engagement partner should determine whether there has been appropriate communication with the other engagement team members throughout the audit regarding information or conditions that are indicative of fraud risks.

Note: To accomplish this communication, the engagement partner might arrange another discussion among the engagement team members about fraud risks. (See paragraphs 49-51 of Auditing Standard No. 12.)

[123/] Such auditing procedures include, but are not limited to, procedures in the overall review (paragraph 9 of this standard), the evaluation of identified misstatements (paragraphs 20-23 of this standard), and the evaluation of the qualitative aspects of the company's accounting practices (paragraphs 24-27 of this standard).

Evaluating the Presentation of the Financial Statements, Including the Disclosures

30. The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

> Note: AU sec. 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles, establishes requirements for evaluating the presentation of the financial statements. Auditing Standard No. 6, Evaluating Consistency of Financial Statements, establishes requirements regarding evaluating the consistency of the accounting principles used in financial statements.

> Note: The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

31. As part of the evaluation of the presentation of the financial statements, the auditor should evaluate whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework. Evaluation of the information disclosed in the financial statements includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the

terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.

> Note: According to AU sec. 508, if the financial statements, including the accompanying notes, fail to disclose information that is required by the applicable financial reporting framework, the auditor should express a qualified or adverse opinion and should provide the information in the report, if practicable, unless its omission from the report is recognized as appropriate by a specific auditing standard.[124/]

Evaluating the Sufficiency and Appropriateness of Audit Evidence

32. Auditing Standard No. 8, Audit Risk, states:

> To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through

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[124/] AU secs. 508.41-.44.

applying due professional care, including obtaining sufficient appropriate audit evidence.[125/]

33. As part of evaluating audit results, the auditor must conclude on whether sufficient appropriate audit evidence has been obtained to support his or her opinion on the financial statements.

34. Factors that are relevant to the conclusion on whether sufficient appropriate audit evidence has been obtained include the following:

a. The significance of uncorrected misstatements and the likelihood of their having a material effect, individually or in combination, on the financial statements, considering the possibility of further undetected misstatement (paragraphs 14 and 17-19 of this standard).

b. The results of audit procedures performed in the audit of financial statements, including whether the evidence obtained supports or contradicts management's assertions and whether such audit procedures identified specific instances of fraud (paragraphs 20-23 and 28-29 of this standard).

c. The auditor's risk assessments (paragraph 36 of this standard).

125/ Paragraph 3 of Auditing Standard No. 8.

d. The results of audit procedures performed in the audit of internal control over financial reporting, if the audit is an integrated audit.

e. The appropriateness (i.e., the relevance and reliability) of the audit evidence obtained.[126/]

35. If the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion or has substantial doubt about a relevant assertion, the auditor should perform procedures to obtain further audit evidence to address the matter. If the auditor is unable to obtain sufficient appropriate audit evidence to have a reasonable basis to conclude about whether the financial statements as a whole are free of material misstatement, AU sec. 508 indicates that the auditor should express a qualified opinion or a disclaimer of opinion.[127/]

36. Evaluating the Appropriateness of Risk Assessments. As part of the evaluation of whether sufficient appropriate audit evidence has been obtained, the auditor should evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate and whether the audit procedures need to be modified or additional procedures need to be performed as a result of any changes in the risk

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[126/] Paragraphs 7-9 of Auditing Standard No. 15, Audit Evidence, discuss the relevance and reliability of audit evidence.

[127/] AU sec. 508.22-.34 contains requirements regarding audit scope limitations.

assessments. For example, the re-evaluation of the auditor's risk assessments could result in the identification of relevant assertions or significant risks that were not identified previously and for which the auditor should perform additional audit procedures.

> Note: Auditing Standard No. 12 establishes requirements on revising the auditor's risk assessment.[128/] Auditing Standard No. 13 discusses the auditor's responsibilities regarding the assessment of control risk and evaluation of control deficiencies in an audit of financial statements.[129/]

Evaluating the Results of the Audit of Internal Control Over Financial Reporting

37. Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, indicates that the auditor should form an opinion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls, misstatements detected during the financial statement audit, and any identified control deficiencies. Auditing Standard No. 5 describes the auditor's responsibilities regarding

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128/ Paragraph 74 of Auditing Standard No. 12.

129/ Paragraphs 32-34 of Auditing Standard No. 13.

evaluating the results of the audit, including evaluating the identified control deficiencies.[130/]

APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Misstatement – A misstatement, if material individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting framework.[131/] A misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework. Misstatements can arise from error (i.e., unintentional misstatement) or fraud.[132/]

130/ Paragraphs 62-70 of Auditing Standard No. 5 discuss evaluating identified control deficiencies, and paragraphs 71-73 of Auditing Standard No. 5 discuss forming an opinion on the effectiveness of internal control over financial reporting.

131/ The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

132/ Paragraph .02 of AU sec. 316, Consideration of Fraud in a Financial Statement Audit.

A3. Uncorrected misstatements – Misstatements, other than those that are clearly trivial,[133] that management has not corrected.

APPENDIX B – Qualitative Factors Related to the Evaluation of the Materiality of Uncorrected Misstatements

B1. Paragraph 17 of this standard states:

> The auditor should evaluate whether uncorrected misstatements are material, individually or in combination with other misstatements. In making this evaluation, the auditor should evaluate the misstatements in relation to the specific accounts and disclosures involved and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.[134]
>
> > Note: In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the ...fact would have been viewed by the reasonable investor as having significantly altered the 'total

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[133] Paragraph 10 of this standard states that, "[t]he auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial."

[134] If the financial statements contain material misstatements, AU sec. 508, Reports on Audited Financial Statements, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

mix' of information made available."[135/] As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him . . . ."[136/]

Note: As a result of the interaction of quantitative and qualitative considerations in materiality judgments, uncorrected misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility[137/] that it could lead to a material contingent liability or a material loss of revenue.[138/] Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount.

135/ TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

136/ TSC Industries, 426 U.S. at 450.

137/ There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

138/ AU sec. 317, Illegal Acts by Clients.

B2. Qualitative factors to consider in the auditor's evaluation of the materiality of uncorrected misstatements, if relevant, include the following:

a. The potential effect of the misstatement on trends, especially trends in profitability.

b. A misstatement that changes a loss into income or vice versa.

c. The effect of the misstatement on segment information, for example, the significance of the matter to a particular segment important to the future profitability of the company, the pervasiveness of the matter on the segment information, and the impact of the matter on trends in segment information, all in relation to the financial statements taken as a whole.

d. The potential effect of the misstatement on the company's compliance with loan covenants, other contractual agreements, and regulatory provisions.

e. The existence of statutory or regulatory reporting requirements that affect materiality thresholds.

f. A misstatement that has the effect of increasing management's compensation, for example, by satisfying the requirements for the award of bonuses or other forms of incentive compensation.

g. The sensitivity of the circumstances surrounding the misstatement, for example, the implications of misstatements involving fraud and possible illegal acts, violations of contractual provisions, and conflicts of interest.

h. The significance of the financial statement element affected by the misstatement, for example, a misstatement affecting recurring earnings as contrasted to one involving a non-recurring charge or credit, such as an extraordinary item.

i. The effects of misclassifications, for example, misclassification between operating and non-operating income or recurring and non-recurring income items.

j. The significance of the misstatement or disclosures relative to known user needs, for example:

- The significance of earnings and earnings per share to public company investors.

- The magnifying effects of a misstatement on the calculation of purchase price in a transfer of interests (buy/sell agreement).

- The effect of misstatements of earnings when contrasted with expectations.

k. The definitive character of the misstatement, for example, the precision of an error that is objectively determinable as contrasted with a misstatement that unavoidably involves a degree of subjectivity through estimation, allocation, or uncertainty.

l. The motivation of management with respect to the misstatement, for example, (i) an indication of a possible pattern of bias by management when developing and accumulating accounting estimates or (ii) a misstatement precipitated by management's continued unwillingness to correct weaknesses in the financial reporting process.

m. The existence of offsetting effects of individually significant but different misstatements.

n. The likelihood that a misstatement that is currently immaterial may have a material effect in future periods because of a cumulative effect, for example, that builds over several periods.

o. The cost of making the correction – it may not be cost-beneficial for the client to develop a system to calculate a basis to record the effect of an immaterial misstatement. On the other hand, if management appears to have developed a system to calculate an amount that represents an immaterial misstatement, it may reflect a motivation of management as noted in paragraph B2.1 above.

p. The risk that possible additional undetected misstatements would affect the auditor's evaluation.

<u>APPENDIX C</u> – Matters That Might Affect the Assessment of Fraud Risks

C1. If the following matters are identified during the audit, the auditor should take into account these matters in the evaluation of the assessment of fraud risks, as discussed in paragraph 28 of this standard:

a. Discrepancies in the accounting records, including:

(1) Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or company policy.

(2) Unsupported or unauthorized balances or transactions.

(3) Last-minute adjustments that significantly affect financial results.

(4) Evidence of employees' access to systems and records that is inconsistent with the access that is necessary to perform their authorized duties.

(5) Tips or complaints to the auditor about alleged fraud.

b. Conflicting or missing evidence, including:

(1) Missing documents.

(2) Documents that appear to have been altered.[139/]

(3) Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.

(4) Significant unexplained items in reconciliations.

(5) Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.

(6) Unusual discrepancies between the company's records and confirmation responses.

(7) Missing inventory or physical assets of significant magnitude.

(8) Unavailable or missing electronic evidence that is inconsistent with the company's record retention practices or policies.

139/ Paragraph 9 of Auditing Standard No. 15, Audit Evidence.

(9) Inability to produce evidence of key systems development and program change testing and implementation activities for current year system changes and deployments.

(10) Unusual balance sheet changes or changes in trends or important financial statement ratios or relationships, e.g., receivables growing faster than revenues.

(11) Large numbers of credit entries and other adjustments made to accounts receivable records.

(12) Unexplained or inadequately explained differences between the accounts receivable subsidiary ledger and the general ledger control account, or between the customer statement and the accounts receivable subsidiary ledger.

(13) Missing or nonexistent cancelled checks in circumstances in which cancelled checks are ordinarily returned to the company with the bank statement.

(14) Fewer responses to confirmation requests than anticipated or a greater number of responses than anticipated.

c. Problematic or unusual relationships between the auditor and management, including:

(1) Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought, including:[140]

a. Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.

b. Denial of access to key information technology operations staff and facilities, including security, operations, and systems development.

(2) Undue time pressures imposed by management to resolve complex or contentious issues.

(3) Management pressure on engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management.

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[140] Denial of access to information might constitute a limitation on the scope of the audit that requires the auditor to qualify or disclaim an opinion. (See Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, and AU sec. 508, Reports on Audited Financial Statements.)

(4) Unusual delays by management in providing requested information.

(5) Management's unwillingness to add or revise disclosures in the financial statements to make them more complete and transparent.

(6) Management's unwillingness to appropriately address significant deficiencies in internal control on a timely basis.

d. Other matters, including:

(1) Objections by management to the auditor meeting privately with the audit committee.

(2) Accounting policies that appear inconsistent with industry practices that are widely recognized and prevalent.

(3) Frequent changes in accounting estimates that do not appear to result from changing circumstances.

(4) Tolerance of violations of the company's code of conduct.

Auditing Standard No. 15

Audit Evidence

Introduction

1. This standard explains what constitutes audit evidence and establishes requirements regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence.

2. Audit evidence is all the information, whether obtained from audit procedures or other sources, that is used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence consists of both information that supports and corroborates management's assertions regarding the financial statements or internal control over financial reporting and information that contradicts such assertions.

Objective

3. The objective of the auditor is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report.[141/]

[141/] Auditing Standard No. 14, Evaluating Audit Results, establishes requirements regarding evaluating whether sufficient appropriate evidence has been obtained. Auditing Standard No. 3, Audit Documentation, establishes requirements regarding documenting the procedures performed, evidence obtained, and conclusions reached in an audit.

Sufficient Appropriate Audit Evidence

4. The auditor must plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion.

5. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the following:

- Risk of material misstatement (in the audit of financial statements) or the risk associated with the control (in the audit of internal control over financial reporting). As the risk increases, the amount of evidence that the auditor should obtain also increases. For example, ordinarily more evidence is needed to respond to significant risks.[142/]

- Quality of the audit evidence obtained. As the quality of the evidence increases, the need for additional corroborating evidence decreases. Obtaining more of the same type of audit evidence, however, cannot compensate for the poor quality of that evidence.

6. Appropriateness is the measure of the quality of audit evidence, i.e., its relevance and reliability. To be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor's opinion is based.

[142/] Paragraph A5 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

Relevance and Reliability

7. Relevance. The relevance of audit evidence refers to its relationship to the assertion or to the objective of the control being tested. The relevance of audit evidence depends on:

a. The design of the audit procedure used to test the assertion or control, in particular whether it is designed to (1) test the assertion or control directly and (2) test for understatement or overstatement; and

b. The timing of the audit procedure used to test the assertion or control.

8. Reliability. The reliability of evidence depends on the nature and source of the evidence and the circumstances under which it is obtained. For example, in general:

- Evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources.
- The reliability of information generated internally by the company is increased when the company's controls over that information are effective.
- Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly.

- Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized, or otherwise converted into electronic form, the reliability of which depends on the controls over the conversion and maintenance of those documents.

9. The auditor is not expected to be an expert in document authentication. However, if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor should modify the planned audit procedures or perform additional audit procedures to respond to those conditions and should evaluate the effect, if any, on the other aspects of the audit.

Using Information Produced by the Company

10. When using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to:[143/]

[143/] When using the work of a specialist engaged or employed by management, see AU sec. 336, Using the Work of a Specialist. When using information produced by a service organization or a service auditor's report as audit evidence, see AU sec. 324, Service Organizations, and for integrated audits, see Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

- Test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information; and
- Evaluate whether the information is sufficiently precise and detailed for purposes of the audit.

Financial Statement Assertions

11. In representing that the financial statements are presented fairly in conformity with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of the various elements of financial statements and related disclosures. Those assertions can be classified into the following categories:

- Existence or occurrence – Assets or liabilities of the company exist at a given date, and recorded transactions have occurred during a given period.
- Completeness – All transactions and accounts that should be presented in the financial statements are so included.
- Valuation or allocation – Asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts.

- Rights and obligations – The company holds or controls rights to the assets, and liabilities are obligations of the company at a given date.

- Presentation and disclosure – The components of the financial statements are properly classified, described, and disclosed.

12. The auditor may base his or her work on financial statement assertions that differ from those in this standard if the assertions are sufficient for the auditor to identify the types of potential misstatements and to respond appropriately to the risks of material misstatement in each significant account and disclosure that has a reasonable possibility[144/] of containing misstatements that would cause the financial statements to be materially misstated, individually or in combination with other misstatements.[145/]

Audit Procedures for Obtaining Audit Evidence

13. Audit procedures can be classified into the following categories:

a. Risk assessment procedures,[146/] and

144/ There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

145/ For an integrated audit, also see paragraph 28 of Auditing Standard No. 5.

146/ Auditing Standard No. 12.

b. Further audit procedures,[147] which consist of:

(1) Tests of controls, and

(2) Substantive procedures, including tests of details and substantive analytical procedures.

14. Paragraphs 15-21 of this standard describe specific audit procedures. The purpose of an audit procedure determines whether it is a risk assessment procedure, test of controls, or substantive procedure.

Inspection

15. Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or physically examining an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorization.

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[147] Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

Observation

16. Observation consists of looking at a process or procedure being performed by others, e.g., the auditor's observation of inventory counting by the company's personnel or the performance of control activities. Observation can provide audit evidence about the performance of a process or procedure, but the evidence is limited to the point in time at which the observation takes place and also is limited by the fact that the act of being observed may affect how the process or procedure is performed.[148/]

Inquiry

17. Inquiry consists of seeking information from knowledgeable persons in financial or nonfinancial roles within the company or outside the company. Inquiry may be performed throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.[149/]

> Note: Inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level

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[148/] AU sec. 331, Inventories, establishes requirements regarding observation of the counting of inventory.

[149/] AU sec. 333, Management Representations, establishes requirements regarding written management representations, including confirmation of management responses to oral inquiries.

for a relevant assertion or to support a conclusion about the effectiveness of a control.

Confirmation

18. A confirmation response represents a particular form of audit evidence obtained by the auditor from a third party in accordance with PCAOB standards.[150/]

Recalculation

19. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

Reperformance

20. Reperformance involves the independent execution of procedures or controls that were originally performed by company personnel.

Analytical Procedures

21. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical

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150/ AU sec. 330, The Confirmation Process.

procedures also encompass the investigation of significant differences from expected amounts.[151/]

Selecting Items for Testing to Obtain Audit Evidence

22. Designing substantive tests of details and tests of controls includes determining the means of selecting items for testing from among the items included in an account or the occurrences of a control. The auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure. The alternative means of selecting items for testing are:

- Selecting all items;
- Selecting specific items; and
- Audit sampling.

23. The particular means or combination of means of selecting items for testing that is appropriate depends on the nature of the audit procedure, the characteristics of the control or the items in the account being tested, and the evidence necessary to meet the objective of the audit procedure.

151/ AU sec. 329, Substantive Analytical Procedures, establishes requirements on performing analytical procedures as substantive procedures.

Selecting All Items

24. Selecting all items (100 percent examination) refers to testing the entire population of items in an account or the entire population of occurrences of a control (or an entire stratum within one of those populations). The following are examples of situations in which 100 percent examination might be applied:

- The population constitutes a small number of large value items;
- The audit procedure is designed to respond to a significant risk, and other means of selecting items for testing do not provide sufficient appropriate audit evidence; and
- The audit procedure can be automated effectively and applied to the entire population.

Selecting Specific Items

25. Selecting specific items refers to testing all of the items in a population that have a specified characteristic, such as:

- <u>Key items</u>. The auditor may decide to select specific items within a population because they are important to accomplishing the objective of the audit procedure or exhibit some other characteristic, e.g., items that are suspicious, unusual, or particularly risk-prone or items that have a history of error.

- All items over a certain amount. The auditor may decide to examine items whose recorded values exceed a certain amount to verify a large proportion of the total amount of the items included in an account.

26. The auditor also might select specific items to obtain an understanding about matters such as the nature of the company or the nature of transactions.

27. The application of audit procedures to items that are selected as described in paragraphs 25-26 of this standard does not constitute audit sampling, and the results of those audit procedures cannot be projected to the entire population.[152/]

Audit Sampling

28. Audit sampling is the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.[153/]

152/ If misstatements are identified in the selected items, see paragraphs 12-13 and paragraphs 17-19 of Auditing Standard No. 14.

153/ AU sec. 350, Audit Sampling, establishes requirements regarding audit sampling.

Inconsistency in, or Doubts about the Reliability of, Audit Evidence

29. If audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.

Conforming Amendment to PCAOB Interim Quality Control Standards

Auditing Standards

AU sec. 110, "Responsibilities and Functions of the Independent Auditor"

Statement on Auditing Standards ("SAS") No. 1, "Codification of Auditing Standards and Procedures" section 110, "Responsibilities and Functions of the Independent Auditor" (AU sec. 110, "Responsibilities and Functions of the Independent Auditor"), as amended, is amended as follows:

Within footnote 1 to paragraph .02, the reference to section 312, Audit Risk and Materiality in Conducting an Audit, is replaced with a reference to Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit.

AU sec. 150, "Generally Accepted Auditing Standards"

SAS No. 95, "Generally Accepted Auditing Standards" (AU sec. 150, "Generally Accepted Auditing Standards"), as amended, is amended as follows:

a. Within paragraph .02, in the third standard of field work, the word "competent" is replaced with the word "appropriate."

b. Footnote 2 to paragraph .04 is deleted.

AU sec. 210, "Training and Proficiency of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 210, "Training and Proficiency of the Independent Auditor" (AU sec. 210, "Training and Proficiency of the Independent Auditor "), as amended, is amended as follows:

The last sentence of paragraph .03 is replaced with:

The engagement partner must exercise seasoned judgment in the varying degrees of his supervision and review of the work done and judgments exercised by his subordinates, who in turn must meet the responsibilities attaching to the varying gradations and functions of their work.

AU sec. 230, "Due Professional Care in the Performance of Work"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 230, "Due Professional Care in the Performance of Work" (AU sec. 230, "Due Professional Care in the Performance of Work"), as amended, is amended as follows:

a. The second and third sentences of paragraph .06 are replaced with:

The engagement partner should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client. The engagement partner is responsible for the assignment of tasks to, and supervision of, the members of the engagement team.[fn4]

b. Footnote 3 to paragraph .06 is deleted.

c. Within footnote 4 to paragraph .06, the phrase "See section 311.11" is replaced with, "See Auditing Standard No. 10, Supervision of the Audit Engagement."

d. Footnote 6 to paragraph .11 is deleted.

e. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

f. At the end of the fifth sentence of paragraph .12, the following parenthetical is added: "(See paragraph 9 of Auditing Standard No. 15, Audit Evidence.)"

AU sec. 310, "Appointment of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 310, "Appointment of the Independent Auditor" (AU sec. 310, "Appointment of the Independent Auditor"), as amended, is amended as follows:

a. Within footnote ** to the title of the standard, the sentence "(See section 313.)" is deleted.

b. Paragraph .02 is replaced with:

   Audit planning is discussed in Auditing Standard No. 9, Audit Planning, and supervision of engagement team members is discussed in Auditing Standard No. 10, Supervision of the Audit Engagement.

c. In paragraph .03, the sentence "(See section 313)" is deleted.

d. Within footnote 3 to paragraph .06, the reference to Section 312, Audit Risk and Materiality in Conducting an Audit, paragraph .04, is replaced with a reference to Paragraph A2 of Auditing Standard No. 14, Evaluating Audit Results.

AU sec. 311, "Planning and Supervision"

SAS No. 22, "Planning and Supervision" (AU sec. 311, "Planning and Supervision"), as amended, is superseded.

AU sec. 9311, "Planning and Supervision: Auditing Interpretations of Section 311"

AU sec. 9311, "Planning and Supervision: Auditing Interpretations of Section 311", as amended, is superseded.

AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"

SAS No. 47, "Audit Risk and Materiality in Conducting an Audit" (AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"), as amended, is superseded.

AU sec. 9312, "Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312"

AU sec. 9312, "Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312" is superseded.

AU sec. 313, "Substantive Tests Prior to the Balance Sheet Date"

SAS No. 45, "Omnibus Statement on Auditing Standards – 1983" (AU sec. 313, "Substantive Tests Prior to the Balance Sheet Date"), as amended, is superseded.

AU sec. 315, "Communications Between Predecessor and Successor Auditors"

SAS No. 84, "Communications Between Predecessor and Successor Auditors" (AU sec. 315, "Communications Between Predecessor and Successor Auditors"), as amended, is amended as follows:

a. In the first sentence of paragraph .12, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .18, the word "competent" is replaced with the word "appropriate."

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

a. The second sentence of paragraph .01 is replaced with:

> This section establishes requirements and provides direction relevant to fulfilling that responsibility, as it relates to fraud, in an audit of financial statements. [fn 2]

b. In footnote 1 to paragraph .01, delete the following information: (see section 312, Audit Risk and Materiality in Conducting an Audit," and the closing parenthesis at the end of that sentence.

c. Footnote 2 to paragraph .01 is replaced with:

For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of financial statements only.

d. The following paragraph .01A is added:

Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, establishes requirements regarding the process of identifying and assessing risks of material misstatement of the financial statements. Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement, establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement. Auditing Standard No. 14, Evaluating Audit Results, establishes requirements regarding the auditor's evaluation of audit results and determination of whether he or she has obtained sufficient appropriate audit evidence.

e. In paragraph .02:

- The third through the sixth bullet points are deleted.
- The seventh bullet point is replaced with:

Responding to fraud risks

. This section discusses certain responses to fraud risks involving the nature, timing, and extent of audit procedures, including:

  - Responses to assessed fraud risks relating to fraudulent financial reporting and misappropriation of assets (see paragraphs .52 through .56).

  - Responses to specifically address the fraud risks arising from management override of internal controls (see paragraphs .57 through .67).

- The eighth bullet point is deleted.

f. Paragraph .03 is deleted.

g. Footnote 5 to paragraph .06 is replaced with:

The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to accounting principles applicable to that company.

h. In the third sentence of paragraph .13, the term "the risk of material misstatement due to fraud" is replaced with the term "fraud risks."

i. Paragraphs .14 through .45 are deleted, along with the preceding heading, "Discussion Among Engagement Personnel Regarding the Risks of

Material Misstatement Due to Fraud."

j. Footnotes 8 through 19 related to paragraphs .14 through .45 are deleted.

k. Paragraphs .46 through .50 are deleted. The heading preceding paragraph .46, "Responding to the Results of the Assessment," is replaced with the heading "Responding to Assessed Fraud Risks."

l. Paragraph .51 is deleted. The heading preceding paragraph .51, "Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed to Address the Identified Risks," is replaced with the heading "Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed."

m. Paragraph .52 is replaced with:

Paragraph 8 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement, states that "[t]he auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement due to error or fraud for each relevant assertion of each significant account and disclosure." Paragraph 12 of Auditing Standard No. 13 states that "the audit procedures that are necessary to address the assessed fraud risks depend upon the types of risks and the relevant assertions that might be affected."

Note: Paragraph 71.b. of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, states that a fraud risk is a significant risk. Accordingly, the requirement for responding to significant risks also applies to fraud risks.

n. In paragraph .53:

- The first sentence is replaced with:

  The following are examples of responses to assessed fraud risks involving the nature, timing, and extent of audit procedures:

- The fifth bullet point is replaced with:

  Interviewing personnel involved in activities in areas in which a fraud risk has been identified to obtain their insights about the risk and how controls address the risk. (See paragraph 54 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement)

- In the sixth bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

o. Footnote 20 to paragraph .53 is replaced with:

AU sec. 329, Substantive Analytical Procedures, establishes requirements regarding performing analytical procedures as substantive tests.

p. The heading preceding paragraph .54, "Additional Examples of Responses to Identified Risks of Misstatements Arising From Fraudulent Financial Reporting," is replaced with the heading "Additional Examples of Audit Procedures Performed to Respond to Assessed Fraud Risks Relating to Fraudulent Financial Reporting."

q. The first sentence in paragraph .54 is replaced with:

The following are additional examples of audit procedures that might be performed in response to assessed fraud risks relating to fraudulent financial reporting:

r. In paragraph .54:

- In the last sentence of the first bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

- In the first sentence of the second bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

- In the first sentence of the third bullet point and the accompanying paragraph to the third bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

s. Footnotes 21 and 22 to paragraph .54 are amended as follows:

- The text of footnote 21 is replaced with "AU sec. 330, The Confirmation Process, establishes requirements regarding the confirmation process in audits of financial statements."

- The text of footnote 22 is replaced with "AU sec. 336, Using the Work of a Specialist, establishes requirements for an auditor who uses the work of a specialist in performing an audit of financial statements."

t. The heading preceding paragraph .55, "Examples of Responses to Identified Risks of Misstatements Arising From Misappropriations of Assets," is replaced with the heading "Examples of Audit Procedures Performed to Respond to Fraud Risks Relating to Misappropriations of Assets."

u. In the first sentence of paragraph .55, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

v. In paragraph .56:

- The first and second sentences are replaced with:

  The audit procedures performed in response to a fraud risk relating to misappropriation of assets usually will be directed toward certain account balances. Although some of the audit procedures noted in paragraphs .53 and .54 and in paragraphs 8 through 15 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement, may apply in such circumstances, such as the procedures directed at inventory quantities, the scope of the work should be linked to the specific information about the misappropriation risk that has been identified.

- In the third sentence, the words "design and" are added before the words "operating effectiveness."

w. The heading preceding paragraph .57, "Responses to Further Address the Risk of Management Override of Controls," is replaced with the heading "Audit Procedures Performed to Specifically Address the Risk of Management Override of Controls."

x. The third sentence of paragraph .57 is replaced with:

Accordingly, as part of the auditor's responses that address fraud risks, the procedures described in paragraphs .58 through .67 should be performed to specifically address the risk of management override of controls.

y. Footnote 23 to paragraph .58 is replaced with:

See paragraphs 28 through 32 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

z. In paragraph .61:

- In the first sentence of the first bullet point, the term "the risk of material misstatement due to fraud" is replaced with the term "fraud risk."

- In the second bullet point, the last two sentences are replaced with the following:

  Effective controls over the preparation and posting of journal entries and adjustments may affect the extent of substantive testing necessary, provided that the auditor has tested the controls. However, even though controls might be implemented and operating effectively, the auditor's substantive procedures for testing journal entries and other adjustments should include the identification and substantive testing of specific items.

- In item (f) of the fifth bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

- The last sentence of the fifth bullet point is replaced with:

  In audits of entities that have multiple locations or business units, the auditor should determine whether to select journal entries from locations based on factors set forth in paragraphs 11 through 14 of Auditing Standard No. 9, Audit Planning.

aa. The last sentence of paragraph .63 is replaced with:

Paragraphs 24 through 27 of Auditing Standard No. 14, Evaluating Audit Results, discuss the auditor's responsibilities for assessing bias in accounting estimates and the effect of bias on the financial statements.

bb. Paragraphs .68 through .78 are deleted, along with the preceding heading "Evaluating Audit Evidence."

cc. Footnotes 26 through 36 related to paragraphs .68 through .78 are deleted.

dd. In the first sentence of paragraph .80, the term "risks of material misstatement due to fraud" is replaced with the term "fraud risks."

ee. The last sentence of paragraph .80 is replaced with:

The auditor also should evaluate whether the absence of or deficiencies in controls that address fraud risks or otherwise help prevent, deter, and detect fraud (see paragraphs 72-73 of Auditing Standard No. 12, <u>Identifying and Assessing Risks of Material Misstatement</u>) represent significant deficiencies or material weaknesses that should be communicated to senior management and the audit committee.

ff. The first sentence of paragraph .81 is replaced with:

The auditor also should consider communicating other fraud risks, if any, identified by the auditor.

gg. In paragraph .83:

- The reference in the first bullet point to paragraphs .14 through .17 is replaced with a reference to paragraphs 52 and 53 of Auditing Standard No. 12, <u>Identifying and Assessing Risks of Material Misstatement</u>.

- The term "risks of material misstatement due to fraud" in the first sentence of the second bullet point is replaced with the term "fraud risks." The reference in the second bullet point to paragraphs .19 through .34 is replaced with references to paragraph 47, paragraphs

56 through 58, and paragraphs 65 through 69 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

- The third bullet point is replaced with:

  The fraud risks that were identified at the financial statement and assertion levels (see paragraphs 59 through 69 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement), and the linkage of those risks to the auditor's response (see paragraphs 5 through 15 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement).

- Within the fourth bullet point, the term "risk of material misstatement due to fraud" in the first sentence is replaced with the term "fraud risk," and the reference to paragraph .41 is replaced with a reference to paragraph 68 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

- The fifth bullet point is replaced with:

  The results of the procedures performed to address the assessed fraud risks, including those procedures performed to further address the risk of management override of controls (See paragraph 15 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatements.)

- The reference in the sixth bullet point to paragraphs .68 through .73 is replaced with a reference to paragraphs 5 through 9 of Auditing Standard No. 14, Evaluating Audit Results.

hh. Paragraph .84 and the heading preceding this paragraph, "Effective Date," are deleted.

ii. The first sentence of paragraph .85 is replaced with:

This appendix contains examples of risk factors discussed in paragraphs 65 through 69 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

AU sec. 317, "Illegal Acts by Clients"

SAS No. 54, "Illegal Acts by Clients" (AU sec. 317, "Illegal Acts by Clients") is amended as follows:

a. The last sentence of paragraph .13 is replaced with:

For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

b. In paragraph .19, the word "competent" is replaced with the word "appropriate."

AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"

SAS No. 55, "Consideration of Internal Control in a Financial Statement Audit" (AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"), as amended, is superseded.

AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"

SAS No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"), as amended, is amended as follows:

a. In the first sentence of paragraph .02, the word "competent" is replaced with the word "appropriate."

b. Footnote 3 to paragraph .04, is replaced with:

   Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, describes the procedures the auditor performs to obtain an understanding of internal control over financial reporting.

c. In the first sentence of paragraph .18, the word "competent" is replaced with the word "appropriate."

d. Within footnote 5 to paragraph .18, the reference to section 326, Evidential Matter, paragraph .19c. is replaced with a reference to paragraph 8 of Auditing Standard No. 15, Audit Evidence.

e. Within footnote 8 to paragraph .27, the reference to section 311, Planning and Supervision, paragraphs .11 through .14 is replaced with a reference to Auditing Standard No. 10, Supervision of the Audit Engagement.

AU sec. 324, "Service Organizations"

SAS No. 70, "Service Organizations" (AU sec. 324, "Service Organizations"), as amended, is amended as follows:

a. In the first sentence of paragraph .07, the reference to Section 319, Consideration of Internal Control in a Financial Statement Audit, is replaced with a reference to Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

b. In the first sentence of paragraph .16, the reference to section 319.90 through .99 is replaced with a reference to paragraph 18 and paragraphs 29 through 31 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

c. In the second sentence of paragraph .23, the reference to section 312, Audit Risk and Materiality in Conducting an Audit, is replaced with a reference to Auditing Standard No. 14, Evaluating Audit Results.

AU sec. 326, "Evidential Matter"

SAS No. 31, "Evidential Matter" (AU sec. 326, "Evidential Matter"), as amended, is superseded.

AU sec. 9326, "Evidential Matter: Auditing Interpretations of Section 326"

AU sec. 9326, "Evidential Matter: Auditing Interpretations of Section 326," as amended, is amended as follows:

a. Paragraphs .01-.05 are deleted, along with the preceding heading "1. Evidential Matter for an Audit of Interim Financial Statements."

b. The reference in paragraph .10 to Section 326, Evidential Matter, paragraph .25, is replaced with a reference to Paragraph 35 of Auditing Standard No. 14, Evaluating Audit Results.

c. In the first and second sentences of paragraph .10, the word "competent" is replaced with the word "appropriate."

d. In the second sentence of paragraph .12, the word "competent" is replaced with the word "appropriate."

e. The last two sentences of paragraph .12 are deleted.

f. In the first sentence of paragraph .13, the word "competent" is replaced with the word "appropriate."

g. In paragraph .17, the word "competent" is replaced with the word "appropriate."

h. In the second sentence of paragraph`.21, the word "competent" is replaced with the word "appropriate."

i. In the fourth sentence of paragraph .22, the word "competent" is replaced with the word "appropriate."

j. In paragraph .23, the word "competent" is replaced with the word "appropriate."

k. Paragraphs .24-.41 are deleted, along with the headings "3. The Auditor's Consideration of the Completeness Assertion" and "4. Applying Auditing Procedures to Segment Disclosures in Financial Statements."

<u>AU sec. 328, "Auditing Fair Value Measurements and Disclosures"</u>

SAS No. 101, "Auditing Fair Value Measurements and Disclosures" (AU sec. 328, "Auditing Fair Value Measurements and Disclosures"), as amended, is amended as follows:

a. In the first sentence of paragraph .03, the word "competent" is replaced with the word "appropriate."

b. The phrase in paragraph .11 "Section 319, Consideration of Internal Control in a Financial Statement Audit, as amended," is replaced with "Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement,"

c. The reference in paragraph .14 to Section 319 is replaced with a reference to Paragraph A5, second note of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

d. In the second sentence of paragraph .14, the reference "(see section 316, Consideration of Fraud in a Financial Statement Audit" is deleted.

e. Within paragraph .25, in the second sentence of the second bullet point and in the first sentence in the third bullet point, the word "competent" is replaced with the word "appropriate."

f. In the second sentence of paragraph .32, the word "competent" is replaced with the word "appropriate."

g. In the first sentence of paragraph .42, the word "competent" is replaced with the word "appropriate."

h. In footnote 8 to paragraph .43, the reference to section 431, Adequacy of Disclosure in Financial Statements, is replaced with a reference to "paragraph 31 of Auditing Standard No. 14, Evaluating Audit Results."

i. In the second sentence of paragraph .44, the word "competent" is replaced with the word "appropriate."

j. The reference in paragraph .47 to section 312, Audit Risk and Materiality in Conducting an Audit, paragraphs .36 through .41, is replaced with a reference to paragraphs 12 through 18 and 24 through 27 of Auditing Standard No. 14, Evaluating Audit Results.

AU sec. 329, "Analytical Procedures"

SAS No. 56, "Analytical Procedures" (AU sec. 329, "Analytical Procedures"), as amended, is amended as follows:

a. The title of the standard, "Analytical Procedures," is replaced with the title, "Substantive Analytical Procedures."

b. The text of paragraph .01 is replaced with:

This section establishes requirements regarding the use of substantive analytical procedures in an audit.

Note: Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, establishes requirements regarding performing analytical procedures as a risk assessment procedure in identifying and assessing risks of material misstatement.

Note: Auditing Standard No. 14, Evaluating Audit Results, establishes requirements regarding performing analytical procedures as part of the overall review stage of the audit.

c. The last sentence of paragraph .03 is deleted.

d. The text of paragraph .04 is replaced with:

Analytical procedures are used as a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions. In some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives.

e. Paragraphs .06-.08 and the preceding heading, "Analytical Procedures in Planning the Audit," are deleted.

f. At the end of paragraph .09, the following new sentence is added:

(See paragraph 11 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.)

g. Within footnote 1 to paragraph .09, the reference to section 326, Evidential Matter, is replaced with a reference to Auditing Standard No. 15, Audit Evidence.

h. Footnote 2 to paragraph .20 is deleted.

i. In paragraph .21:

- In the fourth sentence, the word "likely" is deleted.
- The reference to section 316, Consideration of Fraud in a Financial Statement Audit, is replaced with a reference to Auditing Standard No. 14, Evaluating Audit Results.

j. Footnote 3 to paragraph .21 is deleted.

k. Paragraph .23 and the preceding heading, "Analytical Procedures Used in the Overall Review," and paragraph .24 and the preceding heading, "Effective Date," are deleted.

AU sec. 330, "The Confirmation Process"

SAS No. 67, "The Confirmation Process" (AU sec. 330, "The Confirmation

Process"), is amended as follows:

a. The references in paragraph .02 to section 312, Audit Risk and Materiality in Conducting an Audit, and section 313, Substantive Tests Prior to the Balance-Sheet Date, are replaced with a reference to Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

b. The reference in paragraph .05 to Section 312 is replaced with a reference to Auditing Standard No. 8, Audit Risk.

c. The second sentence of paragraph .06 is replaced with:

See paragraph 8 of Auditing Standard No. 15, Audit Evidence, which discusses the reliability of audit evidence.

d. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

e. In the third sentence of paragraph .11, the reference to Section 326 is replaced with a reference to Auditing Standard No. 15, Audit Evidence.

f. In the first sentence of paragraph .24, the word "competence" is replaced with the word "appropriateness."

g. In the last sentence of paragraph .27, the word "competent" is replaced with the word "appropriate."

AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"

SAS No. 92, "Auditing Derivative Instruments, Hedging Activities, and Investment in Securities" (AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"), as amended, is amended as follows:

a. The reference in paragraph .01 to section 326, Evidential Matter, paragraphs .03 – .08, is replaced with a reference to paragraphs 11 and 12 of Auditing Standard No. 15, Audit Evidence.

b. Paragraph .06 is replaced with:

   Auditing Standard No. 9, Audit Planning, discusses the auditor's responsibilities for consideration of the use of persons with specialized skill or knowledge. Auditing Standard No. 10, Supervision of the Audit Engagement, discusses the auditor's responsibilities for supervision of specialists who are employed by the auditor. AU sec. 336, Using the Work of a Specialist, discusses the auditor's responsibilities for using the work of a specialist engaged by the auditor.

c. The first and second sentences of paragraph .07 are deleted. The third sentence is replaced with:

The auditor should design and perform audit procedures regarding relevant assertions of derivatives and investments in securities that are based on and that address the risks of material misstatement in those assertions.

d. The reference in paragraph .09 to Section 319, Consideration of Internal Control in a Financial Statement Audit, is replaced with a reference to Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

e. The fourth sentence of paragraph .11 is replaced with "Paragraphs 28 through 32 and B1 through B6 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, discuss the information system, including related business processes, relevant to financial reporting."

f. In paragraph .15, the reference to section 319 is replaced with a reference to Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

g. The last sentence of paragraph .35 is replaced with:

In addition, paragraphs 24 through 27 of Auditing Standard No. 14, Evaluating Audit Results, describe the auditor's responsibilities for assessing bias in accounting estimates.

h. In paragraph .43, subparagraph a., the word "competent" is replaced with the word "appropriate."

i. In paragraph .51, the last sentence is replaced with:

(See paragraph 31 of Auditing Standard No. 14, Evaluating Audit Results.)

j. In paragraph .57, subparagraph c., the word "competent" is replaced with the word "appropriate."

AU sec. 333, "Management Representations"

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows:

a. Footnote 4 to paragraph .06 is replaced with:

Auditing Standard No. 14, Evaluating Audit Results, indicates that a misstatement can arise from error or fraud and also discusses the auditor's responsibilities for evaluating accumulated misstatements.

b. Within footnote 6 to paragraph .06, the reference to Section 312 is replaced with a reference to Paragraph 11 of Auditing Standard No. 14, Evaluating Audit Results.

c. Within footnote 7 to paragraph .06, the reference to section 316, Consideration of Fraud in a Financial Statement Audit, paragraphs .38 through .40, is replaced with a reference to section 316, Consideration of Fraud in a Financial Statement Audit, paragraphs .79 through .82.

AU sec. 334, "Related Parties"

SAS No. 45, "Related Parties" (AU sec. 334 "Related Parties"), is amended as follows:

a. In the second sentence of paragraph .09, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

c. In footnote 8 to paragraph .11, the reference to section 431, Adequacy of Disclosure in Financial Statements, is replaced with a reference to paragraph 31 of Auditing Standard No. 14, Evaluating Audit Results.

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334"

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334," is amended as follows:

Within footnote 4 to paragraph .17, the reference to section 312, Audit Risk and Materiality in Conducting an Audit, is replaced with a reference to Auditing Standard No. 8, Audit Risk.

AU sec. 336, "Using the Work of a Specialist"

SAS No. 73, "Using the Work of a Specialist" (AU sec. 336, "Using the Work of a Specialist"), is amended as follows:

a. Footnote 1 to paragraph .01 is replaced with the following:

   Because income taxes and information technology are specialized areas of accounting and auditing, this section does not apply to situations in which an income tax specialist or information technology specialist participates in the audit. Auditing Standard No. 10, Supervision of the Audit Engagement, applies in those situations.

b. Paragraph .05 is replaced with the following:

   This section does not apply to situations in which a specialist employed by the auditor's firm participates in the audit. Auditing Standard No. 10, Supervision of the Audit Engagement, applies in those situations.

c. In the last sentence of paragraph .06, the word "competent" is replaced with the word "appropriate."

d. In the first and last sentences of paragraph .13, the word "competent" is replaced with the word "appropriate."

AU sec. 9336, "Using the Work of a Specialist: Auditing Interpretations of Section 336"

AU sec. 9336, "Using the Work of a Specialist: Auditing Interpretations of Section 336," is amended as follows:

a. In the second sentence of paragraph .04, the word "competent" is replaced with the word "appropriate."

b. In paragraph .05, the word "competent" is replaced with the word "appropriate."

c. In the second sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

d. The penultimate sentence of paragraph .15, is replaced with:

Paragraph 6 of Auditing Standard No. 15, Audit Evidence, states, "[t]o be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor's opinion is based."

AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"

SAS No. 59, "The Auditor's Consideration of an Entity's Ability to Continue as Going Concern" (AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"), as amended, is amended as follows:

The reference in paragraph .02 to section 326, Evidential Matter, is replaced with a reference to Auditing Standard No. 15, Audit Evidence.

AU sec. 342, "Auditing Accounting Estimates"

SAS No. 57, "Auditing Accounting Estimates" (AU sec. 342, "Auditing Accounting Estimates"), as amended, is amended as follows:

a. In the first sentence of paragraph .01, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .07, the word "competent" is replaced with the word "appropriate."

c. The text of footnote 3 to paragraph .07 is replaced with:

   See paragraph 31 of Auditing Standard No. 14, Evaluating Audit Results.

d. The reference in paragraph .08 subparagraph b.1. to section 311, <u>Planning and Supervision</u>, is replaced with a reference to Auditing Standard No. 12, <u>Identifying and Assessing Risks of Material Misstatement</u>.

e. Paragraph .14, is replaced with:

Paragraphs 24 through 27 of Auditing Standard No. 14, <u>Evaluating Audit Results</u>, discuss the auditor's responsibilities for assessing bias and evaluating accounting estimates in relationship to the financial statements taken as a whole.

<u>AU sec. 9342, "Auditing Accounting Estimates: Auditing Interpretations of Section 342"</u>

AU sec. 9342, "Auditing Accounting Estimates: Auditing Interpretations of Section 342," is amended as follows:

In the second sentence of paragraph .02, the word "competent" is replaced with the word "appropriate."

<u>AU sec. 350, "Audit Sampling"</u>

SAS No. 39, "Audit Sampling" (AU sec. 350, "Audit Sampling"), as amended, is amended as follows:

a. Within footnote 2 to paragraph .02, the reference to section 312, Audit Risk and Materiality in Conducting an Audit, is replaced with a reference to Auditing Standard No. 14, Evaluating Audit Results.

b. The last sentence of paragraph .03 is replaced with:

   Either approach to audit sampling can provide sufficient evidential matter when applied properly. This section applies to both nonstatistical and statistical sampling.

c. Paragraph .04 is deleted.

d. In paragraph .06:

   - The first sentence is deleted.

   - In the last sentence, the word "competence" is replaced with the word "appropriateness."

   - The following note is added to the paragraph:

     Note: Auditing Standard No. 15, Audit Evidence, discusses the appropriateness of audit evidence, and Auditing Standard No. 14, Evaluating Audit Results, discusses the auditor's responsibilities for evaluating the sufficiency and appropriateness of audit evidence.

e. Paragraph .08 is deleted.

f. In paragraph .09:

- The sentence in paragraph .09 referring to section 313, which is in parentheses, is deleted.

- The following note is added to the paragraph:

  Note: Auditing Standard No. 8, Audit Risk, describes audit risk and its components in a financial statement audit – the risk of material misstatement (consisting of inherent risk and control risk) and detection risk.

g. In paragraph .11:

- The phrase "(see section 311, Planning and Supervision)" is deleted.

- The sentence "(See section 313.)" is deleted.

h. The second sentence of paragraph .15 is replaced with:

See Auditing Standard No. 9, Audit Planning.

i. In the first bullet in paragraph .16, the phrase "(see section 326, Evidential Matter)" is deleted.

j. In the second bullet of paragraph .16, the phrase "Preliminary judgments about materiality levels" is replaced with the phrase "Tolerable misstatement. (See paragraphs .18-.18A.)"

k. Paragraph .18 is replaced with:

Evaluation in monetary terms of the results of a sample for a substantive test of details contributes directly to the auditor's purpose, since such an evaluation can be related to his or her judgment of the monetary amount of misstatements that would be material. When planning a sample for a substantive test of details, the auditor should consider how much monetary misstatement in the related account balance or class of transactions may exist, in combination with other misstatements, without causing the financial statements to be materially misstated. This maximum monetary misstatement for the account balance or class of transactions is called tolerable misstatement.

l. Paragraph .18A is added:

Paragraphs 8 - 9 of Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit, describe the auditor's responsibilities for determining tolerable misstatement at the account or disclosure level. When the population to be sampled constitutes a portion of an account balance or transaction class, the auditor should determine tolerable misstatement for the population to be sampled for purposes of designing the sampling plan. Tolerable misstatement for the population to be sampled ordinarily should be less than tolerable misstatement for the account balance or transaction class to allow for the possibility that misstatement in the portion of the account or transaction class not subject to audit sampling, individually or in combination with other misstatements, would cause the financial statements to be materially misstated.

m. Paragraph .20 is deleted.

n. The first sentence of paragraph .21 is replaced with the following sentence:

The sufficiency of tests of details for a particular account balance or class of transactions is related to the individual importance of the items examined as well as to the potential for material misstatement.

o. Paragraph .23 is replaced with:

To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should take into account tolerable misstatement for the population; the allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and the characteristics of the population, including the expected size and frequency of misstatements.

p. Paragraph .23A is added:

Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical sampling approach. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

q. The last sentence of paragraph .25 is replaced with:

The auditor also should evaluate whether the reasons for his or her inability to examine the items have (a) implications in relation to his or her risk assessments (including the assessment of fraud risk), (b) implications regarding the integrity of management or employees, and (c) possible effects on other aspects of the audit.

r. Footnote 6 to paragraph .26 is replaced with:

Paragraphs 10 through 23 of Auditing Standard No. 14, Evaluating Audit Results, discuss the auditor's consideration of differences between the accounting records and the underlying facts and circumstances.

s. Within footnote 7 to paragraph .32, the phrase "(see section 319.85)" is deleted. In the first sentence of the footnote, the phrase "often plans" is replaced with the phrase "may plan." The last sentence of the footnote, which is in brackets, is deleted.

t. The last sentence of paragraph .38 is replaced with:

When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

u. The fifth sentence of paragraph .39 is replaced with:

Paragraphs 44 through 46 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement, describe the auditor's responsibilities for performing procedures between the interim date of testing and period end.

v. In paragraph .39, the last sentence, which is in brackets, is deleted.

w. In paragraph .44:

- The first sentence is replaced with:

  In some circumstances, the auditor may design a sample that will be used for dual purposes: as a test of control and as a substantive test.

- The third sentence is replaced with:

  For example, an auditor designing a test of a control over entries in the voucher register may design a related substantive test at a risk level that is based on an expectation of reliance on the control.

- The fifth sentence is replaced with:

  In evaluating such tests, deviations from the control that was tested and monetary misstatements should be evaluated separately using the risk levels applicable for the respective purposes.

- The following Note is added to the paragraph:

  > Note: Paragraph 47 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement, provides additional discussion of the auditor's responsibilities for performing dual-purpose tests.

x. The reference in paragraph .45 to paragraph .04 is changed to a reference to paragraph .03.

y. In item 2 of paragraph .48, the last sentence is deleted.

z. Within footnote 1 to item 4 in paragraph .48, the sentence "(See section 313.)" is deleted.

aa. The sentence in item 6 of paragraph .48 "(See section 313.)" is deleted.

AU sec. 9350, "Audit Sampling: Auditing Interpretations of Section 350"

AU sec. 9350, "Audit Sampling: Auditing Interpretations of Section 350," is superseded.

AU sec. 380, "Communication With Audit Committees"

SAS No. 61, "Communication With Audit Committees" (AU sec. 380, "Communication With Audit Committees"), as amended, is amended as follows:

In footnote 5 to paragraph .10, the reference to section 316A.38 -.40 is replaced with a reference to AU secs. 316.79 -.82; the reference to section 316A is replaced with a reference to section 316.

AU sec. 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles"

SAS No. 69, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles" (AU sec. 411, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles"), as amended, is amended as follows:

a. In paragraph .04, the reference in (c) to section 431 is replaced with a reference to paragraph 31 of Auditing Standard No. 14, Evaluating Audit Results; in (d), the reference to section 431 is replaced with a reference to paragraph 31 of Auditing Standard No. 14.

b. The reference in footnote 1 to paragraph .04 to 312.10 is replaced with a reference to Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit.

AU sec. 431, "Adequacy of Disclosure in Financial Statements"

SAS No. 32, "Adequacy of Disclosure in Financial Statements" (AU sec. 431, "Adequacy of Disclosure in Financial Statements"), as amended, is superseded.

AU sec. 508, "Reports on Audited Financial Statements"

SAS No. 58, "Reports on Audited Financial Statements" (AU sec. 508, "Reports on Audited Financial Statements"), as amended, is amended as follows:

a. In paragraph 18C, the phrase "and in AU sec. 431" is deleted.

b. In subparagraph .20.a., the word "competent" is replaced with the word "appropriate."

c. In the second sentence of paragraph .22, the word "competent" is replaced with the word "appropriate."

d. In the third sentence of paragraph .24, the word "competent" is replaced with the word "appropriate."

e. In footnote 15 to paragraph .38, the first sentence is replaced with:

In this context, practicable means that the information is reasonably obtainable from management's accounts and records and that providing the information in the report does not require the auditor to assume the position of a preparer of financial information.

f. The references in paragraph .49 to section 312, Audit Risk and Materiality, and to section 342, Auditing Accounting Estimates, are replaced with a reference to paragraph 13 of Auditing Standard No. 14, Evaluating Audit Results.

g. In the first sentence of paragraph .63, the word "competent" is replaced with the word "appropriate."

h. In paragraph .66, the second sentence is replaced with:

(See paragraph 31 of Auditing Standard No. 14, Evaluating Audit Results.)

AU sec. 9508, "Reports on Audited Financial Statements: Auditing Interpretations of Section 508"

AU sec. 9508, "Reports on Audited Financial Statements: Auditing Interpretations of Section 508," is amended as follows:

In paragraph .02, the word "competent" is replaced with the word "appropriate."

AU sec. 530, "Dating of the Independent Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 530, "Dating of the Independent Auditor's Report" (AU sec. 530, "Dating of the Independent Auditor's Report"), as amended, is amended as follows:

a. In the first sentence of paragraph .01, the word "competent" is replaced with the word "appropriate."

b. In the second note to paragraph .01, the word "competent" is replaced with the word "appropriate."

c. In the first sentence of paragraph .05, the word "competent" is replaced with the word "appropriate."

AU sec. 543, "Part of Audit Performed by Other Independent Auditors"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 543 "Part of Audit Performed by Other Independent Auditors" (AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), as amended, is amended as follows:

a. The following note is added as the second note to paragraph .01:

Note: For situations in which the auditor engages an accounting firm or individual accountants to participate in the audit engagement and AU sec. 543 does not apply, the auditor should supervise them in accordance with the requirements of Auditing Standard No. 10, Supervision of the Audit Engagement.

b. Within paragraph .12:

- Subparagraph b. is replaced with:

  A list of significant risks, the auditor's responses, and the results of the auditor's related procedures.

- Subparagraph f. is replaced with:

  A schedule of accumulated misstatements, including a description of the nature and cause of each accumulated misstatement, and an evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

AU sec. 9543, "Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543"

AU sec. 9543, "Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543," as amended, is amended as follows:

a. Paragraph .16 is replaced with:

Interpretation – The principal auditor's response should ordinarily be made by the engagement partner. The engagement partner should take those steps that he or she considers reasonable under the circumstances to be informed of known matters pertinent to the other auditor's inquiry. For example, the engagement partner may inquire of engagement team members responsible for various aspects of the engagement or he or she may direct engagement team members to bring to his or her attention any significant matters of which they become aware during the audit. The principal auditor is not required to perform any procedures directed toward identifying matters that would not affect his or her audit or his or her report.

b. Footnote 4 to paragraph .16 is deleted.

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows:

a. Within footnote 7 to paragraph .11, the first sentence is replaced with:

Paragraphs 10 through 23 of Auditing Standard No. 14, Evaluating Audit Results, require the auditor to accumulate and evaluate the misstatements identified during the audit.

b. The reference in paragraph .13 to section 319, Consideration of Internal Control in a Financial Statement Audit, is replaced with a reference to Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

c. Within the last sentence of paragraph .16, the title of section 329, "Analytical Procedures," is replaced with the title "Substantive Analytical Procedures."

d. Footnote 20 to paragraph .26 is deleted.

e. The reference in paragraph .56, subparagraph C5, to section 319 is replaced with a reference to section 316.

Auditing Standard No. 3, Audit Documentation

Auditing Standard No. 3, Audit Documentation, as amended, is amended as follows:

a. Within paragraph 3, subparagraph b. is replaced with:

Supervisory personnel who review documentation prepared by other members of the engagement team.

b. Paragraph 9A is added:

Documentation of risk assessment procedures and responses to risks of misstatement should include (1) a summary of the identified risks of misstatement and the auditor's assessment of risks of material misstatement at the financial statement and assertion levels and (2) the auditor's responses to the risks of material misstatement, including linkage of the responses to those risks.

c. Within paragraph 12:

- Within subparagraph a.:, (1) a footnote reference 2A is added at the end of the first sentence:

  See paragraphs 12-13 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, and paragraphs .66-.67 of AU sec. 316, Consideration of Fraud in a Financial Statement Audit.

  and (2) the second sentence of subparagraph a. is deleted.

- Subparagraph b. is replaced with:

  Results of auditing procedures that indicate a need for significant modification of planned auditing procedures, the existence of material misstatements (including omissions in the financial statements), and the existence of significant deficiencies or material weaknesses in internal control over financial reporting.

- Subparagraph c. is replaced with:

  Accumulated misstatements and evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

- Footnote 2B is added to subparagraph c.:

  See paragraphs 10-23 of Auditing Standard No. 14, Evaluating Audit Results.

- Subparagraph d. is replaced with:

  Disagreements among members of the engagement team or with others consulted on the engagement about final conclusions reached on significant accounting or auditing matters, including the basis for the final resolution of those disagreements. If an engagement team member disagrees with the final conclusions reached, he or she should document that disagreement.

- Subparagraph f. is replaced with:

Significant changes in the auditor's risk assessments, including risks that were not identified previously, and the modifications to audit procedures or additional audit procedures performed in response to those changes.

- Footnote 2C is added to subparagraph f.:

  See paragraph 74 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, and paragraph 36 of Auditing Standard No. 14, Evaluating Audit Results.

- Subparagraph f-1. is added:

  Risks of material misstatement that are determined to be significant risks and the results of the auditing procedures performed in response to those risks.

d. Within paragraph 19:

- Subparagraph b. is replaced with:

  A list of significant risks, the auditor's responses, and the results of the auditor's related procedures.

- Subparagraph f. is replaced with:

A schedule of accumulated misstatements, including a description of the nature and cause of each accumulated misstatement, and an evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

e. Paragraph 21 and the preceding heading, "Effective Date," are deleted.

Auditing Standard No. 4, Reporting on Whether a Previously Reported Material Weakness Continues to Exist

Auditing Standard No. 4, Reporting on Whether a Previously Reported Material Weakness Continues to Exist, as amended, is amended as follows:

In the first sentence of paragraph 18, the word "competent" is replaced with the word "appropriate."

Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, is amended as follows:

a. In the second sentence of paragraph 3, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph 9, the phrase "any assistants" is replaced with the phrase "the engagement team members."

c. Within footnote 10 to paragraph 14, the reference to paragraphs .19-.42 of AU sec. 316, Consideration of Fraud in a Financial Statement Audit, is replaced with a reference to Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

d. The reference in paragraph 15 to AU sec. 316.44 and .45 is replaced with a reference to paragraphs 65-69 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

e. Within footnote 11 to paragraph 20, the reference to AU sec. 312, Audit Risk and Materiality in Conducting an Audit, is replaced with a reference to Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit.

f. Within footnote 12 to paragraph 28, the reference to AU sec. 326, Evidential Matter, is replaced with a reference to Auditing Standard No. 15, Audit Evidence.

g. Within footnote 13 to the note to paragraph 31, the reference to AU sec. 312.39 is replaced with a reference to paragraph 14 of Auditing Standard No. 14, Evaluating Auditing Results. The reference to AU sec. 316.50 is replaced with a reference to paragraph 5 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

h. The references in paragraph 36 to paragraphs .16-.20, .30-.32, and .77-.79 of AU sec. 319, Consideration of Internal Control in a Financial Statement Audit, are replaced with references to paragraph 29 and Appendix B of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

i. In the first sentence of paragraph 51, the word "competent" is replaced with the word "appropriate."

j. In the first sentence of paragraph 89, the word "competent" is replaced with the word "appropriate."

k. Within the note to paragraph C6 in Appendix C, the word "competent" is replaced with the word "appropriate."

Auditing Standard No. 6, Evaluating Consistency of Financial Statements

Auditing Standard No. 6, Evaluating Consistency of Financial Statements, is amended as follows:

a. Footnote 3 to paragraph 4 is deleted.

b. In paragraph 10, the reference to AU sec. 431, Adequacy of Disclosure in Financial Statements, is replaced with a reference to paragraph 31 of Auditing Standard No. 14, Evaluating Audit Results.

Auditing Standard No. 7, Engagement Quality Review

Auditing Standard No. 7, Engagement Quality Review, is amended as follows:

a. Footnote 3 to paragraph 5 is replaced with:

> The term "engagement partner" has the same meaning as the "practitioner-in-charge of an engagement" in PCAOB interim quality control standard QC sec. 40, The Personnel Management Element of a Firm's System of Quality Control-Competencies Required by a Practitioner-in-Charge of an Attest Engagement. QC sec. 40 describes the competencies required of a practitioner-in-charge of an attest engagement.

b. In paragraph 10, the note following subparagraph b. is replaced with:

> Note: A significant risk is a risk of material misstatement that requires special audit consideration.

Ethics Standards

ET sec. 102, "Integrity and Objectivity"

ET sec. 102, "Integrity and Objectivity," is amended as follows:

Footnote 1 to paragraph .05 is replaced with:

See paragraph 5.b. of Auditing Standard No. 10, Supervision of the Audit Engagement, and paragraph 12.d. of Auditing Standard No. 3, Audit Documentation.

II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rules and discussed any comments it received on the proposed rules. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

(a) Purpose

Section 103(a) of the Act directs the Board, by rule, to establish, among other things, "auditing and related attestation standards . . . to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by th[e] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." As discussed more fully in Exhibit 3, the Board adopted eight auditing standards and related amendments that benefit investors by establishing requirements that enhance the effectiveness of the auditor's assessment of and response to the risks of material misstatement in an audit.

In an audit performed in accordance with PCAOB standards, risk underlies the entire audit process, including the procedures that the auditor performs to support the opinion expressed in the auditor's report. Most of the Board's interim auditing standards relating to assessing and responding to risk in an audit of financial statements were developed in the 1980s.[154/] Those standards described in general terms the auditor's responsibilities for assessing and responding to risk. They directed auditors to vary the amount of audit attention related to particular financial statement accounts based on the risks presented by them. The standards also allowed the auditor to use tests of controls to reduce substantive testing.[155/]

A number of factors and events led the Board to reexamine those standards and seek to improve them. These included the widespread use of risk-based audit methodologies; recommendations to the profession on ways in which auditors could improve risk assessment;[156/] advice from the Board's Standing Advisory Group ("SAG");[157/] adoption of Auditing Standard No. 5, An Audit of Internal Control Over

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154/ Examples of those standards include AU sec. 312, Audit Risk and Materiality in Conducting an Audit, and AU sec. 319, Consideration of Internal Control in a Financial Statement Audit.

155/ AU sec. 319.

156/ See, e.g., Public Oversight Board, Panel on Audit Effectiveness ("PAE"), Report and Recommendations (August 31, 2000). For a summary of the PAE's recommendations related to risk assessment, see PCAOB Standing Advisory Group ("SAG") Meeting Briefing Paper, "Risk Assessment in Financial Statement Audits" (February 16, 2005), Appendix A, available at: http://www.pcaobus.org/News_and_Events/Events/2005/02-16.aspx.

157/ Webcasts of SAG meetings are available on the Board's Web site at: http://www.pcaobus.org/News_and_Events/Webcasts.

Financial Reporting That Is Integrated with An Audit of Financial Statements; and observations from the Board's oversight activities.

On October 21, 2008, the Board proposed a set of auditing standards to update the requirements for assessing and responding to risk in an audit ("the original proposed standards").[158] The original proposed standards were intended to improve the auditing standards and to benefit investors by establishing requirements that enhance the effectiveness of auditors' assessment of and response to risk through:

- Performing procedures that provide a reasonable basis for identifying and assessing risks of material misstatement, whether due to error or fraud

- Tailoring the audit to respond appropriately to the risks of material misstatement

- Making a comprehensive evaluation of the evidence obtained during the audit to form the opinion(s) in the auditor's report

The Board also sought to emphasize the auditor's responsibilities for consideration of fraud by incorporating requirements for identifying and responding to the risks of material misstatement due to fraud ("fraud risks") and evaluating audit results from the existing PCAOB standard, AU sec. 316, Consideration of Fraud in a Financial

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[158] PCAOB Release No. 2008-006, Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk (October 21, 2008).

Statement Audit.[159/] Incorporating these requirements makes clear that the auditor's responsibilities for assessing and responding to fraud risks are an integral part of the audit process rather than a separate, parallel process. It also benefits investors by prompting auditors to make a more thoughtful and thorough assessment of fraud risks and to develop appropriate audit responses.

Improvements in the standards related to risk assessment also should enhance integration of the audit of financial statements with the audit of internal control over financial reporting ("audit of internal control") by articulating a process for identifying and assessing risks of material misstatement that applies to both portions of the integrated audit when the auditor is performing an integrated audit.

The proposed rules also amend the Board's interim standards including superseding the following sections of PCAOB interim auditing standards:

- AU sec. 311, Planning and Supervision
- AU sec. 312, Audit Risk and Materiality in Conducting an Audit
- AU sec. 313, Substantive Tests Prior to the Balance Sheet Date
- AU sec. 319, Consideration of Internal Control in a Financial Statement Audit

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159/ Paragraphs .14-.51 and paragraphs .68-.78 of AU sec. 316, Consideration of Fraud in a Financial Statement Audit.

- AU sec. 326, Evidential Matter

- AU sec. 431, Adequacy of Disclosure in Financial Statements

Similarly, the auditing interpretations of AU secs. 311, 312, and 350 have been incorporated into the risk assessment standards and thus are superseded. The auditing interpretations of AU sec. 326, except for Interpretation No. 2 (AU secs. 9326.06-.23), also are superseded.[160]

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

B. Board's Statement on Burden on Competition

The Board does not believe that the proposed rule changes will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rule changes would apply equally to all registered public accounting firms conducting audits in accordance with PCAOB standards.

C. Board's Statement on Comments on the Proposed Rules Received from Members, Participants or Others

The Board released the proposed rules for public comment in PCAOB Release No. 2008-006 (October 21, 2008). The Board received 33 written comments. The Board considered these comments and made changes to the initial proposed rules. As a result,

[160] Interpretation No. 2 relates in part to AU sec. 336 and AU sec. 337, Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments, and it will be evaluated in connection with standards-setting projects related to those standards.

the Board again sought public comment in PCOAB Release No. 2009-007 (December 21, 2009). The Board received 23 written comment letters relating to its reproposal of the proposed rules. A copy of PCAOB Release Nos. 2008-006 and 2009-007 and the comment letters received in response to the PCAOB's request for comment in both releases are available on the PCAOB's web site at www.pcaobus.org.

The Board has carefully considered all comments it has received. In response to the written comments received on both the initial and reproposal of the proposed rules, the Board has clarified and modified certain aspects of the proposed rules, as discussed below.

Overview of the Risk Assessment Standards

Many commenters on the original proposed standards were supportive of the Board's efforts to update its risk assessment requirements and offered numerous suggestions for changing the original proposed standards. After considering all of the comments received on those standards, the Board made numerous refinements to the original proposed standards. Because the standards address many fundamental aspects of the audit process and are expected to serve as a foundation for future standards-setting, the Board reproposed the standards for public comment on December 17, 2009 ("the reproposed standards").[161/]

[161/] PCAOB Release No. 2009-007, Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk (December 17, 2009).

The Board received 23 comment letters on the reproposed standards.[162/] The Board discussed the comments received with the SAG on April 8, 2010.[163/] Most commenters were generally supportive of the reproposed standards and the improvements made to those standards. Many commenters also offered suggestions to improve the standards, which the Board has carefully analyzed.

After consideration of the comments received, the Board has refined the standards to provide additional clarity. The Board has decided to adopt the following standards for assessing and responding to risk in an audit and the related amendments to PCAOB standards:

- Auditing Standard No. 8, Audit Risk
- Auditing Standard No. 9, Audit Planning
- Auditing Standard No. 10, Supervision of the Audit Engagement
- Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit

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[162/] Comments on the original proposed standards and the reproposed standards are available on the Board's Web site at: http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket026.aspx.

[163/] A transcript of the portion of the meeting that related to the reproposed standards is available on the Board's Web site at: http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket026.aspx.

- Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement

- Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement

- Auditing Standard No. 14, Evaluating Audit Results

- Auditing Standard No. 15, Audit Evidence

1. Notable Areas of Change in the Standards

The changes made to the reproposed standards reflect refinements rather than significant shifts in approach. This section describes the areas of change to the reproposed standards that are most notable, e.g., because they affect multiple standards or multiple sections of an individual standard. This Release discusses these and other changes in more detail.

a. Planning and Supervision Standards

The reproposed standards included a standard covering both audit planning and supervision. Some commenters observed that audit planning and supervision should be covered in separate standards.

Audit planning and supervision, although related in some respects, are distinct activities that should be presented in separate standards. Accordingly, the Board has divided the planning and supervision standard into separate standards for planning and for supervision. Presenting the requirements for planning and supervision in separate standards is a technical change that, by itself, does not affect the auditor's responsibilities for planning the audit or supervision of the work of engagement team members as described in the reproposed standards.

b. Requirements for Multi-location Audits

The reproposed standard on audit planning and supervision included requirements regarding establishing the scope of testing of individual locations in multi-location engagements. The reproposed standard on consideration of materiality in planning and performing an audit included requirements for determining materiality of individual locations in multi-location audits. Some commenters requested clarification on the Board's expectations regarding how to apply those requirements in audits in which part of the work is performed by other auditors, specifically, auditors of financial statements of individual locations or business units that are included in the consolidated financial statements.

The multi-location requirements have been revised to take into account situations in which part of the work is performed by other auditors.[164/] This release discusses those

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164/ Paragraphs 11-14 of Auditing Standard No. 9, Audit Planning, and paragraph 10 of Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit.

revisions in more detail and explains the Board's expectations regarding how to apply the respective requirements in situations involving other auditors.

The reproposed standard on audit planning and supervision also included a statement, similar to a statement in Auditing Standard No. 5, that "The direction in paragraph 5 of Proposed Auditing Standard, The Auditor's Responses to the Risks of Material Misstatement, regarding incorporating an element of unpredictability in the auditing procedures means that the auditor should vary the nature, timing, and extent of audit procedures at locations or business units from year to year." Some commenters stated that the statement in the reproposed audit planning and supervision standard was unnecessarily prescriptive. After considering the comments received, the requirement regarding unpredictability was removed from the audit planning standard, and the discussion in Auditing Standard No. 13 regarding incorporating an element of unpredictability was expanded to include varying the testing in the selected locations.[165/] However, this does not change the requirements in Auditing Standard No. 5 regarding incorporating unpredictability in testing controls at individual locations in audits of internal control.[166/]

165/ Paragraph 5 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

166/ Paragraphs 61 and B13 of Auditing Standard No. 5.

c. Requirement for Performing Walkthroughs

In the original proposed standards, the standard on identifying and assessing risks of material misstatement referred auditors to Auditing Standard No. 5 for a discussion of the performance of walkthroughs. Some commenters on the original proposed standards stated that the proposed standard should include a discussion of walkthroughs rather than referring to Auditing Standard No. 5. The reproposed standard on identifying and assessing risks of material misstatement included a discussion of the objectives for understanding likely sources of potential misstatements and of performing walkthroughs, which paralleled a discussion in Auditing Standard No. 5.[167/] Some commenters expressed concerns that those new requirements would lead to unnecessary walkthroughs, particularly in audits of financial statements only.

The intention of including the discussion of walkthroughs was to describe how to perform walkthroughs, not to impose additional requirements regarding when to perform walkthroughs. The discussion has been revised to focus on how the auditor should perform walkthroughs, and the discussion of the objectives for understanding likely sources of potential misstatements has been removed.[168/] Consequently, the objectives in paragraph 34 of Auditing Standard No. 5 for understanding potential sources of likely misstatement will continue to apply only to integrated audits.

167/ Paragraph 34 of Auditing Standard No. 5.

168/ Paragraphs 37-38 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

d. Requirements Regarding Financial Statement Disclosures

Because of the importance of disclosures to the fair presentation of financial statements and based on observations from the Board's oversight activities, the reproposed standards included additional requirements intended to increase the auditor's attention on the disclosures in the financial statements. For example, the reproposed standard on identifying and assessing risks of material misstatement included a new requirement related to developing an expectation about the necessary financial statement disclosures as part of obtaining an understanding of the company and its environment. Some commenters stated that the requirements should be clarified as applying to disclosures required by the applicable financial reporting framework. Also, the reproposed standard on evaluating audit results included expanded requirements for the auditor to evaluate whether the financial statements include the required disclosures. Some commenters stated that the standard should clarify that the requirements apply only to material disclosures.

After analyzing the comments, those two requirements have been revised to clarify that they refer to the fair presentation of the financial statements in conformity with the applicable financial reporting framework.[169/]

169/ Paragraph 13 of Auditing Standard No. 12 and paragraph 31 of Auditing Standard No. 14, Evaluating Audit Results.

2. Discussion of Comments That Relate to Many of the Reproposed Standards

The following paragraphs discuss matters raised by commenters that relate to many of the reproposed standards. Section II.C.13 of this release contains a discussion of other topics raised by commenters on matters other than the risk assessment standards or the related amendments.

a. Consideration of Fraud in the Audit

Section I of the Board's adopting release discusses the Board's objectives regarding incorporating into its risk assessment standards the requirements for identifying and responding to risks of material misstatement due to fraud ("fraud risks") and evaluating audit results from AU sec. 316, Consideration of Fraud in a Financial Statement Audit.[170/]

The number of comments received on this approach to incorporate the requirements from AU sec. 316 declined significantly from the original proposed standards.[171/] The views of commenters continue to be mixed. One commenter supported the approach, and two commenters expressed concerns about the approach.

170/ The risk assessment standards incorporate paragraphs .14-.51 and .68-.78 of AU sec. 316. Accordingly, those paragraphs are removed from AU sec. 316 by means of a related amendment.

171/ As discussed in Section I, the risk assessment standards were originally proposed on October 21, 2008. See PCAOB Release No. 2008-006, Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk.

The risk assessment standards continue to include relevant requirements from AU sec. 316. The Board has observed from its oversight activities instances in which auditors have performed the procedures required in AU sec. 316 mechanically, without using the procedures to develop insights on fraud risk or to modify the audit plan to address that risk. The Board also has observed instances in which firms have failed to respond appropriately to identified fraud risks.

These observations suggest that some auditors may improperly view the consideration of fraud as an isolated, mechanical process rather than an integral part of audits under PCAOB standards. Integrating the requirements from AU sec. 316 into the risk assessment standards emphasizes to auditors that assessing and responding to fraud risks is an integral part of an audit in accordance with PCAOB standards, rather than a separate consideration. Such integration also should prompt auditors to make a more thoughtful and thorough assessment of the risks affecting the financial statements, including fraud risks, and to develop appropriate audit responses. Furthermore, AU sec. 316, as amended, will continue to provide relevant information on determining the necessary procedures for considering fraud in a financial statement audit. (See section II.C.11.F.(ii). of this release for more discussion about AU sec. 316.)

b. Organization and Style of Standards (Including the Use of Notes and Appendices)

In response to comments on the original proposed standards, the Board presented the reproposed standards using an organization and style that is intended to be a template for future standards of the Board. The organization and style includes an objective for each standard, which provides additional context for understanding the requirements in the standard, and a separate appendix for definitions of terms used in each standard.

Commenters generally supported the organization and style of the reproposed standards, and some commenters suggested that existing PCAOB standards be revised to implement this organization and style. As stated in the release accompanying the reproposed standards, the organization and style used in the reproposed standards draws from previously issued standards of the Board, e.g., Auditing Standard No. 7, Engagement Quality Review. Also, the Board will apply this template in the course of its other standards-setting activities.

Commenters expressed concerns about including requirements in appendices and notes to the standard. Consistent with standards previously issued by the Board, the notes and appendices in the risk assessment standards are integral parts of the standards and carry the same authoritative weight as the other portions of the standards.

c. Use of Terms

PCAOB Rule 3101, Certain Terms Used in Auditing and Related Professional Practice Standards, sets forth the terminology that the Board uses to describe the degree of responsibility that the auditing and related professional practice standards impose on auditors. The original proposed standards used terms in the requirements in a manner that was consistent with Rule 3101.

Some comments received on the original proposed standards suggested revisions to the terms used in the requirements or asked for clarification about certain terms or phrases, e.g., "take into account." The reproposed standards reflected numerous revisions to the terms used in the standards, and the risk assessment standards reflect further refinements. For example, the standards use "should consider" only when referring to a requirement to consider performing an action or procedure, which is consistent with Rule 3101.

As explained in the release accompanying the reproposed standards, the phrase "take into account" has been used previously in PCAOB standards in reference to information or matters that the auditor should think about or give attention to in performing an audit procedure or reaching a conclusion.[172/] Accordingly, the results of the auditor's thinking on the relevant matters should be reflected in the performance and

[172/] AU sec. 316.45 and paragraphs 14, 44, 59, and B 12 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

documentation of the respective audit procedure performed or conclusion reached. The accompanying standards continue to use "take into account" in the same way.

Some commenters asked about the meaning of certain terms, e.g., "assess," "evaluate," or "determine." Those commenters also stated that the Board should use those terms consistently throughout its standards. The Board has reviewed the use of each of those terms and has revised the standards as necessary to apply those terms more consistently. Subsequent sections of this release discuss specific revisions to the individual standards.

One commenter expressed concerns about statements that involve the use of present tense in the reproposed standards. As with standards that the Board previously issued, the present tense is used in the risk assessment standards for statements that are factual or definitional, e.g., to provide additional explanation of a required auditing procedure.[173/] Subsequent sections of this release discuss specific instances of the use of present tense in the risk assessment standards.

d. Requirements and the Application of Judgment

Some commenters on the original proposed standards stated that the original proposed standards contained requirements that were "too prescriptive," limiting the auditor's ability to "use professional judgment or scale the audit," e.g., because of the

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173/ See, e.g., paragraph 21 of Auditing Standard No. 5 for an example of the use of the present tense for this purpose.

number of requirements in the standards and because the standards did not explicitly refer to professional judgment in the requirements. In the release accompanying the reproposed standards, the Board discussed the importance of professional judgment in fulfilling the requirements of the standards. After examining each requirement, the Board revised certain provisions in the reproposed standards to streamline the presentation of those requirements.

Although the Board received fewer comments on the reproposed standard related to this topic, two commenters continue to express concerns about whether the reproposed standards made adequate allowance for the auditor to use professional judgment in assessing and responding to risk in an audit.

PCAOB standards recognize that the auditor uses judgment in planning and performing audit procedures and evaluating the evidence obtained from those procedures.[174/] As under other PCAOB standards, auditors need to exercise judgment in fulfilling the requirements of the risk assessment standards in the particular circumstances. Making references to judgment in selected portions of the standards, however, could be misinterpreted as indicating that judgment is required only in certain aspects of the audit. Instead of referring to judgment selectively, the risk assessment standards set forth principles for meeting the requirements of the standards and allow the

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174/ See, e.g., paragraph .11 of AU sec. 230, Due Professional Care in the Performance of Work.

auditor to determine the most appropriate way to comply with the requirements in the circumstances.

3. Auditing Standard No. 8 – Audit Risk

a. Background

Auditing Standard No. 8 discusses audit risk and the relationships among the various components of audit risk in an audit of financial statements. The standard applies to integrated audits and to audits of financial statements only.

b. Objective

The reproposed standard stated that the objective of the auditor is to conduct the audit of financial statements in a manner that reduces audit risk to an appropriately low level. This objective provided important context for understanding how the concept of audit risk is applied in an audit.

One commenter observed that the reproposed standards sometimes used the phrase, "appropriately low level" and occasionally used the phrase "acceptably low level," and that commenter suggested revising the standards to use "acceptably low level" in each instance. The Board continues to believe the term "appropriately low level" is more suitable because it is aligned more closely with the degree of assurance described in the auditor's opinion, i.e., the auditor conducts the audit to reduce audit risk to an appropriately low level in order to express an opinion with reasonable assurance. In contrast, the term "acceptably low" is less clear and could be misinterpreted. The risk assessment standards have been revised to use the phrase "appropriately low level," as applicable.

c. Due Professional Care and Sufficient Appropriate Audit Evidence

The reproposed standard stated that, to form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. It also stated that reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.[175/]

A commenter suggested that due professional care is a responsibility throughout the audit, similar to professional skepticism and judgment, and need not be repeated throughout the Board's standards. The Board agrees that due professional care is a responsibility throughout the audit. On the other hand, existing PCAOB standards state that due professional care allows the auditor to obtain reasonable assurance,[176/] and the statement in Auditing Standard No. 8 acknowledges that principle.

175/ Paragraph 3 of Auditing Standard No. 8.

176/ AU sec. 230.10.

d. Audit Risk and Risk of Material Misstatement

Some commenters on the original proposed standard requested more explanation about risks at the overall financial statement level, e.g., by providing examples of such risks. The reproposed standard elaborated further on risks at the financial statement level.[177/]

Commenters on the reproposed standard asked for more explanation regarding how financial statement level risks can result in material misstatement of the financial statements. The examples of financial statement level risks in Auditing Standard No. 8 have been expanded to illustrate how those risks can result in material misstatement of the financial statements.[178/]

Some individual commenters offered suggestions for refining or clarifying the discussion of the risk of material misstatement and its components. For example, one commenter suggested that the description of the risk of material misstatement should state that the risk exists "prior to the audit" to more clearly indicate that it is the company's risk. The Board agrees that the risk of material misstatement exists irrespective of the audit, while the risk of not detecting material misstatement is the auditor's risk. However, the suggested phrase could be misinterpreted, e.g., as implying that the auditor need not consider the risk of misstatements occurring during the audit.

177/ Paragraph 6 of Auditing Standard No. 8.

178/ Ibid.

The reproposed standard included a statement that inherent risk and control risk are the company's risks; they exist independently of the audit. One commenter suggested that the statement was not informative and suggested revising the standard to state that inherent risk and control risk are functions of the company's characteristics, but influence the auditor's actions. The Board agrees that more discussion of the auditor's consideration of inherent risk and control risk is appropriate. Thus, Auditing Standard No. 8 has been expanded to discuss the sources of evidence the auditor uses when assessing inherent risk and control risk.[179/] Also, the description of control risk in Auditing Standard No. 8 has been aligned with the discussion of internal control concepts in Auditing Standard No. 5.

One commenter expressed a concern that descriptions of inherent risk, control risk, and detection risk that included the phrase "that could be material, individually or in combination with other misstatements," may be misinterpreted by the auditor as a requirement to consider whether the combination of dissimilar risks will result in a material misstatement. The commenter suggested changing "combination" to "aggregate." However, the standard does not discuss the combination of risks but, rather, the risk of a misstatement that could be material, individually or in combination with other misstatements, which is consistent with the description of the auditor's evaluation of uncorrected misstatements in Auditing Standard No. 14, Evaluating Audit Results. Thus, the term "combination" was retained as proposed.

179/ Paragraph 8 of Auditing Standard No. 8.

e. **Detection Risk**

The reproposed standard indicated that detection risk is reduced by performing substantive procedures. Some commenters stated that the discussion of detection risk should be modified to indicate that auditors can reduce detection risk through procedures other than substantive procedures (e.g., risk assessment procedures and tests of controls). A commenter also suggested changing the sentence in the standard to refer to "audit procedures" instead of "substantive procedures."

The Board acknowledges that auditors might obtain evidence of misstatements through procedures other than substantive procedures. However, that does not diminish the auditor's responsibility to plan and perform substantive procedures for significant accounts and disclosures that are sufficient to provide reasonable assurance of detecting misstatements that would result in material misstatement of the financial statements. Changing "substantive procedures" to "audit procedures," as suggested by the commenter, is not consistent with AU sec. 319, Consideration of Internal Control in a Financial Statement Audit, and could be misunderstood by auditors, resulting in inadequate substantive procedures.[180/] To provide further clarification, Auditing Standard No. 8 has been revised to describe the role of risk assessment procedures and tests of

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[180/] AU secs. 319.81-.82. AU sec. 319, along with AU sec. 311, Planning and Supervision, AU sec. 312, Audit Risk and Materiality in Conducting an Audit, AU sec. 313, Substantive Tests Prior to the Balance Sheet Date, AU sec. 326, Evidential Matter, and AU sec. 431, Adequacy of Disclosure in Financial Statements, are superseded by the risk assessment standards.

controls in assessing the risk of material misstatement, which, in turn, affects the appropriate level of detection risk.[181]

Some commenters expressed concerns that the reproposed standard did not adequately link the concepts of inherent risk and control risk to detection risk. They stated that a discussion on the relationship of these concepts is necessary for the auditor to determine the acceptable level of detection risk for the financial statement assertions, which, in turn, is used to determine the nature, timing, and extent of substantive procedures. The following discussion, which is adapted from AU sec. 319, was added to paragraph 10 of Auditing Standard No. 8: "The auditor uses the assessed risk of material misstatement to determine the appropriate level of detection risk for a financial statement assertion. The higher the risk of material misstatement, the lower the level of detection risk needs to be in order to reduce audit risk to an appropriately low level."[182]

f. Integrated Audit Considerations

Auditing Standard No. 8 applies both to audits of financial statements only and to the financial statement audit portion of integrated audits. Audit risk in the audit of financial statements relates to whether the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, while audit risk in an audit of internal control over financial reporting ("audit of internal control") relates to

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181/ Paragraphs 8-9 of Auditing Standard No. 8.

182/ Paragraph 10 of Auditing Standard No. 8.

whether the auditor expresses an inappropriate audit opinion when one or more material weaknesses exist. The two forms of audit risk are related, however, and Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, indicates that the risk assessment procedures apply to both the audit of financial statements and the audit of internal control.

Some commenters suggested revisions to the first paragraph and the first footnote of the reproposed standard to clarify how the concepts of audit risk in this standard apply to audits of financial statements only and to integrated audits. The first paragraph has been revised to indicate that Auditing Standard No. 8 applies to either an audit of financial statements only or to an integrated audit. The first footnote also has been revised to clarify that, in integrated audits, the risks of material misstatement are the same for both the audit of financial statements and the audit of internal control.

4. Auditing Standard No. 9 – Audit Planning

a. Background

Auditing Standard No. 9 describes the auditor's responsibilities for planning an integrated audit or an audit of financial statements only.

b. Planning and Supervision

The original proposed standard and the reproposed standard discussed both audit planning and supervision, similar to AU sec. 311. Some commenters observed that audit planning and supervision should be covered in separate standards.

The Board agrees that audit planning and supervision of engagement team members are distinct activities that should be covered in separate standards. Accordingly, the Board has divided the requirements of the reproposed planning and supervision standard into separate standards. Dividing the requirements for planning and supervision into separate standards does not affect the auditor's responsibilities for planning the audit or supervising the work of engagement team members.

c. Responsibilities of the Engagement Partner

AU sec. 311 stated, "The auditor with final responsibility for the audit may delegate portions of the planning and supervision of the audit to other firm personnel." Auditing Standard No. 9 uses the term "engagement partner" instead of "auditor with final responsibility for the audit" and states more directly that the engagement partner is responsible for properly planning the audit. The standard also allows the engagement partner to seek assistance from appropriate engagement team members in fulfilling his or her planning responsibilities. Because the requirements in Auditing Standard No. 9 apply to the engagement partner and engagement team members who assist the engagement partner in planning the audit, the standard uses the term "auditor," and a footnote was added to clarify that the requirements in the standard apply to the engagement partner and other engagement team members who participate in planning the audit.

d. Preliminary Engagement Activities

The reproposed standard included a note in paragraph 6 stating that the decision regarding continuance of the client relationship and the determination of compliance with independence and ethics requirements were not limited to preliminary engagement activities and should be reevaluated with changes in circumstances. One commenter expressed concern that the note did not describe the changes in circumstances for which it would be appropriate for the auditor to reevaluate these decisions. The acceptance and continuance of the client relationship are discussed in QC sec. 20, System of Quality Control for a CPA Firm's Accounting and Auditing Practice. Other PCAOB standards discuss certain circumstances that warrant reevaluating the client relationship.[183/] Auditors also may reevaluate their engagement acceptance decision for other reasons. However, because auditors must comply with independence and ethics requirements throughout the audit, the note was moved in Auditing Standard No. 9 to modify paragraph 6.b. and revised to state that determination of compliance with independence and ethics requirements is not limited to preliminary engagement activities and should be reevaluated upon changes in circumstances.

[183/] See, e.g., paragraphs .18-.21 of AU sec. 317, Illegal Acts by Clients.

e. Planning Activities

The reproposed standard stated that, as part of establishing the audit strategy and audit plan, the auditor should evaluate whether certain matters specified in the standard are important to the company's financial statements and internal control over financial reporting ("internal control") and, if so, how those matters would affect the auditor's procedures. The requirement in the reproposed standard was the same as in paragraph 9 of Auditing Standard No. 5, thus extending its application to an audit of financial statements.

Evaluation of the matters listed in paragraph 7 of Auditing Standard No. 9 can lead auditors to develop more effective audit strategies and audit plans. For example, evaluation of those matters can highlight areas that might warrant additional attention during the auditor's risk assessment procedures, which, in turn, could affect the audit procedures performed in response to the risks of material misstatement. Also, evaluation of the internal control related matters can help the auditor develop an appropriate audit strategy, e.g., in determining accounts for which reliance on controls might be appropriate in the audit of financial statements.

Some commenters suggested changes to the requirement, including deleting some of the matters discussed in the requirement, moving other matters elsewhere within the standard, or making specific revisions to the language of the standard. Also, some commenters suggested using "should consider" instead of "should evaluate."

The Board considered the suggested changes to the standard and determined that those changes would not substantially improve the standard. Also, it is important for the language in this requirement to be identical to the language in Auditing Standard No. 5 to emphasize that this required procedure is to be performed only once in an integrated audit, with the results of the procedure to be applied in planning both the financial statement audit and the audit of internal control. Also, reframing the requirement from "should evaluate" to "should consider" would weaken the requirement. Therefore, Auditing Standard No. 9 retains the wording from the reproposed standard.

f. Audit Strategy and Audit Plan

Auditing Standard No. 9 requires the auditor to take into account certain matters when establishing the overall audit strategy, including the reporting objectives of the engagement and the nature of the communications required by PCAOB standards; the factors that are significant in directing the activities of the engagement team; the results of preliminary engagement activities and the auditor's evaluation of certain important matters; and the nature, timing, and extent of resources necessary to perform the engagement.[184/] These matters generally relate to information that auditors obtain through other required procedures. One commenter suggested that this requirement should discuss the need for specialists. Auditing Standard No. 9 was revised to include a reference to

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184/ Paragraph 9 of Auditing Standard No. 9.

paragraph 16 regarding the requirement for the auditor to determine whether specialized skill or knowledge is needed to perform the engagement.

The reproposed standard required the auditor to develop and document an audit plan that includes the planned nature, timing, and extent of the risk assessment procedures. One commenter suggested that it was unnecessary to document the timing of the risk assessment procedures because risk assessment is an ongoing process that occurs throughout the execution of the audit. Auditing Standard No. 9 retains the requirement to document the timing of the risk assessment procedures. Identifying and appropriately assessing the risks of material misstatement provide a basis for designing and implementing responses to the risks of material misstatement, so the timing of the risk assessment procedures is important to determine the timing of other audit procedures.

The reproposed standard also required the auditor to develop and document the planned nature, timing, and extent of tests of controls and substantive procedures. One commenter suggested that the requirement should specify that the audit plan include planned tests at the "relevant assertion level." Auditing Standard No. 9 retains the requirement as reproposed. Audit procedures are not performed only at the assertion level, e.g., certain general audit procedures and tests of certain entity-level controls in the audit of internal control over financial reporting. Therefore, it is not appropriate to update the standard with the suggested language.

g. Requirements for Multi-location Engagements

Auditing Standard No. 9 establishes requirements that apply to audits of companies with operations in multiple locations or business units. Auditing Standard No. 9 requires the auditor to determine the extent to which audit procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. This includes determining the locations or business units at which to perform audit procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual locations or business units. The auditor is required to assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit. Auditing Standard No. 9 also lists factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures. These requirements are risk-focused and aligned with the requirements in Auditing Standard No. 5.

An example was added to one of the factors in Auditing Standard No. 9 to highlight that the auditor's consideration of risks associated with a location or business unit includes whether significant unusual transactions are executed at that location or business unit, e.g., whether certain transactions were conducted at the location or business unit to achieve a particular accounting result. AU sec. 316 already requires the auditor to perform procedures regarding significant unusual transactions.

The reproposed standard included a statement, similar to Auditing Standard No. 5, that "The direction in paragraph 5 of Proposed Auditing Standard, The Auditor's Responses to the Risks of Material Misstatement, regarding incorporating an element of unpredictability in the auditing procedures means that the auditor should vary the nature, timing, and extent of audit procedures at locations or business units from year to year." Some commenters stated that the statement in the reproposed standard was unnecessarily prescriptive. After considering the comments received, the requirement regarding unpredictability was removed from the audit planning standard, and the requirements in Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement, regarding incorporating an element of unpredictability were expanded to include discussion of varying the testing in the selected locations.[185/] However, this does not change the requirements in Auditing Standard No. 5 regarding incorporating unpredictability in testing controls at individual locations in audits of internal control.[186/]

The reproposed standard included a requirement for the auditor to determine the extent to which auditing procedures should be performed at selected locations or business

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185/ Paragraph 5 of Auditing Standard No. 13.

186/ Paragraphs 61 and B13 of Auditing Standard No. 5.

units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatements. One commenter was concerned that the use of the term "consolidated financial statements" is inconsistent with the terminology used elsewhere in the standards and that the financial statements of companies with multiple divisions might not meet the definition of consolidated. The use of "consolidated financial statements" is consistent with the term used in Auditing Standard No. 5. The use of the term "consolidated" applies to situations in which the company has multiple locations or business units. Auditing Standard No. 9 retains the language as reproposed.

Some commenters requested clarification on how the requirements are expected to be applied in audits in which part of the work is performed by other auditors of financial statements of individual locations or business units that are included in the consolidated financial statements. A paragraph was added to Auditing Standard No. 9 to clarify that the auditor should apply the requirements in paragraphs 11-13 to determine the locations or business units for testing when the auditor plans to use the work and reports of other independent auditors who have audited the financial statements of one or more of the locations or business units (including subsidiaries, divisions, branches, components, or investments) that are included in the consolidated financial statements. AU sec. 543, Part of Audit Performed by Other Independent Auditors, describes the auditor's responsibilities when the auditor uses the work and reports of other independent auditors.[187/]

h. Persons with Specialized Skill or Knowledge

Auditing Standard No. 9 indicates that the auditor should determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results. The responsibility has been extended from a similar requirement in AU sec. 311 regarding considering whether specialized information technology ("IT") skill or knowledge is needed in an audit. The requirement was extended to specialized skill or knowledge in areas besides IT, e.g., valuation specialists, actuarial specialists, income tax specialists, and forensic specialists, because of the prevalent use of such individuals by auditors.

The reproposed standard included a note that described the term "specialized skill or knowledge" as persons engaged or employed by the auditor who have specialized skill or knowledge. Some commenters suggested that this note be removed because paragraph 17 included a similar description. The note was removed from Auditing Standard No. 9 because it was unnecessary and redundant.

One commenter suggested revising the standard to require the auditor to consider using a fraud specialist. The suggested requirement to consider using a fraud specialist

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187/ Paragraph 14 of Auditing Standard No. 9.

was not added to Auditing Standard No. 9 because the requirement in the reproposed standard already covers fraud specialists, and the types of specialized skill or knowledge that might be needed on a particular audit depend on the particular circumstances and the skill and knowledge of the engagement team.

Some commenters suggested that the requirements relating to the involvement of specialists be reframed as "assisting" the auditor. Such a formulation is too narrow to describe the range of involvement of specialists, which could include providing assistance to the auditor or actually performing audit procedures.

Paragraph 17 of Auditing Standard No. 9 describes the required level of knowledge of the subject matter in terms of the general types of procedures that the auditor should be able to perform with regard to the person with specialized skill or knowledge. Paragraph 17, by itself, does not impose procedural requirements for working with persons with specialized skill or knowledge because those responsibilities already are described in either the supervision provisions of Auditing Standard No. 10, Supervision of the Audit Engagement, or AU sec. 336, Using the Work of a Specialist, as applicable.

5. Auditing Standard No. 10 – Supervision of the Audit Engagement

a. Background

Auditing Standard No. 10 sets forth requirements for supervising the audit engagement, including supervising the work of engagement team members.

Auditing Standard No. 10 retains the basic requirements regarding supervision from AU sec. 311, with changes to align the requirements more closely with the other risk assessment standards. Auditing Standard No. 10 does not change the responsibilities for supervision from those in the supervision section of the reproposed standard on audit planning and supervision. However, the language in the standard has been revised in certain respects to describe more directly the supervisory responsibilities of the engagement partner and engagement team members who assist the engagement partner in supervision. As discussed later in this section, the Board has separate standards-setting projects regarding specialists and principal auditors, which will likely result in changes to the auditor's responsibilities regarding the auditor's use of specialists and use of other auditors, and, in turn, may result in changes to Auditing Standard No. 10.

b. Planning and Supervision

As discussed in section II.C.4.b., the original proposed standard and the reproposed standard included requirements for both audit planning and supervision, similar to AU sec. 311. Some commenters observed that audit planning and supervision should be covered in separate standards.

The Board agrees that audit planning and supervision of engagement team members are distinct activities that should be covered in separate standards. Accordingly, the Board has divided the requirements of the planning and supervision standard into separate standards. Dividing the requirements for planning and supervision into separate standards does not affect the auditor's responsibilities for planning the audit or supervising the work of engagement team members.

c. Objective

When the requirements for planning and supervision were divided into separate standards, the objective for supervision of the work of engagement team members was adapted from the elements of proper supervision in the reproposed standard. Auditing Standard No. 10 states, "The objective of the auditor is to supervise the audit engagement, including supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached." The revised objective does not alter the supervision responsibilities included in the original proposed standard or the reproposed standard.

d. **Responsibilities of the Engagement Partner**

AU sec. 311 stated, "The auditor with final responsibility for the audit may delegate portions of the planning and supervision of the audit to other firm personnel." Auditing Standard No. 10 uses the term "engagement partner" instead of "auditor with final responsibility for the audit."

Auditing Standard No. 10 states that the engagement partner is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for proper supervision of the work of engagement team members and for compliance with PCAOB standards, including standards regarding using the work of specialists,[188/] other auditors,[189/] internal auditors,[190/] and others who are involved in testing controls.[191/] As discussed previously, as the Board considers changes to the auditor's responsibilities regarding the auditor's use of specialists and use of other auditors, it also may consider changes to Auditing Standard No. 10.

Auditing Standard No. 10 allows the engagement partner to seek assistance from appropriate engagement team members in fulfilling his or her responsibilities pursuant to

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188/ See Section II.C.5.f. .

189/ Ibid.

190/ AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.

191/ Paragraphs 16-19 of Auditing Standard No. 5.

the standard. Engagement team members who assist the engagement partner in supervision should comply with the relevant requirements of Auditing Standard No. 10. The requirements in PCAOB standards for assignment of responsibilities to engagement team members also apply to assignments that involve assisting the engagement partner with his or her responsibilities pursuant to the standard.[192/]

e. Supervision of the Work of Engagement Team Members

Previously adopted PCAOB standards use either the term "engagement team members" or the term "assistants." Auditing Standard No. 10 uses "engagement team members," which is consistent with the other risk assessment standards. The Board is amending other PCAOB standards to conform to this terminology.

Auditing Standard No. 10 describes the required supervisory activities that should be performed by the engagement partner and, as applicable, by other engagement team members with supervisory responsibilities.[193/] Those activities include informing engagement team members of their responsibilities and information relevant to those responsibilities, directing engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other

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[192/] See, e.g. AU sec. 230.06 and paragraph 5 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

[193/] Paragraph 5 of Auditing Standard No. 10.

engagement team members performing supervisory activities, and reviewing the work of engagement team members as described in the standard.

Auditing Standard No. 10 describes the factors that should be taken into account in determining the necessary extent of supervision, i.e., the extent of supervision necessary so that the work of engagement team members is performed as directed and appropriate conclusions are formed based on the results of their work.[194/] Factors that affect the necessary extent of supervision include the risks of material misstatement, the nature of work assigned to the engagement team member, and the nature of the company, which includes the organizational structure of the company and its size and complexity. The extent of supervision of the work of an individual engagement team member increases or decreases, but cannot be eliminated, based on those factors. For example, the extent of supervision should be commensurate with the risks of material misstatement, which means, among other things, that the higher risk areas of the audit require more supervisory attention from the engagement partner.

One commenter suggested that the standard provide examples of "levels of supervision in relation to review," such as face-to-face review when reviewing higher risk areas. Auditing Standard No. 10 does not prescribe a particular method of review, so the engagement partner can determine the most effective way to comply with the

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[194/] Paragraph 6 of Auditing Standard No. 10.

requirements regarding the necessary nature of supervisory activities and necessary extent of supervision.

f. Persons with Specialized Skill or Knowledge and Other Auditors, Accounting Firms, and Individual Accountants

Auditing Standard No. 10 states that the engagement partner is responsible for, among other things, compliance with PCAOB standards regarding using of the work of specialists and refers to AU sec. 336. AU sec. 336 applies to situations in which the auditor engages a specialist in an area other than accounting or auditing and uses the work of that specialist as audit evidence.[195/] Paragraphs 5-6 of Auditing Standard No. 10 describe the nature and extent of the supervisory activities necessary for proper supervision of a person with specialized skill or knowledge who participates in the audit and is either (a) employed by the auditor or (b) engaged by the auditor to provide services in a specialized area of accounting or auditing. AU sec. 336 has been amended to clarify when the auditor should look to the supervisory requirements in Auditing Standard No. 10 instead of AU sec. 336.

195/ AU sec. 336 also applies to situations in which the auditor uses the work of a specialist engaged or employed by management. The discussion in this section of the release focuses on the auditor's use of specialists who are employed or engaged by the auditor.

AU sec. 543 describes the principal auditor's[196/] responsibilities for using the work and reports of other independent auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements presented. The principal auditor should look to the requirements in AU sec. 543[197/] in those situations. For situations in which the auditor engages an accounting firm or individual accountants to participate in the audit engagement and AU sec. 543 does not apply,[198/] the auditor should supervise them in accordance with the requirements of Auditing Standard No. 10. AU sec. 543 has been amended to emphasize those points.

It should be noted, however, that the Board has separate standards-setting projects regarding specialists and principal auditors, which will include comprehensive reviews of AU sec. 336 and AU sec. 543, respectively, in light of, among other things, observations from the Board's inspection activities. Those projects will likely result in changes to the auditor's responsibilities regarding the auditor's use of specialists and use of other auditors, and, in turn, may result in changes to Auditing Standard No. 10.

196/ AU sec. 543 uses the term "principal auditor" to refer to the auditor who issues the audit report on the financial statements presented.

197/ For integrated audits, see also paragraphs C8-C11 of Auditing Standard No. 5.

198/ Examples of situations that are not covered by AU sec. 543 include loan staff arrangements.

g. Differences of Opinion within an Engagement Team

The original proposed standard included a requirement, adapted from AU sec. 311.14, that the engagement partner and other engagement team members should make themselves aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among the engagement team members. Since the intention of including this provision was to require adequate documentation of disagreements, this paragraph was removed from the reproposed standard, and the documentation requirements from the original proposed standard were incorporated into an amendment to Auditing Standard No. 3, Audit Documentation.[199/] The documentation requirements regarding disagreements among members of the engagement team or with others consulted on the engagement about final conclusions reached on significant accounting or auditing matters include documenting the basis for the final resolution of those disagreements. If an engagement team member disagrees with the final conclusions reached, he or she should document that disagreement.

One commenter indicated concern that the requirement for the engagement partner and other engagement team members to be aware of how disagreements should be handled has been removed. The commenter indicated that disagreements are a sensitive area and that it is important that engagement team members are aware of how disagreements should be handled. In connection with the requirement to direct

[199/] Paragraph 12.d. of Auditing Standard No. 3.

engagement team members to bring significant accounting and auditing issues to the attention of the engagement partner or other engagement team members performing supervisory activities, Auditing Standard No. 10 also states that each engagement team member has a responsibility to bring to the attention of appropriate persons, disagreements or concerns the engagement team member might have with respect to accounting and auditing issues that he or she believes are of significance to the financial statements or the auditor's report regardless of how those disagreements or concerns may have arisen.[200/]

6. Auditing Standard No. 11 – Consideration of Materiality in Planning and Performing an Audit

a. Background

Auditing Standard No. 11 discusses the auditor's responsibilities for applying the concept of materiality, as described by the courts in interpreting the federal securities laws, in planning the audit and determining the scope of the audit procedures. The standard applies to integrated audits and audits of financial statements only.

b. Materiality in the Context of an Audit

Auditing Standard No. 11 discusses the concept of materiality that is applicable to audits performed in accordance with PCAOB standards, which is the articulation of

200/ Note to paragraph 5.b. of Auditing Standard No. 10.

materiality used by the courts in interpreting the federal securities laws.[201/] The Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the ...fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[202/]

Some commenters questioned the use of the court's articulation in the reproposed standard and suggested that this articulation might be difficult for auditors to apply. Also, some commenters asked whether the use of this articulation of materiality, in contrast to the quotation from a FASB Concept Statement[203/] used in AU sec. 312 was intended to result in a change in audit practice.

Although the discussion of materiality in the accounting literature might help auditors understand how accounting standards-setters view materiality in the context of preparation and presentation of financial statements, the concept of materiality that is relevant for audits to which PCAOB standards apply is the concept used by the courts in interpreting the federal securities laws. Because the auditor has a responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial

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201/ Paragraph 2 of Auditing Standard No. 11.

202/ See TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

203/ Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information. FASB Concepts Statements are not included in FASB's Codification of Accounting Standards.

statements, it is important for the auditor to plan and perform his or her audit procedures based on the applicable concept of materiality. Accordingly, Auditing Standard No. 11 uses the concept of materiality articulated by the courts.

Because the courts' articulation of the concept of materiality is not new, using that articulation in Auditing Standard No. 11 is not intended to result in changes in practice for most auditors. Auditing Standard No. 11 emphasizes that an auditor's consideration of materiality should reflect matters that would affect the judgment of a reasonable investor.

c. Establishing a Materiality Level for the Financial Statements as a Whole

Auditing Standard No. 11 requires the auditor to establish an appropriate materiality level for the financial statements as a whole.[204/] This materiality level should be established in light of the particular circumstances based on factors that could influence the judgment of a reasonable investor. The standard states that this requirement includes consideration of the company's earnings and other relevant factors. This statement is intended to emphasize that a company's net earnings are often an important factor in the total mix of information available to a reasonable investor, but Auditing Standard No. 11 does not require the use of earnings as the basis for the established materiality level in all cases. Other factors besides earnings might be more relevant depending on the particular circumstances, e.g., based on a company's industry or

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204/ Paragraph 6 of Auditing Standard No. 11.

situations in which the company's earnings were near zero. Auditors are expected to consider the factors that would be relevant to the judgment of a reasonable investor.

d. Qualitative Considerations

The concept of materiality involves consideration of both quantitative and qualitative factors.[205/] Under Auditing Standard No. 11, qualitative considerations can affect the auditor's establishment of materiality levels in the following ways:

- Establishing a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This involves matters such as consideration of the elements of the financial statements that are more important to a reasonable investor and the level of misstatements that would influence the judgment of a reasonable investor.

- Establishing lower levels of materiality for certain accounts or disclosures when, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. The requirement in the standard[206/] is consistent with the

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[205/] Paragraph 3 of Auditing Standard No. 11.

[206/] Paragraph 7 of Auditing Standard No. 11.

principle of considering the judgment of a reasonable investor when establishing materiality levels because it recognizes that, in certain circumstances, misstatements in some accounts might have more significant consequences than in other accounts. The following are examples of such circumstances:

- Laws, regulations, or the applicable financial reporting framework affect investors' expectations about the measurement or disclosure of certain items, e.g., related party transactions and compensation of senior management.

- Significant attention has been focused on a particular aspect of a company's business that is separately disclosed in the financial statements, e.g., a recent business acquisition.

- Certain disclosures are particularly important to investors in the industry in which the company operates.

Auditing Standard No. 11 does not allow the auditor to establish a materiality level for an account or disclosure at an amount that exceeds the materiality level for the financial statements as a whole.

The reproposed standard included a statement, adapted from AU sec. 312, that ordinarily it is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors.[207/] One commenter suggested removing the word "ordinarily" from the statement because, in the commenter's view, it is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors. Auditing Standard No. 11 retains the statement as proposed. This statement reflects the principle that judgments about whether a particular misstatement is material involve consideration of the particular circumstances, including the nature of the misstatement and its effect on the financial statements. Also, if an auditor is aware of potential misstatements that would be material based on qualitative factors, he or she has a responsibility to design audit procedures to detect such misstatements.

e. Tolerable Misstatement

The reproposed standard required the auditor to determine tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level.[208/] Tolerable misstatement is a concept used in determining the scope of audit procedures. AU sec. 350, *Audit Sampling*, indicates that tolerable misstatement is the maximum amount of misstatement in an account or a class of transactions that may exist without causing the financial statements to be materially misstated.[209/] Tolerable misstatement is required to be set at an amount

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207/ AU sec. 312.20.

208/ Paragraphs 8-9 of Auditing Standard No. 11.

209/ AU sec. 350.18.

less than the materiality level for the financial statements as a whole and for particular accounts or disclosures, if lower materiality levels were established for particular accounts or disclosures.

Some commenters suggested replacing the term "tolerable misstatement" in the reproposed standard with the term "performance materiality," which is the term used in the International Standards on Auditing ("ISAs").

The Board decided to retain the term "tolerable misstatement" in its standards. The concept of tolerable misstatement is already understood by auditors, and the Board is not seeking to change the concept as described in PCAOB standards. Because the term "performance materiality" uses the word "materiality," it could be misunderstood, e.g., by nonauditors, as having a meaning other than that intended in the standard. The concept of materiality that applies to financial statements of companies that are audited in accordance with PCAOB standards is rooted in case law and reflects a reasonable investor's perspective. In contrast, tolerable misstatement is a concept used in audit scoping decisions at the account level, considering potential uncorrected and undetected misstatement.

One commenter stated that the requirement to establish tolerable misstatement eliminated the need to establish a lower level of materiality for particular accounts or disclosures. However, the two concepts are designed for different purposes. The requirement to establish a lower materiality level is intended to address the need for a lower threshold when, in light of the particular circumstances, misstatements of lesser amounts have a substantial likelihood of influencing the judgment of a reasonable investor. As mentioned previously, tolerable misstatement is a concept used in audit scoping decisions at the account level, considering potential uncorrected and undetected misstatement.

The reproposed standard also required the auditor to take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of financial statements of prior periods. One commenter suggested that the Board should clarify its intent regarding this requirement and provide additional guidance regarding its application. Tolerable misstatement is affected by the expected level of misstatement in the account or disclosure, and the nature, cause, and amount of misstatements from prior periods are relevant to developing expectations about the level of misstatement. Generally, as the expected level of misstatement increases, the amount of tolerable misstatement decreases.

f. Consideration of Materiality for Multi-location Engagements

The reproposed standard included requirements for establishing materiality levels in multi-location engagements. The reproposed standard stated that when the auditor plans to perform procedures at selected locations or business units, the auditor should establish the materiality level for the individual locations or business units at an amount that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the consolidated financial statements. The reproposed standard also stated that the materiality level for the selected locations or business units generally should be lower than the materiality level for the consolidated financial statements. Those requirements were an application of the fundamental principles to audits of consolidated financial statements of companies with multiple locations or business units.

Some commenters suggested removing the word "generally" as it could be misinterpreted as permitting the use of the materiality level for the consolidated financial statements as a whole for planning and performing audit procedures at the individual location or business unit level. Other commenters questioned how the requirements would be applied when a principal auditor makes reference to the report of another auditor in the auditor's report on consolidated financial statements in accordance with AU sec. 543.

After considering the comments, the Board has made certain clarifying revisions to the requirements for multi-location engagements.[210/] First, the language in the standard has been revised to use term "tolerable misstatement" for an individual location to more clearly distinguish that term from the materiality level for the financial statements as a whole. In addition, the requirements were revised to state that tolerable misstatement for

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[210/] Paragraph 10 of Auditing Standard No. 11.

a location or business unit should be less than the materiality level for the financial statements as a whole. The word "generally" was removed from the requirements to reduce the risk of misinterpretation of the provision. Also, the phrase "to be used in performing audit procedures" has been removed from the requirement to determine tolerable misstatement for the individual locations or business units to avoid a misinterpretation about the principal auditor's responsibilities for situations in which the principal auditor makes reference to the report of the other auditor in accordance with AU sec. 543. Auditing Standard No. 11 requires the principal auditor to determine tolerable misstatement for the location or business unit audited by the other auditor, but the principal auditor is not expected to impose that determination of tolerable misstatement on the other auditor. Rather, tolerable misstatement for the location or business unit audited by the other auditor would be relevant to certain requirements under AU sec. 543[211/] and in determining an appropriate amount of tolerable misstatement for the remaining locations or business units included in the consolidated financial statements.

g. Reevaluating the Materiality Level and Tolerable Misstatement

The reproposed standard stated that the established materiality level and tolerable misstatement should be reevaluated if changes in the particular circumstances or

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[211/] For example, AU sec. 543.10 states that the auditor should adopt measures to assure the coordination of the principal auditor's activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements.

additional information comes to the auditor's attention that are likely to influence the judgment of a reasonable investor. In addition, the reproposed standard provided examples of situations that would require such reevaluation, and additional examples were discussed in the release accompanying the reproposed standards.

Some commenters suggested that the examples in the release should be included in the reproposed standard. The examples in Auditing Standard No. 11 have been revised to clarify the types of situations that would require reevaluation of the established materiality level and tolerable misstatement.

The reevaluation required by Auditing Standard No. 11 is important because if that reevaluation results in a lower materiality level or levels and tolerable misstatement than the auditor's initial determination, the standard states that the auditor should (1) evaluate the effect, if any, of the lower amount or amounts on his or her risk assessments and audit procedures and (2) modify the nature, timing, and extent of audit procedures as necessary to obtain sufficient appropriate audit evidence.[212/]

Auditing Standard No. 11 does not allow the auditor to modify the established level or levels of materiality and tolerable misstatement solely because they are approximately equal to or are exceeded by the amount of uncorrected misstatements. Such a practice is inconsistent with the requirement to reevaluate the established materiality level or levels or tolerable misstatement if changes in the particular circumstances or additional information come to the auditor's attention that are likely to

212/ Paragraph 12 of Auditing Standard No. 11.

affect the judgments of a reasonable investor. Rather, Auditing Standard No. 14 establishes requirements for evaluating uncorrected misstatements[213/] and describes the auditor's responsibilities in situations in which uncorrected misstatements approach established materiality level or levels used in planning and performing an audit.[214/]

7. Auditing Standard No. 12 – Identifying and Assessing Risks of Material Misstatement

a. Background

Auditing Standard No. 12 describes the auditor's responsibilities for the process of identifying and assessing risks of material misstatement in an audit of financial statements only and in an integrated audit. This process includes (1) performing information-gathering procedures, known as risk assessment procedures, and (2) identifying and assessing the risks of material misstatement using information obtained from the risk assessment procedures.

As discussed in the release accompanying the reproposed standards, the requirements in this standard are intended to improve the auditor's risk assessments and ability to focus on areas of increased risk in audits of financial statements only and in integrated audits. The effectiveness of a risk-based audit depends on whether the auditor identifies the risks of material misstatement and has an appropriate basis for assessing

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213/ Paragraphs 17-23 of Auditing Standard No. 14.

214/ Paragraph 14.b. of Auditing Standard No. 14.

those risks. Inappropriate identification or assessment of risks of material misstatements can lead to overlooking relevant risks to the financial statements, e.g., business conditions that affect asset quality or create pressures to manipulate the financial statements, or assessing risks too low without having an appropriate basis for the assessment. In turn, these situations can lead to misdirected or inadequate audit work.

Auditing Standard No. 12 employs a top-down approach to risk assessment. Such an approach begins at the financial statement level and with the auditor's overall understanding of the company and its environment and works down to the significant accounts and disclosures and their relevant assertions. Also, the requirements for performing risk assessment procedures are designed to be scalable to companies of varying size and complexity.

In an integrated audit, the risks of material misstatement affect both the audit of financial statements and the audit of internal control, so the risk assessment process described in Auditing Standard No. 12 is for a single process that applies to both the audit of financial statements and the audit of internal control. Auditing Standard No. 12 seeks to enhance the integration of the audit of financial statements with the audit of internal control by aligning these risk assessment standards with Auditing Standard No. 5. Accordingly, Auditing Standard No. 12 reflects certain foundational risk assessment principles from Auditing Standard No. 5 that also apply to audits of financial statements. On the other hand, the provisions of this standard also are designed to be tailored for audits of financial statements only, e.g., the requirements relating to the understanding of internal control over financial reporting.

b. Objective

Some commenters recommended that the Board revise the objective in the reproposed standard to indicate that the auditor's identification and assessment of risks are through understanding of the company and its environment. The objective in Auditing Standard No. 12 was retained from the reproposed standard. The revision suggested by the commenters is too narrow because Auditing Standard No. 12 requires other risk assessment procedures beyond obtaining an understanding of the company and its environment.

c. Performing Risk Assessment Procedures

The overarching requirement for risk assessment procedures in Auditing Standard No. 12 is that the auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of the risks of material misstatement, whether due to error or fraud, and to design further audit procedures.[215/] Auditing Standard No. 12 discusses the auditor's responsibilities for determining and

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215/ Paragraph 4 of Auditing Standard No. 12. The phrase "design further audit procedures" applies to substantive procedures and to tests of controls in the audit of financial statements and the audit of internal control over financial reporting.

performing the risk assessment procedures necessary to satisfy that overarching requirement.[216/]

Risks of material misstatement may exist at the financial statement level or at the assertion level. Risks of material misstatement also can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting. Since the risks of material misstatement come from various sources, the auditor's risk assessment procedures need to encompass both external factors and company-specific factors. Auditing Standard No. 12 requires the following risk assessment procedures:

- Obtaining an understanding of the company and its environment;[217/]
- Obtaining an understanding of the company's internal control over financial reporting;[218/]

216/ Paragraphs 5-58 of Auditing Standard No. 12.

217/ Paragraphs 7-17 of Auditing Standard No. 12.

218/ Paragraphs 18-40 of Auditing Standard No. 12.

- Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company;[219]

- Performing analytical procedures;[220]

- Conducting a discussion among engagement team members regarding the risks of material misstatement;[221] and

- Inquiring of the audit committee, management, and others within the company about the risks of material misstatement.[222]

The reproposed standard required the auditor to perform risk assessment procedures that are designed to help the auditor identify the areas of greater risk, appropriately assess those risks, and design and perform further audit procedures to address risks of material misstatements in the financial statements, whether due to error or fraud. One commenter suggested adding the phrase "and to design further audit procedures focused on the areas of greatest risk" to the end of the sentence in paragraph

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219/ Paragraphs 41-45 of Auditing Standard No. 12.

220/ Paragraphs 46-48 of Auditing Standard No. 12.

221/ Paragraphs 49-53 of Auditing Standard No. 12.

222/ Paragraphs 54-58 of Auditing Standard No. 12.

4. The suggested language is not included in Auditing Standard No. 12 because that principle is already addressed in Auditing Standard No. 13.

One commenter on the reproposed standard asked for more discussion of the connection between the components of audit risk and the risk assessment process. That discussion has been added to Auditing Standard No. 8.[223/]

d. Obtaining an Understanding of the Company and its Environment

Like the reproposed standard, Auditing Standard No. 12 requires the auditor to obtain an understanding of the company and its environment to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement ("obtaining an understanding of the company").[224/] These requirements are an expansion of requirements that were in AU sec. 311 regarding obtaining knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics as part of audit planning.[225/] The expanded requirements are intended to focus the auditor on the degree of "knowledge of the company" that is necessary for a risk-based audit and to explain how knowledge of the company informs the auditor's identification and assessment of risk.

223/ Paragraphs 8-11 of Auditing Standard No. 8.

224/ Paragraph 7 of Auditing Standard No. 12.

225/ AU secs. 311.06-.09.

Auditing Standard No. 12 requires that the understanding of the company and its environment include understanding the following:

- Relevant industry, regulatory, and other external factors;
- The nature of the company;
- The company's selection and application of accounting principles, including related disclosures;
- The company's objectives and strategies and those related business risks that might reasonably be expected to result in risks of material misstatement; and
- The company's measurement and analysis of its financial performance.[226/]

Auditing Standard No. 12 requires the auditor to evaluate whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement.[227/] This requirement builds on the requirement in paragraph 7 of Auditing Standard No. 9 to evaluate whether, among other things, the extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting is important to the company's financial

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[226/] Paragraph 7 of Auditing Standard No. 12.

[227/] Paragraph 8 of Auditing Standard No. 12.

statements and internal control over financial reporting and, if so, how those changes will affect the auditor's procedures. PCAOB standards have recognized that many risks of material misstatement arise due to changes in the company. For example, AU sec. 319 listed the following examples of circumstances that can result in risks or changes to existing risks: changes in operating environment; new personnel; new or revamped information systems; rapid growth; new technology; new business models, products, or activities; corporate restructurings; expanded foreign operations; and new accounting pronouncements.[228/]

Paragraphs 9-17 of Auditing Standard No. 12 explain more fully the necessary understanding of the preceding aspects of the company and its environment, e.g., what it means to obtain an understanding of the nature of the company. The discussion of relevant industry, regulatory, and other external factors is adapted from AU sec. 311. The discussion of the nature of the company is also adapted from AU sec. 311 and has been updated to reflect certain changes in business practices since AU sec. 311 was originally issued (e.g., to encompass alternative investments and financing arrangements and to recognize the development of new business models).

One commenter said that the requirement to obtain an understanding of the company and its environment should be revised because none of the aspects of the company and its environment listed in paragraph 7 is an event, condition, or company

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[228/] AU sec. 319.38.

activity. However, the understanding of those aspects should lead the auditor to obtain an understanding of relevant events, conditions, and company activities. For example, obtaining an understanding of relevant industry, regulatory, and external factors helps an auditor understand the external conditions in which the company operates that represent risks of material misstatement at the financial statement level.

The reproposed standard contained a note about how the size and complexity of the company can affect the risks of misstatement and the controls necessary to address those risks. This note was intended to be a reminder to auditors that both size and complexity affect risks. One commenter stated that complexity rather than size is likely to heighten risk. Auditing Standard No. 12 retains the note as reproposed.[229/] The size and complexity of the company can affect the risks of misstatement and the controls necessary to address those risks. Scaling the audit is most effective as a natural extension of the risk-based approach and applies to all audits, and the requirements in Auditing Standard No. 12 are intended to be scalable to companies of varying size and complexity. Auditing Standard No. 12 contains certain notes regarding scaling the audit based on a company's size and complexity.

[229/] First note to paragraph 10 of Auditing Standard No. 12.

(i). Additional Procedures to Obtain an Understanding of the Company and its Environment

The reproposed standard presented a list of procedures that the auditor should consider performing as part of obtaining an understanding of the company and its environment. These procedures include reading public information about the company, observing or reading transcripts of earnings calls, obtaining an understanding of compensation arrangements with senior management, and obtaining information about significant unusual developments regarding trading activity in the company's securities. The auditor's decisions about whether to perform one or more of the additional procedures and the extent of those procedures depend on whether the matters addressed in those procedures are important to the company's internal control or financial statements and whether such procedures are necessary to meet the overall requirements for obtaining an understanding of the company and performing risk assessment procedures.

Members of the Board's Standing Advisory Group ("SAG") suggested that these matters could provide valuable information for identifying risks of material misstatement, e.g., to obtain information about business risks relevant to financial reporting or to identify incentives or pressures on management to manipulate financial results.[230/] Also, the Public Oversight Board, Panel on Audit Effectiveness, Report and Recommendations

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[230/] February 16, 2005. Webcasts of SAG meetings are available on the Board's website at: http://www.pcaobus.org/News_and_Events/Webcasts.

("PAE Report"), recommended that auditors consider published analysts' reports and forecasts when gaining an understanding of the company's business and industry, assessing risks, and evaluating identified misstatements.[231]

Commenters requested clarification of the Board's expectations regarding these procedures and expressed concern that the broad language used to describe some of the procedures might lead auditors to expend considerable efforts to decide and document whether to perform certain procedures. This requirement is not intended to require auditors to make a specific determination about each bit of data to which a procedure might be applied, e.g., to document each individual item of publicly available information to decide whether it should be reviewed.

Instead, the intention is for auditors to consider whether and to what extent such procedures should be performed to achieve the objectives in paragraphs 4 and 7 of Auditing Standard No. 12. For example, observing the company's earnings calls and other meetings with investors are likely to provide important information about the measurement and review of the company's financial performance, particularly the performance measures monitored by investors and analysts. Likewise, an understanding of compensation arrangements with senior management often can provide important information about incentives or pressures on management to manipulate the financial statements.

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[231] Public Oversight Board, Panel on Audit Effectiveness, Report and Recommendations (August 31, 2000), p. 58.

Auditing Standard No. 12 was revised to clarify that considering whether to perform the procedures listed in paragraph 11 also includes consideration of the extent of the procedures.

(ii). Selection and Application of Accounting Principles, Including Related Disclosures

PCAOB standards require auditors to obtain an understanding of the accounting practices common to the industry and to evaluate the quality of a company's accounting principles as part of his or her response to fraud risks and in determining matters to be communicated to the audit committee.[232/] Auditing Standard No. 12 imposes a responsibility to obtain an understanding of the applicable financial reporting framework and to evaluate whether the company's selection and application of accounting principles are consistent with the applicable accounting framework and the accounting principles used in the relevant industry.[233/] Such procedures can provide important information for identifying relevant matters such as (1) accounts that are susceptible to misstatement, e.g., if an account balance is determined using accounting principles that are inconsistent with the applicable financial reporting framework or (2) more general conditions that affect risks of material misstatement, e.g., if the company's selection or application of

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[232/] See AU sec. 316 and AU sec. 380, Communication With Audit Committees.

[233/] Paragraph 12 of Auditing Standard No. 12.

accounting principles is more aggressive than prevailing practices in the relevant industry.

In connection with obtaining an understanding of the applicable financial reporting framework and evaluating the company's selection and application of accounting principles, including related disclosures, Auditing Standard No. 12 requires the auditor to develop expectations about the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework.[234/] The language in this requirement was revised to clarify that the auditor should develop an expectation about the disclosures as part of the risk assessment procedures and that the expectations should be based on the disclosures necessary for the fair presentation of the financial statements in conformity with the applicable financial reporting framework.

Auditing Standard No. 12 also presents a list of matters that, if present, are relevant to the necessary understanding of the company's selection and application of accounting principles.[235/] The amount of auditor attention devoted to an individual matter would depend on its importance in meeting the overall requirements for obtaining an understanding of the company and performing risk assessment procedures.[236/]

234/ Ibid.

235/ Paragraph 13 of Auditing Standard No. 12.

236/ Paragraphs 4 and 7 of Auditing Standard No. 12.

(iii). Company Objectives, Strategies, and Related Business Risks

The reproposed standard required the auditor to obtain an understanding of the company's objectives, strategies, and related business risks in order to identify those business risks that could reasonably be expected to result in material misstatement of the financial statements. The PAE Report recommended that auditors be required to obtain an understanding of the company's business risks.[237/]

Commenters on the reproposed standard requested additional discussion about business risks, including going concern risks, fraud risks, and how business risks can result in misstatements of the financial statements. Additional discussion has been added to Auditing Standard No. 8 and Auditing Standard No. 12.[238/]

Auditing Standard No. 12 discusses how business risks can lead to misstatements and provides examples of business risks that may result in a risk of material misstatement of the financial statements.[239/] However, the list of examples is meant to be illustrative rather than a checklist of factors to consider. Auditors would need to consider the business risks that are relevant to the particular company and industry. For example, in

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237/ PAE Report, p. 20.

238/ Paragraph 6 of Auditing Standard No. 8 and the note to paragraph 15 of Auditing Standard No. 12.

239/ Paragraphs 5 and 14-15 of Auditing Standard No. 12.

today's economic environment, business risks might include financing risks (e.g., access to necessary financing) or product risks (e.g., investments in certain financial products).

(iv). The Company's Measurement and Analysis of its Financial Performance

The risk assessment procedures in the reproposed standard included obtaining an understanding of the company's performance measures. The purpose of obtaining that understanding is to identify those performance measures, whether external or internal, that affect the risks of material misstatement. For example, understanding performance measures can help the auditor identify accounts or disclosures that might be susceptible to manipulation to achieve certain performance targets (or to conceal failures to achieve those targets) or to understand how management uses performance measures to monitor risks affecting the financial statements.

Commenters requested clarification regarding the examples of performance measures. A note was added to Auditing Standard No. 12 to explain the significance of the individual examples.[240/]

e. Obtaining an Understanding of Internal Control Over Financial Reporting

Auditing Standard No. 12 describes the auditor's responsibilities for obtaining an understanding of internal control over financial reporting ("understanding of internal control"). Auditing Standard No. 12 requires the auditor to obtain a sufficient

240/ Paragraph 17 of Auditing Standard No 12.

understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.[241/] These requirements are, in substance, equivalent to those in AU sec. 319, but the formulation in the proposed standard is aligned more clearly with Auditing Standard No. 5. Like the requirements in AU sec. 319, the requirements in Auditing Standard No. 12 indicate that although the auditor's primary focus is on internal control over financial reporting, the auditor may obtain an understanding of controls related to operations or compliance objectives if they pertain to data that the auditor plans to use in applying auditing procedures.[242/]

Auditing Standard No. 12 sets forth certain principles regarding the sufficiency of the auditor's understanding of internal control. The size and complexity of the company; the auditor's existing knowledge of the company's internal control; the nature of the company's internal controls, including the company's use of IT; the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting affect the nature, timing, and extent of procedures necessary to obtain an understanding of internal control. For example, the auditor's procedures to obtain an understanding of internal control would be more extensive when the auditor plans to test controls more extensively (e.g., in an integrated

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241/ Paragraph 18 of Auditing Standard No. 12.

242/ Paragraph 19 of Auditing Standard No. 12.

audit), the company's internal control is more complex, or the company's controls have changed significantly.

The reproposed standard stated that the auditor's understanding of internal control includes evaluating the design of controls and determining whether the controls are implemented. Commenters observed that the reproposed standard stated that walkthroughs that include the necessary procedures ordinarily are sufficient to evaluate design effectiveness, but the reproposed standard did not make a similar statement about the use of walkthroughs to determine whether controls have been implemented. Auditing Standard No. 12 has been revised to include a statement that walkthroughs that include the procedures described in the standard ordinarily are sufficient to determine whether a control has been implemented.[243/] Under Auditing Standard No. 12, as under AU sec. 319,[244/] the amount of audit attention devoted to design and operating effectiveness will vary based on the auditor's plan for testing controls. For example, if the auditor plans to test controls, more attention should be devoted to controls that the auditor plans to test.

(i). Obtaining an Understanding of Individual Components of Internal Control Over Financial Reporting

To describe the auditor's responsibilities for obtaining an understanding of internal control, it was necessary to describe the components of internal control over

243/ Paragraph 20 of Auditing Standard No. 12.

244/ AU sec. 319.58.

financial reporting. The components described in Auditing Standard No. 12 are similar to those in AU sec. 319.[245/] Auditing Standard No. 12 also states that auditors may use other suitable, recognized frameworks[246/] in accordance with the provisions of the standard. If the auditor uses a suitable, recognized internal control framework with components that differ from those in the standard, the auditor should adapt the requirements in the standard for the components in the framework used.[247/]

(ii). Control Environment

Auditing Standard No. 12 requires the auditor to assess the following matters as part of obtaining an understanding of the control environment:

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and

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245/ Paragraph 21 of Auditing Standard No. 12.

246/ See Securities Exchange Act Release No. 34-47986 (June 5, 2003) for a description of the characteristics of a suitable, recognized framework.

247/ Paragraph 22 of Auditing Standard No. 12.

- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.[248/]

Although this requirement is aligned with a similar requirement in Auditing Standard No. 5 for evaluating the control environment, the auditor's process for assessing the control environment in an audit of financial statements only is not expected to be the same as that required when expressing an opinion on internal control over financial reporting. For audits of financial statements only, Auditing Standard No. 12 allows the auditor to base his or her assessment on evidence obtained as part of obtaining an understanding of the control environment and other relevant knowledge possessed by the auditor.[249/]

Because of the importance of an effective control environment to address fraud risks, Auditing Standard No. 12 states that if the auditor identifies a control deficiency in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor.[250/]

248/ Paragraph 24 of Auditing Standard No. 12.

249/ Ibid.

250/ Paragraph 25 of Auditing Standard No. 12.

(iii) The Company's Risk Assessment Process

Auditing Standard No. 12 requires the auditor to obtain an understanding of management's risk assessment process for (a) identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud, (b) assessing the likelihood and significance of misstatements resulting from those risks, and (c) deciding about actions to address those risks.[251/] The standard also requires the auditor to obtain an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.[252/] Compliance with these requirements will help make sure that the auditor's risk assessments are appropriately informed by management's risk assessments and the controls that management put in place to address the risks.

(iv). Information and Communication

The reproposed standard required the auditor to obtain an understanding of the information system, including the related business processes, relevant to financial reporting. One commenter suggested removing the requirement to understand the company's business processes. The requirement was retained as reproposed.[253/] Obtaining an understanding of the company's business processes assists the auditor in obtaining an

251/ Paragraph 26 of Auditing Standard No. 12.

252/ Paragraph 27 of Auditing Standard No. 12.

253/ Paragraph 28 of Auditing Standard No. 12.

understanding of how transactions are initiated, authorized, processed, and recorded. Also, the requirement to understand business processes is a recommendation in the PAE Report.[254/] Auditing Standard No. 12 describes the necessary understanding of business processes to help auditors identify those business processes that are relevant to financial reporting.[255/]

Auditing Standard No. 12 also contains requirements for understanding the period-end financial reporting process[256/] and describes important elements of that process.[257/] Because the period-end financial reporting process is a common source of potential misstatements, it is important for the auditor to have an adequate understanding of the aspects of the period-end financial reporting process in all audits, including audits of financial statements only. Auditing Standard No. 12 requires the auditor only to obtain an understanding[258/] of the process, as compared to Auditing Standard No. 5, which requires the auditor also to evaluate that process in the audit of internal control.

254/ PAE Report, p. 15.

255/ Paragraphs 28-32 of Auditing Standard No. 12.

256/ AU sec. 319.49 used the term "financial reporting process used to prepare the entity's financial statements," but Auditing Standard No. 12 uses the same term as used in Auditing Standard No. 5.

257/ Paragraphs 28 and 32 of Auditing Standard No. 12.

258/ Paragraph 20 of Auditing Standard No. 12 discusses procedures that the auditor performs to obtain an understanding of internal control.

To appropriately highlight the importance of IT risks in determining the scope of the audit, the standard requires the auditor to obtain an understanding of how IT affects the company's flow of transactions. The standard also contains a note that states that the identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the approach used to identify significant accounts and disclosures and their relevant assertions and, when applicable, to select the controls to test, as well as to assess risk and allocate audit effort.

Regarding the auditor's understanding of communication, one commenter suggested that the standard clarify that the auditor should understand how the company communicates financial reporting roles and responsibilities and significant matters relating to financial reporting. The requirement in Auditing Standard No. 12 has been revised to clarify that point.[259/]

(v). Control Activities

The reproposed standard required the auditor to obtain an understanding of control activities that is sufficient to assess the factors that affect the risks of material misstatement and to design further audit procedures. As under AU sec. 319, a more extensive understanding of control activities is needed in areas in which the auditor plans to test controls. Thus, for purposes of evaluating the effectiveness of internal control over financial reporting in an integrated audit, the auditor's understanding of control activities

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259/ Paragraph 33 of Auditing Standard No. 12.

encompasses a broader range of accounts and disclosures than that which is normally obtained in an audit of financial statements only.

Some commenters expressed concern that the language in the requirement could be misinterpreted as requiring the auditor to obtain an understanding of all controls, even in an audit of financial statements only in which the auditor does not plan to test controls. A few commenters suggested framing the requirement in terms of understanding control activities relevant to the audit.

The Board did not intend to expand the auditor's responsibilities for obtaining an understanding of control activities beyond what is required in AU sec. 319. The discussion in Auditing Standard No. 12 on obtaining an understanding of control activities has been revised, primarily using language adapted from AU sec. 319, to clarify that the substance of the requirement has not changed.[260/]

(vi). Performing Walkthroughs

The original proposed standard referred auditors to Auditing Standard No. 5 for a discussion of the performance of walkthroughs. Some commenters on the original proposed standard stated that the standard should include a discussion of walkthroughs rather than referring to Auditing Standard No. 5. The reproposed standard included a discussion of performing walkthroughs as part of meeting certain specified objectives,

260/ AU sec. 319.42 and paragraph 34 of Auditing Standard No. 12.

which paralleled a requirement in Auditing Standard No. 5[261/] regarding understanding likely sources of potential misstatements. Some commenters expressed concerns that the discussion would lead to unnecessary walkthroughs, particularly in audits of financial statements only.

The intention of including the discussion of walkthroughs was to explain how to perform walkthroughs rather than to impose requirements regarding when walkthroughs should be performed. The standard has been revised to focus on how the auditor should perform walkthroughs, e.g., in connection with understanding the flow of transactions in the information system relevant to financial reporting, evaluating the design of controls relevant to the audit, and determining whether those controls have been implemented.[262/] The discussion of the objectives for understanding likely sources of potential misstatements has been removed from Auditing Standard No. 12, so those objectives would continue to apply only to integrated audits.

(vii). Relationship of Understanding of Internal Control to Tests of Controls

Auditing Standard No. 12, like the reproposed standard, contains a discussion about the relationship between obtaining an understanding of controls and testing controls, including entity-level controls.[263/] The requirements in Auditing Standard No.

261/ Paragraph 34 of Auditing Standard No. 5.

262/ Paragraph 37 of Auditing Standard No. 12.

263/ Paragraph 39 of Auditing Standard No. 12.

12 clarify that the objective of obtaining an understanding of internal control as a risk assessment procedure is different from testing controls for the purpose of assessing control risk[264/] or for the purpose of expressing an opinion on internal control over financial reporting in the audit of internal control.[265/] The standard allows the auditor the flexibility of obtaining an understanding of internal control concurrently with performing tests of controls if he or she obtains sufficient appropriate evidence to achieve the objectives of both procedures.[266/]

f. Information Obtained from Past Audits and Other Engagements

(i). Information from Past Audits

The reproposed standard included a requirement for the auditor to incorporate knowledge obtained during past audits into the auditor's process for identifying risks of material misstatement. One commenter asked for clarification of the meaning of the term "incorporate." Two commenters stated that the most important issue is to determine whether information from past audits is still relevant.

The term "incorporate" is not new and should be familiar to most auditors. For example, it has been used in AU sec. 316 regarding the requirement to incorporate an

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264/ Paragraphs 16-31 of Auditing Standard No. 13.

265/ Paragraph B1 of Auditing Standard No. 5.

266/ Paragraph 39 of Auditing Standard No. 12.

element of unpredictability in the audit in response to fraud risks. The requirement in the reproposed standard was similar to a requirement in Auditing Standard No. 5 to incorporate knowledge obtained during past audits in subsequent year audits of internal control.[267/] Accordingly the term has been retained in Auditing Standard No. 12.

Auditing Standard No. 12 also states that if the auditor plans to limit the nature, timing, or extent of his or her risk assessment procedures by relying on information from past audits, the auditor should evaluate whether the prior-years' information remains relevant and reliable.[268/]

(ii). Information from Other Engagements

The reproposed standard included a requirement for the auditor to take into account relevant information obtained through other engagements performed by the auditor for the company.[269/] This requirement was intended to focus on the responsibility to take relevant information into account in identifying and assessing risks rather than to prescribe a particular method for obtaining that information.

267/ Paragraph 57 of Auditing Standard No. 5.

268/ Paragraph 43 of Auditing Standard No. 12.

269/ PCAOB Rule 1001, Definitions of Terms Employed in Rules, states that, when used in rules of the PCAOB, unless the context otherwise requires, "[t]he term 'auditor' means both public accounting firms registered with the Public Company Accounting Oversight Board and associated persons thereof."

Some commenters suggested that the requirement should be limited to consideration of other engagements performed by the engagement partner. The suggested change would weaken the standard. Limiting the consideration of information to engagements performed for the company by the engagement partner is too narrow because it omits other important information sources that are available to the engagement team. Also, limiting the consideration to engagements performed by the engagement partner is inconsistent with prior PCAOB standards. For example, AU sec. 311.04 stated that procedures the auditor may consider in planning an audit usually involve discussions with other firm personnel, and includes the following example "Discussing matters that may affect the audit with firm personnel responsible for non-audit services to the entity." Also, paragraph 03 of AU sec. 9311, Planning and Supervision: Auditing Interpretations of Section 311, stated:

> The auditor should consider the nature of non-audit services that have been performed. He should assess whether the services involve matters that might be expected to affect the entity's financial statements or the performance of the audit, for example, tax planning or recommendations on a cost accounting system. If the auditor decides that the performance of the non-audit services or the information likely to have been gained from it may have implications for his audit, he should discuss the matter with personnel who rendered the services and consider how the expected conduct and scope of his audit may be affected. In some cases, the auditor

may find it useful to review the pertinent portions of the work papers prepared for the non-audit engagement as an aid in determining the nature of the services rendered or the possible audit implications.

Other commenters suggested that the requirement be revised to use more of the language from AU sec. 9311. The requirement in Auditing Standard No. 12[270/] has been revised as follows:

> The auditor should obtain an understanding of the nature of the services that have been performed for the company by the auditor or affiliates of the firm[271/] and should take into account relevant information obtained from those engagements in identifying risks of material misstatement.[272/]

One commenter stated that audit firms will need to develop very costly reporting systems to enable them to convey relevant information about nonassurance engagements to audit engagement teams. Existing PCAOB and SEC rules already require firms to track and report nonaudit services provided to the company. Complying with these requirements would mean that the audit firms have a mechanism in place to track these

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270/ Paragraph 45 of Auditing Standard No. 12.

271/ See PCAOB Rule 3501(a)(i), which defines "affiliate of the accounting firm."

272/ Paragraph 7 of Auditing Standard No. 9.

services. For example, PCAOB Rules 3524[273/] and 3526[274/] require the auditor to describe to the company's audit committee, among other things, the scope of and the potential effect on independence of other services provided by the firm. It is expected that the system used to capture, track, and monitor these services for compliance with these PCAOB independence rules would also be applicable to comply with the requirements of Auditing Standard No. 12.

g. Performing Analytical Procedures

The reproposed standard retained requirements from AU sec. 329, Analytical Procedures, to perform analytical procedures during the planning phase of the audit.[275/] Such analytical procedures are, in essence, risk assessment procedures, so the respective requirements and direction have been incorporated into Auditing Standard No. 12.[276/] One commenter stated that it is unclear whether the PCAOB intends a change in practice regarding the execution of analytical procedures performed as risk assessment procedures, e.g., because the requirements in the reproposed standard discussed developing expectations and comparing them to recorded amounts. AU sec. 329, states

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273/ PCAOB Rule 3524, Audit Committee Pre-approval of Certain Tax Services.

274/ PCAOB Rule 3526, Communication With Audit Committees Concerning Independence.

275/ AU secs. 329.06-.08.

276/ Paragraphs 46-48 of Auditing Standard No. 12.

that analytical procedures involve developing expectations and comparing those expectations to recorded amounts.[277/]

Auditing Standard No. 12 states that analytical procedures performed as risk assessment procedures often use data that is preliminary or data that is aggregated at a high level and that in those instances such analytical procedures are not designed with the level of precision necessary for substantive analytical procedures.[278/] In those situations, the auditor's expectations in performing analytical procedures as risk assessment procedures do not require the same degree of precision as substantive analytical procedures.

h. Conducting a Discussion among Engagement Team Members Regarding Risks of Material Misstatement

Like the reproposed standard, Auditing Standard No. 12 includes a requirement that key engagement team members discuss (1) the company's selection and application of accounting principles, including related disclosure requirements and (2) the susceptibility of the company's financial statements to material misstatement due to error or fraud.[279/] The standard explains that key engagement team members include the engagement partner and all engagement team members who have significant engagement

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277/ AU sec. 329.05.

278/ Paragraph 48 of Auditing Standard No. 12.

279/ Paragraph 49 of Auditing Standard No. 12.

responsibilities.[280/] The term "significant engagement responsibilities" should be familiar to auditors because it is already used in AU sec. 316 regarding the appropriate assignment of engagement team members in the overall responses to fraud risks.

One commenter stated that the requirement for participation in the discussion among engagement team members on the reproposed standard should be revised to use the language in ISA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment, so that the engagement partner makes the determination of what needs to be reported to whom on a "need to know" basis.

The language in Auditing Standard No. 12 was retained as reproposed. The Board believes that the discussion among engagement team members is an important part of the auditor's risk assessment procedures. Through its oversight activities, the Board has observed deficiencies relating to discussions among engagement team members regarding fraud risks, including instances in which key engagement team members did not participate.[281/]

(i). Discussion of the Potential for Material Misstatement Due to Fraud

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280/ Paragraph 50 of Auditing Standard No. 12.

281/ PCAOB Release 2007-001, Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud (January 22, 2007).

A number of comments were received regarding the requirements for discussing the risks of material misstatement due to fraud.

One commenter suggested that the standard should require the auditor to consider using a fraud specialist. The Board believes that this point is already covered by the requirement in Auditing Standard No. 9 to evaluate whether a person with specialized skill or knowledge is needed to assess risks.[282/]

One commenter suggested that the requirement to discuss how the financial statements could be materially misstated through omitting or presenting incomplete disclosures also should include the possibility of presenting inaccurate disclosures. The requirement has been revised to include that topic.[283/] Another commenter stated that the standard should provide more "guidance" about how fraud risks relate to disclosures. The manner in which management might intentionally omit disclosures or present inaccurate or incomplete disclosures to commit or conceal intentional misstatement of the financial statements necessarily depends on the circumstances, including the incentives or pressures and the opportunities to manipulate the financial statements. The discussion of fraud risks required by the standard should prompt engagement team members to consider ways in which omissions or inaccuracies in disclosures might be involved with fraudulent financial reporting.

282/ Paragraphs 16-17 of Auditing Standard No. 12.

283/ Paragraph 52 of Auditing Standard No. 12.

Another commenter stated that the requirement for the auditor to emphasize certain matters regarding fraud to the engagement team members during the fraud risk discussion does not assign the responsibility to a specific person. The requirement focuses on the communication of important matters rather than on the person communicating the matters. Since the engagement partner has the overall responsibility for the audit engagement, the engagement partner is likely to be the most appropriate person to make the communications. However, Auditing Standard No. 12 allows the communications to be made by another engagement team member, when appropriate.

(ii) Communication Among Engagement Team Members

Auditing Standard No. 12 states that communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change. This requirement carries forward and builds upon a requirement in AU sec. 316.[284/]

i. Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement

Like the reproposed standard, Auditing Standard No. 12 requires the auditor to make inquiries of the audit committee, or equivalent (or its chair), management, the internal audit function, and others within the company who might reasonably be expected to have information that is important to the identification and assessment of risks of

284/ AU sec. 316.18.

material misstatement.[285] The requirement to inquire of others who "might reasonably be expected to have information" is similar to a requirement in AU sec. 316 for making inquiries of others about the existence or suspicion of fraud, and it establishes a principle to guide the auditor in determining those other persons to whom the inquiries should be addressed.[286]

(i). Inquiries Regarding Fraud Risks

The reproposed standard also required the auditor to make inquiries of the audit committee (or its chair), management, the internal audit function, and others within the company about the risks of fraud. Commenters suggested that the requirements for identifying other individuals within the company to whom inquiries should be directed should include determining the extent of such inquiries. Auditing Standard No. 12 reflects the suggested revision to that requirement because inquiries of other individuals should be designed to obtain information relevant to identifying and assessing fraud risks.[287]

The reproposed standard included a requirement to take into account the fact that management is often in the best position to commit fraud when evaluating management's responses to inquiries about fraud risks and determining when it is necessary to

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[285] Paragraph 54 of Auditing Standard No. 12.

[286] AU sec. 316.24.

[287] Paragraph 57 of Auditing Standard No. 12.

corroborate management's responses. One commenter stated that the requirement was unclear and the use of the term "take into account" did not seem consistent with the Board's explanation in the release accompanying the reproposed standards. This requirement has been revised to clarify the requirement and to use "take into account" in a manner that is consistent with the other PCAOB standards.[288/]

Auditing Standard No. 12 requires that the auditor use his or her knowledge of the company and its environment, as well as information from other risk assessment procedures, to determine the nature of the inquiries about risks of material misstatement. This requirement carries forward and builds upon a requirement in AU sec. 316.[289/]

Auditing Standard No. 12 includes an additional required inquiry of the internal auditor about whether he or she is aware of instances of management override of controls and the nature and circumstances of such overrides. Also, Auditing Standard No. 12 requires the auditor to make inquiries of management and the audit committee, or equivalent regarding tips or complaints about the company's financial reporting.[290/] These required inquiries were added in light of research indicating that many incidents of fraud

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288/ Paragraph 58 of Auditing Standard No. 12.

289/ AU sec. 316.24.

290/ Paragraph 56 of Auditing Standard No. 12.

are uncovered through tips.[291/] These inquiries can provide important evidence about fraud risks.

Auditing Standard No. 12 requires the auditor, when evaluating management's responses to inquiries about fraud risks and determining when it is necessary to corroborate management's responses, to take into account the fact that management is often in the best position to commit fraud. The standard also requires the auditor to obtain evidence to address inconsistencies in responses to inquiries. This requirement carries forward and builds upon a requirement in AU sec. 316.[292/]

j. Identifying and Assessing the Risks of Material Misstatement

Auditing Standard No. 12 sets forth a process for identifying and assessing the risks of material misstatement using the information obtained from the risk assessment procedures and other relevant knowledge possessed by the auditor.[293/] This process involves:

291/ See, e.g., Association of Certified Fraud Examiners, 2008 Report to the Nation on Occupational Fraud & Abuse (2008).

292/ AU sec. 316.27.

293/ Under Auditing Standard No. 12, the auditor has a responsibility to perform risk assessment procedures that provide an appropriate basis for his or her risk assessment. Auditing Standard No. 12 does not include the provision in the prior interim standards that allowed the auditor to assess risk at the maximum solely for efficiency reasons. Rather, the auditor needs to have a sufficient understanding of the company and its environment, including its internal control, in order to determine the risks of material misstatement and, in turn, to design effective tests of controls and substantive procedures.

- Identifying risks of misstatement using information obtained from risk assessment procedures and considering the characteristics of the accounts and disclosures in the financial statements.

- Evaluating whether the identified risks relate pervasively to the financial statements as a whole and potentially affect many assertions.

- Evaluating the types of potential misstatements that could result from the identified risks and the accounts, disclosures, and assertions that could be affected. This includes evaluating how risks at the financial statement level could affect risks at the assertion level.

- Assessing the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statements. In making this assessment, the auditor may take into account the planned degree of reliance on controls that the auditor plans to test, if the auditor performs tests of controls in accordance with PCAOB standards.

- Identifying significant accounts and disclosures and their relevant assertions.

- Determining whether any of the identified and assessed risks of material misstatement are significant risks.[294/]

One commenter suggested that the word "material" should be inserted before the word "misstatement" in paragraph 56.a. of the reproposed standard. No change was made to Auditing Standard No. 12 because inserting the word "material" would inappropriately narrow the auditor's focus on only material risks too early in the process of identifying and assessing risks of misstatement, i.e., before assessing the likelihood and magnitude of potential misstatements related to the risks.

Commenters suggested that the standard should clarify that the likelihood and magnitude of potential misstatements should be considered in determining which risks are significant risks. Auditing Standard No. 12 includes an additional requirement that states, "To determine whether an identified and assessed risk is a significant risk, the auditor should evaluate whether the risk requires special audit consideration because of the nature of the risk or the likelihood and potential magnitude of misstatement related to the risk."[295/] Also, the list of factors that should be evaluated in determining which risks are significant risks was expanded to include "the effect of the quantitative and qualitative risk factors discussed in paragraph 60 of the standard [on identifying significant accounts and disclosures and their relevant assertions] on the likelihood and

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294/ Paragraph 59 of Auditing Standard No. 12.

295/ Paragraph 70 of Auditing Standard No. 12.

potential magnitude of misstatements."[296] Including this new factor highlights the relationship between the identification of significant accounts and disclosures and their relevant assertions and the identification of significant risks. Specifically, risk factors that form the basis for identifying significant accounts and disclosures and their relevant assertions also inform the identification of significant risks, and significant risks affect one or more relevant assertions of significant accounts or disclosures.

Another commenter on the reproposed standard suggested that the term "likelihood" be defined more in terms of reasonable possibility as that term is used in Auditing Standard No. 5. However, that change would be inconsistent with the requirement to assess the likelihood of misstatements, i.e., the possibility that the risk would result in misstatement of the financial statements.

One commenter indicated that the requirement in the note to paragraph 59.c. of the reproposed standard "inappropriately infers that the auditor should, and can, associate the risks at the financial statement level with particular assertions in order to assess risks at the assertion level." Auditing Standard No. 8 states that risks of material misstatement at the financial statement level have a pervasive effect on the financial statements as a whole and potentially affect many assertions, and the standard provides examples of how risks at the financial statement level can result in misstatements.[297] It is important for the

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[296] Paragraph 71 of Auditing Standard No. 12.

[297] Paragraph 6 of Auditing Standard No. 8.

auditor to take into account risks of material misstatement at the financial statement level in order to evaluate types of misstatements that could occur.

Under PCAOB standards, significant accounts and disclosures and their relevant assertions are identified based upon their risk characteristics. Thus, the auditor needs to identify and assess the risks in order to identify the relevant assertions of significant accounts and disclosures in accordance with PCAOB standards. For example, Auditing Standard No. 5 requires the auditor to identify significant accounts and disclosures and their relevant assertions in integrated audits.[298/] Also, AU sec. 319 required the auditor to perform substantive procedures for the relevant assertions of significant accounts and disclosures for all audits of financial statements, which implicitly required the auditor to identify those accounts, disclosures, and assertions.[299/] Auditing Standard No. 12 imposes a more explicit requirement on the auditor to identify significant accounts and disclosures and their relevant assertions in all audits.

(i). Factors Relevant to Identifying Fraud Risks

Auditing Standard No. 12 requires that the auditor evaluate whether the information gathered from the risk assessment procedures indicates that one or more fraud risk factors are present and should be taken into account in identifying and

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298/ Paragraph 28 of Auditing Standard No. 5.

299/ Ibid.

assessing fraud risks.[300] The reproposed standard included a paragraph that stated that the auditor should not assume that all of the fraud risk factors discussed in must be observed to conclude that a fraud risk exists. Commenters suggested that the language was not clear as to the action that auditors would need to take to "not assume." The paragraph has been revised to clarify that all of the conditions are not required to be observed or evident to conclude that a fraud risk exists.[301]

(ii). Consideration of the Risk of Omitted or Incomplete Disclosures

The reproposed standard stated that the auditor's evaluation of fraud risk factors should include an evaluation of how fraud could be perpetrated or concealed by omitting required disclosures or by presenting incomplete disclosures. One commenter stated that the requirement should also include consideration of the possibility of presenting inaccurate disclosures. Other commenters stated that the requirement should be revised to refer to disclosures required by the applicable financial reporting framework. The requirement has been revised to encompass inaccurate disclosures and to refer to disclosures required for the fair presentation of the financial statements in conformity with the applicable financial reporting framework.[302]

(iii). Presumption of Fraud Risk Involving Improper Revenue Recognition

300/ Paragraph 65 of Auditing Standard No. 12.

301/ Paragraph 66 of Auditing Standard No. 12.

302/ Paragraph 67 of Auditing Standard No. 12.

Like the reproposed standard, Auditing Standard No. 12 contains a requirement that the auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.[303/] One commenter recommended rewording this paragraph to state that while revenue recognition should be presumed to be a higher level of risk, there are exceptions. The requirement was retained as stated in the reproposed standard because a significant number of financial reporting frauds relate to revenue recognition.[304/]

k. Definition of Significant Risk

The reproposed standard defined significant risk as a risk of material misstatement that requires special audit consideration. Some commenters stated that the definition of "significant risk" in the reproposed standard should be revised to indicate that significant risks are "identified risks" and that they are determined using the "auditor's judgment" or risks that the auditor "determines." Adding a reference to the auditor's determination or auditor's judgment is unnecessary because those points are inherent in the requirements for identifying significant risks, e.g., in the required evaluation of the likelihood and potential magnitude of misstatements related to the risk. Similarly, the reference to "identified risks" is unnecessary because it is already

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303/ Paragraph 68 of Auditing Standard No. 12.

304/ See, e.g., Committee of Sponsoring Organizations of the Treadway Commission, Fraudulent Financial Reporting: 1998-2007 (May 2010).

mentioned in the requirement for determining significant risks. Accordingly, the definition of significant risk included in the reproposed standard is retained.

8. <u>Auditing Standard No. 13 – The Auditor's Responses to the Risks of Material Misstatement</u>

a. Background

Auditing Standard No. 13 establishes requirements for responding to the risks of material misstatement, including responses regarding the general conduct of the audit and responses involving audit procedures. Auditing Standard No. 13 applies to integrated audits and audits of financial statements only.

b. Linking Assessed Risks and Auditor's Responses

The reproposed standard included a requirement for the auditor to design and implement appropriate responses to the "assessed risks of material misstatement" to address comments received on the original proposed standard for improving the linkage between the auditor's responses and the identification and assessment of risks of material misstatement. Acknowledging the improvements in the reproposed standard, some commenters continued to suggest that the objective also should state that the auditor is to address the assessed risks of material misstatement.

In the Board's view, obtaining sufficient appropriate evidence to support the auditor's opinion requires the auditor to adequately respond to the risks of material misstatement. Accordingly, the title and objective of the standard continue to refer to responding to the risks of material misstatement. However, the Board recognizes that the appropriate identification and assessment of the risks of material misstatement in accordance with Auditing Standard No. 12 enable the auditor to effectively respond to the risks of material misstatement. Auditing Standard No. 13 continues to impose on auditors an unconditional responsibility to design and implement responses that address the risks of material misstatement identified and assessed in accordance with Auditing Standard No. 12.[305/] As with the reproposed standard, noncompliance with the requirements in Auditing Standard No. 12 that leads to a failure to identify or appropriately assess a risk of material misstatement also could result in a failure to appropriately respond to the risk of material misstatement in accordance with this standard.[306/]

c. Overall Responses to Risks

The reproposed standard included a requirement for the auditor to respond to the risks of material misstatement through overall responses and responses involving the nature, timing, and extent of audit procedures. Overall responses relate to the general conduct of the audit, e.g., appropriately assigning and properly supervising engagement team members, incorporating an element of unpredictability into the audit, evaluating the company's selection and application of significant accounting principles, and making

305/ Paragraph 3 of Auditing Standard No. 13.

306/ Failure to address a risk of material misstatement also might indicate a failure to comply with Auditing Standard No. 12.

pervasive changes to the audit. Such responses are required by AU sec. 316 in response to fraud risks, but the reproposed standard extended the requirement to apply to risks of material misstatement due to error or fraud. These responses, by their nature, are appropriate for addressing risks of material misstatement due to error or fraud.

Some commenters expressed concerns regarding the expansion of the requirement for incorporating an element of unpredictability to apply to risks of material misstatement other than fraud risks.

In the Board's view, although incorporating an element of unpredictability is intended primarily to address fraud risks, it also can enable the auditor to detect errors or control deficiencies that could otherwise remain undetected. In addition, the requirement to incorporate an element of unpredictability when testing controls already exists in Auditing Standard No. 5. Auditing Standard No. 13 continues to indicate that the auditor should incorporate an element of unpredictability as part of the response to the risks of material misstatement, including fraud risks.[307/]

One commenter requested clarification regarding the differences between the first and third examples used to illustrate ways to incorporate an element of unpredictability in paragraph 5.c. of the reproposed standard. The first example in Auditing Standard No. 13 is intended to illustrate that the auditor may decide to perform audit procedures for a particular account, disclosure, or assertion even though the auditor's risk assessment did

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[307/] Paragraph 5.c. of Auditing Standard No. 13.

not identify specific risks associated with those accounts.[308/] The third example is intended to illustrate that when sampling a particular financial statement amount, the auditor may consider selecting items with amounts lower than the threshold that the auditor had used in the past, or expanding the selection to other sections of the population that the auditor had not tested in the past.[309/]

The reproposed standard required the auditor to evaluate whether it is necessary to make pervasive changes to the audit to adequately address the assessed risks of material misstatement. The reproposed standard did not require that pervasive changes be made in every audit. Instead, it required the auditor to evaluate whether pervasive changes that affect many aspects of the audit are needed to address the assessed risks of material misstatement. Commenters questioned the use of the term "pervasive" in the requirement. Auditing Standard No. 13 provides additional explanation of the types of circumstances in which pervasive changes might be necessary.[310/]

Existing PCAOB standards require the auditor to apply professional skepticism as part of due care,[311/] and Auditing Standard No. 13 states that the auditor's response to fraud risks involves the application of professional skepticism in gathering and evaluating

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308/ Paragraph 5.c. (1) of Auditing Standard No. 13.

309/ Paragraph 5.c. (3) of Auditing Standard No. 13.

310/ Paragraph 6 of Auditing Standard No. 13.

311/ AU secs. 230.07-.09.

audit evidence.[312/] The requirement is intended to emphasize the importance of professional skepticism in responding to risks of material misstatement without limiting its application to the auditor's responses.

One commenter expressed concern that the reproposed standard did not explicitly require the auditor to implement overall responses to risks at the financial statement level. Such an explicit requirement would inappropriately limit the auditor's overall responses to risks at the financial statement level. Many of the overall responses also apply to risks at the assertion level, e.g., assigning more experienced personnel or applying a greater extent of supervision to accounts or disclosures with higher risk.

d. Responses Involving the Nature, Timing, and Extent of Audit Procedures

The reproposed standard required the auditor to design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure. Auditing Standard No. 13 retained this requirement as reproposed. The requirement emphasizes that the auditor should focus on each relevant assertion of each significant account and disclosure and the risks of material misstatement associated with the relevant assertion when designing and performing audit procedures.

312/ Paragraph 7 of Auditing Standard No. 13.

The reproposed standard also included requirements for the auditor to design the testing of controls to accomplish the objectives of both the audit of financial statements and the audit of internal control in an integrated audit. This requirement is aligned with Auditing Standard No. 5. One commenter suggested that that the requirement be removed because it relates only to integrated audits. The requirement was retained as reproposed because Auditing Standard No. 13 applies to integrated audits as well as audits of financial statements only, and tests of controls are a necessary response in the audit of internal control.[313/]

e. Tests of Controls in an Audit of Internal Control

Auditing Standard No. 13 includes requirements for performing tests of controls in the audit of financial statements.[314/]

In an integrated audit, the tests of controls performed in the audit of internal control are part of the auditor's responses to the risks of material misstatement, as indicated in paragraph 9-10 of Auditing Standard No. 13.[315/] To help facilitate the integration of tests of controls in an integrated audit, the standard continues to use

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313/ Paragraph 9.c. of Auditing Standard No. 13.

314/ Paragraphs 16-35 of Auditing Standard No. 13.

315/ Paragraph 39 of Auditing Standard No. 5 states, "The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion."

language similar to that of Auditing Standard No. 5 when describing analogous terms and concepts relating to the testing of controls.

f. Tests of Controls and Control Risk Assessment in the Audit of Financial Statements

(i). Requirements on When to Test Controls

AU sec. 319 required auditors to obtain evidence about the design effectiveness and operating effectiveness of controls (a) when the auditor plans to rely on selected controls to reduce his or her substantive procedures and (b) in those limited circumstances in which the auditor cannot obtain sufficient appropriate evidence through substantive procedures alone.[316/] Thus, except in those limited circumstances, AU sec. 319 provided auditors with flexibility to decide when or whether to test controls.

Auditing Standard No. 13 does not change the requirements in AU sec. 319 regarding when testing controls is necessary in audits of financial statements only.[317/] In those audits, auditors continue to have the same flexibility in deciding when or whether to test controls to reduce their substantive procedures.[318/] Auditing Standard No. 13

316/ AU sec. 319.66.

317/ Certain clarifying revisions were made to the discussion of relying on controls to modify the auditor's substantive procedures, in response to comments on the reproposed standard. See footnote 12 to paragraph 16 of Auditing Standard No. 13.

318/ Paragraph 16 of Auditing Standard No. 13.

includes additional statements that emphasize the flexibility that auditors have in making these decisions and provides additional examples, adapted from AU sec. 319.68, of situations in which auditors cannot obtain sufficient appropriate audit evidence through substantive procedures alone.[319/]

(ii). Period of Reliance

Auditing Standard No. 13 states that when the auditor relies on controls to assess control risk at less than the maximum, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire period of reliance.[320/] The concept of the period of reliance was introduced in Auditing Standard No. 5 and discussed further in the PCAOB staff guidance, Staff Views: An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements – Guidance for Auditors of Smaller Public Companies. Auditing Standard No. 13 provides a definition of "period of reliance" that parallels the language in paragraph B4 of Auditing Standard No. 5.[321/]

319/ Paragraph 17 of Auditing Standard No. 13.

320/ Paragraph 16 of Auditing Standard No. 13.

321/ Paragraph A.3 of Auditing Standard No. 13.

(iii). Evidence about the Effectiveness of Controls

Auditing Standard No. 13 describes the principle, adapted from AU sec. 319,[322/] that the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. In applying that principle, Auditing Standard No. 13 requires the auditor to obtain more persuasive audit evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. In addition, Auditing Standard No. 13 requires the auditor to obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls, including situations in which substantive procedures alone cannot provide sufficient appropriate audit evidence.[323/]

(iv). Testing Operating Effectiveness

Auditing Standard No. 13 requires the auditor to determine, among other things, whether the person performing the control possesses the necessary authority and competence to perform the control effectively.[324/] This requirement is intended to call to the auditor's attention that whether he or she possesses the appropriate level of authority and the knowledge and skills necessary to perform the control function is essential to

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322/ AU sec. 319.90.

323/ Paragraph 18 of Auditing Standard No. 13.

324/ Paragraph 21 of Auditing Standard No. 13.

whether a person can effectively perform the control. Thus, the auditor is required to make such determination before he or she can conclude about the effectiveness of the control.

(v). Timing of Tests of Controls – Evidence Obtained during an Interim Period

The reproposed standard stated that the auditor must obtain evidence about the effectiveness of controls selected for testing for the entire period of reliance. When the auditor tests controls during an interim period, additional evidence that is necessary concerning the operation of those controls for the remaining period of reliance depends on a series of factors listed in the reproposed standard, including, among other factors, the possibility of significant changes in internal control over financial reporting occurring subsequent to the interim date.

One commenter suggested adding "control environment" to the list of factors that could affect the auditor's determination of what additional evidence is necessary. The control environment has an important, but indirect, effect on the likelihood that a misstatement will be prevented or detected on a timely basis. Also, unlike monitoring controls, the control environment is not designed to identify possible breakdowns in other controls. Accordingly, the control environment, by itself, does not reduce the amount of evidence needed concerning controls over specific relevant assertions for the remaining period. The control environment is not included in the list of factors in Auditing Standard No. 13.

Another commenter suggested adding a requirement for the auditor to obtain, when applicable, audit evidence about subsequent changes to the controls tested during the interim period. A note has been added to Auditing Standard No. 13 requiring the auditor to obtain evidence about such subsequent changes, if significant.[325/]

(vi). Timing of Tests of Controls – Evidence from Past Audits

Auditing Standard No. 13 states that the auditor should obtain evidence during the current year audit about the design and operating effectiveness of controls upon which the auditor relies.[326/] This requirement is based on the principle that auditors should support their control risk assessments each year with current evidence. However, when the auditor has tested the controls in the past and plans to rely on the same controls for the current year audit, the amount of evidence needed will vary based on the relevant factors listed in the standard.[327/] These additional factors generally relate to the degree of reliance on the control, the risk that the control will fail to operate as designed, and the nature and amount of evidence that the auditor has already obtained regarding the effectiveness of the controls. These requirements are consistent with Auditing Standard No. 5. Also, the standard allows the auditor to use a benchmarking strategy, when appropriate, for automated application controls for subsequent years' audits, as do the

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325/ Paragraph 30 of Auditing Standard No. 13.

326/ Paragraph 31 of Auditing Standard No. 13.

327/ Ibid.

provisions of Auditing Standard No. 5. However, the standard does not permit testing controls once every third year because the standard requires evidence regarding the effectiveness of controls to be obtained each year.

Some commenters expressed concern that the requirements in the reproposed standard for determining the amount of evidence needed in the current year could be interpreted as requiring the auditor to consider each factor listed for each of the controls that the auditor tested in the past, regardless of whether or not the auditor plans to rely on those controls for purposes of the current year audit. The requirement was intended to apply when the auditor tested the controls in the past audits and plans to rely on those controls and use evidence about the effectiveness of those controls obtained in prior years for purposes of the current year audit. That requirement is clarified in Auditing Standard No. 13.[328/]

(vii). Assessing Control Risk

Auditing Standard No. 13 requires the auditor to assess control risk for relevant assertions.[329/] This requirement is not new. AU sec. 319 established requirements for the

328/ Ibid.

329/ Paragraphs 32-34 of Auditing Standard No. 13.

auditor to assess control risk, and Auditing Standard No. 5 discusses control risk assessment in the financial statement audit portion of the integrated audit.[330/]

Auditing Standard No. 13 requires the auditor to assess the control risk at the maximum level for relevant assertions when the controls necessary to sufficiently address the assessed risk of material misstatement in those assertions are missing or ineffective or when the auditor has not obtained sufficient appropriate evidence to support a control risk assessment below the maximum level.[331/]

One commenter expressed a concern that the reproposed standard seemed to indicate that no reduction of the control risk assessment should occur based on understanding the design effectiveness of controls. The commenter suggested that a control that does not exist or is not designed effectively should have a different impact on the auditor's testing than a control that is designed effectively but not tested by the auditor.

The risk assessment standards already address the points raised by the commenter regarding the effect of control deficiencies on the auditor's testing. Auditing Standard No. 12 requires the auditor to obtain an understanding of the design of the company's controls

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330/ AU secs. 319.70, .83-.90 and paragraphs B4-B5 of Auditing Standards No. 5.

331/ Paragraph 33 of Auditing Standard No. 13.

as part of his or her risk assessment procedures.[332/] If the auditor identifies design deficiencies in the company's controls, the auditor would take that into account in identifying and assessing the risks of material misstatement, and Auditing Standard No. 13 requires the auditor to implement responses to address those risks of material misstatement. When deficiencies are detected during the auditor's testing of controls that the auditor plans to rely on, Auditing Standard No. 13 requires the auditor to (1) perform tests of other controls related to the same assertion as the ineffective controls, or (2) revise the control risk assessment and modify the planned substantive procedures as necessary in light of the increased assessment of risk.[333/]

Another commenter suggested that the reproposed standard provide more direction about evaluating control deviations by adding a paragraph from Auditing Standard No. 5 regarding evaluating control deficiencies. The referenced paragraph does not apply specifically to assessing control risk in a financial statement audit, and Auditing Standard No. 13 requires the auditor to evaluate the evidence from all sources, including the results of test of controls, when assessing control risk for relevant assertions.[334/]

[332/] Paragraph 20 of Auditing Standard No. 12.

[333/] Paragraph 34 of Auditing Standard No. 13.

[334/] Paragraph 32 of Auditing Standard No. 13.

g. Substantive Procedures

Auditing Standard No. 13 requires the auditor to perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.[335/] By definition, a relevant assertion of a significant account and disclosure has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated.[336/] The requirement to obtain evidence from substantive procedures for each relevant assertion of each significant account and disclosure reflects the principle that the auditors need to implement appropriate responses to address the assessed risks of material misstatement.

Existing PCAOB standards indicate that some risks of material misstatement might require more evidence from substantive procedures because of certain inherent limitations of internal control.[337/] For example, more evidence from substantive procedures ordinarily is needed for relevant assertions that have a higher susceptibility to management override or to lapses in judgment or breakdowns resulting from human failures. Observations from the Board's oversight activities have underscored the importance of this principle. Auditing Standard No. 13 includes this principle because it

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335/ Paragraph 36 of Auditing Standard No. 13.

336/ Paragraph A9 of Auditing Standard No. 5.

337/ See, e.g., paragraph .14 of AU sec. 328, Auditing Fair Value Measurements and Disclosures.

is particularly relevant to the determination of the nature, timing, and extent of substantive procedures. It is also consistent with the principles regarding detection risk discussed in Auditing Standard No. 8.

h. Timing of Substantive Procedures

The repropposed standard included a requirement for the auditor to take into account certain factors in determining whether it is appropriate to perform substantive procedures at an interim date. One commenter suggested that another point be added to the standard to require the auditor to review "the internal control changes that have been made to date and the nature and extent of monitoring such changes by the client staff." Auditing Standard No. 13 requires the auditor to consider the effect of known or expected changes in the company, its environment, and its internal control over financial reporting during the remaining period on its risk assessments when determining whether to perform substantive procedures at an interim date.[338/] This additional requirement recognizes that both changes in controls and other changes to the company and its environment can affect the risks of material misstatement and, thus, the effectiveness of interim substantive procedures. For example, significant changes in industry or market conditions near year end could increase the risk of material misstatement regarding the valuation of assets at year end, which, in turn, would require significant audit attention during the remaining period.

338/ Paragraph 44.a.(3) of Auditing Standard No. 13.

The reproposed standard stated that when an auditor performs substantive procedures as of an interim date, the auditor should perform substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. The reproposed standard also required that the auditor perform certain procedures that were adapted from AU sec. 313.

Some commenters suggested that the Board remove the mandatory procedures in the reproposed standard, arguing that the procedures should be determined by the auditor based on professional judgment. Removing those requirements as suggested by the commenters would weaken PCAOB standards. Observations from the Board's oversight activities have included instances in which inadequate audit work was performed when extending the conclusion reached at the interim date to the end of the period covered by the financial statements. Therefore, retaining the mandatory procedures in this standard continues to be appropriate.[339/]

i. Substantive Procedures Responsive to Significant Risks

Like the original proposed standard, the reproposed standard stated that the auditor should perform substantive procedures, including tests of details, that are

[339/] Paragraph 45 of Auditing Standard No. 13.

specifically responsive to the significant risks. AU sec. 329 indicates that tests of details should be performed in response to significant risks.[340/]

One commenter continued to express concern about imposing a presumptively mandatory responsibility for auditors to perform tests of details in response to significant risks. Auditing Standard No. 13 retains the requirement as reproposed.[341/] The nature and importance of significant risks warrant a high level of assurance from substantive procedures to adequately address the risk. Also, analytical procedures alone are not well suited to detecting certain types of misstatements related to significant risks, including, in particular, fraud risks. For example, when fraud risks are present, management might be able to override controls to allow adjustments that result in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions.

j. Dual-purpose Test

Auditing Standard No. 13 recognized that, in certain situations, the auditor might perform a substantive test of a transaction concurrently with a test of a control relevant to that transaction, i.e., a dual-purpose test. The auditor is required to design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. In addition, the auditor is required to evaluate the results of the test in forming

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340/ AU sec. 329.09.

341/ Paragraph 11 of Auditing Standard No. 13.

conclusions about both the assertion and the effectiveness of the control being tested.[342/] The standard refers the auditors to the relevant requirements in AU sec. 350, Audit Sampling, for determining the proper sample size in a dual-purpose test.

9. Auditing Standard No. 14 – Evaluating Audit Results

a. Background

Auditing Standard No. 14 describes the auditor's responsibilities regarding the process of evaluating the results of the audit and determining whether sufficient appropriate audit evidence has been obtained in order to form the opinion to be expressed in the auditor's report. This standard consolidates into one auditing standard the requirements that were previously included in five separate auditing standards.[343/] The standard highlights matters that are important to the auditor's conclusions about the financial statements and the effectiveness of internal control.

b. Definition of Misstatement

The reproposed standard defined the term "misstatement" as follows:

342/ Paragraph 47 of Auditing Standard No. 13.

343/ AU sec. 312, regarding evaluating audit results, including uncorrected misstatements; AU sec. 316, regarding fraud considerations that are relevant to evaluating audit results; AU sec. 329, regarding performing the overall review; AU sec. 326, regarding determining whether sufficient appropriate audit evidence has been obtained; and AU sec. 431, regarding the evaluation of disclosures.

> A misstatement, if material individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting framework.[344] A misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework. Misstatements can arise from error (i.e., unintentional misstatement) or fraud.

Some commenters indicated that the definition applied to "material misstatement" rather than "misstatement" and suggested revisions to the definition, e.g., moving the second sentence to the beginning of the definition.

Auditing Standard No. 14 carries forward the definition of "misstatement" as reproposed.[345] This definition is not a definition of the term "material misstatement." Rather, the definition emphasizes that misstatements prevent financial statements from being fairly presented in conformity with the applicable financial reporting framework, as discussed in AU sec. 411, The Meaning of Present Fairly in Conformity With Generally

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[344] The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to accounting principles applicable to that company.

[345] Paragraph A2 of Appendix A to Auditing Standard No. 14.

Accepted Accounting Principles. The phrase used in the definition, "if material individually or in combination with other misstatements," is equivalent to the phrase "In the absence of materiality considerations," which was used in the description of the term "misstatement" in an auditing interpretation of AU sec. 312.[346/] The second sentence of the definition in Auditing Standard No. 14 describes the most common types of misstatements.[347/]

c. Performing Analytical Procedures in the Overall Review

Auditing Standard No. 14 adapted the requirements that were previously included in AU secs. 316 and 329 to read the financial statements and disclosures and perform analytical procedures in the overall review. The standard imposes on auditors a responsibility to read the financial statements and disclosures and perform analytical procedures to (a) evaluate the auditor's conclusions formed regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement.[348/] In particular, Auditing Standard No. 14 requires the auditor to evaluate whether (a) evidence gathered in response to unusual or

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346/ Paragraph .02 of AU sec. 9312, Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312, which is superseded by the risk assessment standards, stated "In the absence of materiality considerations, a misstatement causes the financial statements not to be in conformity with generally accepted accounting principles."

347/ See also paragraph A2 of Auditing Standard No. 14.

348/ Paragraph 5 of Auditing Standard No. 14.

unexpected transactions, events, amounts, or relationships previously identified during the audit is sufficient and (b) unusual or unexpected transactions, events, amounts, or relationships indicate risks of material misstatement that were not identified previously.[349/] Performing analytical procedures in the overall review assists the auditor in assessing the conclusions reached and in evaluating the overall financial statement presentation.

Auditing Standard No. 14 adapted a requirement, which previously existed in AU sec. 316, for the auditor to perform analytical procedures relating to revenue through the end of the period.[350/] These procedures are intended to identify unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including a material misstatement due to fraud. Performing analytical procedures relating to revenue is important in light of the generally higher risk of financial statement fraud involving revenue accounts.

Auditing Standard No. 14 requires the auditor to corroborate management's explanations regarding significant unusual or unexpected transactions, events, amounts, or relationships. The standard also states that if management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail to be useful, the auditor should perform procedures to

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349/ Paragraph 6 of Auditing Standard No. 14.

350/ Paragraph 7 of Auditing Standard No. 14.

address the matter.[351] Auditing Standard No. 15, Audit Evidence, states that inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level.[352] Therefore, obtaining corroboration of management's responses is important in obtaining sufficient appropriate audit evidence.

d. Clearly Trivial

Auditing Standard No. 14 requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial.[353] Like AU sec. 312, the standard allows the auditor to set a threshold for accumulating misstatements, provided that the threshold is set at a de minimis level that could not result in material misstatement of the financial statements, individually or in combination with other misstatements, after considering the possibility of further undetected misstatement.[354] The specific limitation on setting a threshold for accumulating misstatements is important to assure a proper evaluation of the effect of uncorrected misstatements on the financial statements.

351/ Paragraph 8 of Auditing Standard No. 14.

352/ Paragraph 17 of Auditing Standard No. 15.

353/ Paragraph 10 of Auditing Standard No. 14.

354/ Paragraph 11 of Auditing Standard No. 14.

e. Accumulating Misstatements

The reproposed standard required the auditor to accumulate identified misstatements other than those that are clearly trivial. The reproposed standard also required the auditor to use his or her best estimate of the total misstatement in the accounts and disclosures that the auditor has tested, not just the amount of misstatements specifically identified. This includes misstatements related to accounting estimates and projected misstatements from substantive procedures that involve audit sampling.[355/]

Commenters suggested that the standard should use terms such as "known and likely misstatement" or other terms to categorize the misstatements. Auditing Standard No. 14 uses the term "identified misstatement" to refer to misstatements that are identified during the audit and the term "accumulated misstatements" to refer to misstatements that are more than clearly trivial and, thus, should be accumulated by the auditor. Because Auditing Standard No. 14 requires the auditor to use his or her best estimate of the misstatements (which is how AU sec. 312 described "likely misstatements"), it is not necessary to use the term "known and likely misstatements."

f. Correction of Misstatements

Auditing Standard No. 14 requires that if management made corrections to accounts or disclosures in response to misstatements detected by the auditor, the auditor

[355/] Paragraphs 10-12 of Auditing Standard No. 14.

should evaluate management's work to determine whether the corrections have been recorded properly and to determine whether uncorrected misstatements remain.[356] The standard imposes on auditors a responsibility to determine whether misstatements identified by the auditor and communicated to management are correctly recorded in the accounting records.

g. Considerations When Accumulated Misstatements Approach the Materiality Level or Levels Used in Planning and Performing Audit Procedures

Auditing Standard No. 14 requires the auditor to determine whether the overall strategy needs to be revised when the aggregate of misstatements accumulated during the audit approaches the materiality level or levels used in planning and performing the audit. When the aggregate of misstatements approaches the materiality level or levels used in planning and performing an audit, there likely will be greater than an appropriately low level of risk that possible undetected misstatements, combined with uncorrected misstatements accumulated during the audit, could be material to the financial statements. If the auditor assesses this risk to be unacceptably high, he or she should perform additional audit procedures or determine that management has adjusted the financial statements so that the risk that the financial statements are materially misstated has been reduced to an appropriately low level.[357]

356/ Paragraph 16 of Auditing Standard No. 14.

357/ Paragraph 14 of Auditing Standard No. 14.

The reproposed standard stated that when the aggregate of accumulated misstatements approaches the materiality used in planning and performing the audit, the auditor should perform additional procedures or determine that management has adjusted the financial statements so that the risk of material misstatement has been reduced to an appropriately low level. One commenter suggested that it is not clear what the additional procedures are and that more work is not always the answer. The additional procedures that are necessary depend upon, among other things, the procedures performed by the auditor to date and the nature of the misstatements that were detected.

h. Requirement to Reevaluate the Materiality Level

Auditing Standard No. 11 includes a requirement to reevaluate the established materiality level or levels in certain circumstances. Auditing Standard No. 14 states that if the reevaluation of the materiality level or levels established in accordance with Auditing Standard No. 11 results in a lower amount for the materiality level or levels, the auditor should take into account that lower materiality level in the evaluation of uncorrected misstatements.[358/] The requirements are intended to prevent the auditor from incorrectly concluding that uncorrected misstatements are immaterial because he or she used outdated financial statement information. However, the standard does not allow the auditor to establish a higher level or levels of materiality when uncorrected misstatements exceed the initially established level or levels of materiality.

358/ Paragraph 17 of Auditing Standard No. 14.

Reevaluating the established materiality level or levels prior to evaluating the effect of uncorrected misstatements will cause audit results to be evaluated based on the latest financial information.

i. Evaluating Uncorrected Misstatements

The reproposed standard stated that the auditor should evaluate the uncorrected misstatements in relation to accounts and disclosures and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors. The reproposed standard retained the provisions regarding qualitative factors that were included in an auditing interpretation to AU sec. 312,[359/] with some minor revisions to align the factors more closely to the terminology in the reproposed standard and to omit qualitative factors that apply only to nonissuers. A commenter indicated that the term "profitability," which is included in the qualitative factors in Appendix B, is not defined, and the commenter suggested including examples of profitability in the reproposed standard. Although this term is not explicitly defined in Auditing Standard No. 14, it should be familiar to auditors because the related auditing interpretation was issued in 2000. Auditing Standard No. 14 carries forward the requirements and the related list of qualitative factors that are substantially the same as those in the auditing interpretation.[360/]

359/ AU secs. 9312.15-.17.

360/ AU sec. 9312 and paragraph 17 and Appendix B of Auditing Standard No. 14.

Auditing Standard No. 14 requires an evaluation of the effects of both uncorrected misstatements detected in prior years and misstatements detected in the current year that relate to prior years.[361] The standard does not address how to evaluate the effects of prior period misstatements because that is an accounting and financial reporting matter. For example, the SEC staff has provided guidance in SEC Staff Accounting Bulletin ("SAB") Topic 1.N, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, on the effects of prior year misstatements when quantifying misstatements in the current year financial statements. This SAB provides the SEC staff's views regarding evaluating the quantitative and qualitative factors regarding the materiality of uncorrected misstatements and evaluating the effects of prior year misstatements.

Auditing Standard No. 14 states that the auditor cannot assume that an instance of error or fraud is an isolated occurrence and that the auditor should evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement.[362] This procedure is important to inform the auditor's conclusions about whether the auditor's risk assessments remain appropriate and whether he or she has obtained sufficient appropriate evidence to support his or her opinion.

361/ Paragraph 18 of Auditing Standard No. 14.

362/ Paragraph 19 of Auditing Standard No. 14.

The reproposed standard included a requirement to evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement. A commenter suggested that this evaluation should be performed at the time the misstatement is identified. In the Board's view, it is not necessary to prescribe the timing for the evaluation of the nature and effects of misstatements on the risk assessments. However, performing this evaluation during the course of the audit could allow the auditor to make the necessary modifications to his or her planned audit procedures on a more timely basis.

The reproposed standard required the auditor to evaluate whether identified misstatements might be indicative of fraud and, in turn, how they affect the auditor's evaluation of materiality and the related audit responses. This requirement is adapted from AU sec. 316.[363/] One commenter suggested that when there is an indicator of fraud, the requirement should make clear that clearly trivial misstatements may need to be evaluated to determine if they should be included in the accumulated misstatements. Like AU sec. 316, the requirement in the reproposed standard was phrased in terms of identified misstatements rather than accumulated misstatements because fraud of relatively small amounts can be material to the financial statements.

[363/] AU sec. 316.75.

Auditing Standard No. 14 retains the requirement as reproposed.[364/] If an auditor detects a misstatement, he or she should evaluate whether the misstatement is indicative of fraud when deciding whether a misstatement is clearly trivial and thus does not warrant being included with accumulated misstatements. Additionally, in situations in which the auditor believes that a misstatement is or might be intentional and the effect on the financial statements could be material or cannot be readily determined, Auditing Standard No. 14 requires that the auditor perform procedures to obtain additional audit evidence to determine whether the fraud has occurred or is likely to have occurred. If the fraud has occurred or is likely to have occurred, the auditor is required to determine its effect on the financial statements and the auditor's report thereon.

j. Communication of Accumulated Misstatements to Management

The reproposed standard required the auditor to communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them. The reproposed standard also required the auditor to obtain an understanding of the reasons that management decided not to correct misstatements communicated by the auditor.

Some commenters suggested that the standard should specifically require the auditor to request management to correct the misstatements.

364/ Paragraph 20 of Auditing Standard No. 14.

Auditing Standard No. 14 retains the requirement as reproposed.[365/] It is not necessary to specifically require the auditor to request that management correct the misstatements because management has its own legal responsibilities in relation to the preparation and maintenance of the company's books, records, and financial statements. Section 13(i) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78m(i), requires the financial statements filed with the SEC to reflect all material correcting adjustments identified by the auditor.

k. Communication of Illegal Acts

Auditing Standard No. 14 requires the auditor to determine his or her responsibility under AU secs. 316.79-.82A, AU sec. 317, and Section 10A of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j-1, if the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred.[366/]

l. Evaluating the Qualitative Aspects of the Company's Accounting Practices

Auditing Standard No. 14 requires the auditor to evaluate the qualitative aspects of the company's accounting practices, including potential bias in management's

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365/ Paragraphs 15 and 25 of Auditing Standard No. 14.

366/ Paragraph 23 of Auditing Standard No. 14.

judgments regarding the amounts and disclosures in the financial statements.[367/]

Auditing Standard No. 14 also states that if the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, the auditor should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements. Also, the standard states that the auditor should evaluate whether the auditor's risk assessments, including, in particular, the assessment of fraud risks, and the related audit responses remain appropriate.[368/]

The reproposed standard included an example of management bias, which was based on observations from the Board's oversight activities. This example indicated that when management identifies adjusting entries that offset misstatements identified by the auditor, the auditor should perform procedures to determine why the underlying misstatement was not identified previously. The auditor also should evaluate the implications on the integrity of management, and the auditor's risk assessments, including fraud risk assessments, and perform additional procedures as necessary to address the risk of further undetected misstatements. A commenter suggested using the phrase "identified misstatements other than those that are ... clearly trivial" instead of "identified

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367/ Paragraph 24 of Auditing Standard No. 14.

368/ Paragraph 26 of Auditing Standard No. 14.

misstatements." The requirement has been revised to refer to misstatements accumulated by the auditor as required by paragraph 10 of Auditing Standard No. 14.[369/]

m. Assessment of Fraud Risks

The reproposed standard required the auditor to evaluate whether the accumulated results of auditing procedures and other observations affect the auditor's assessment of fraud risks made throughout the audit and whether the audit procedures need to be modified to respond to those risks.[370/] The reproposed standard included a reference to Appendix C, which listed matters that might affect the assessment of fraud risks. Appendix C stated that if the matters listed in the appendix are identified during the audit, the auditor should determine whether the assessment of fraud risks remains appropriate or needs to be revised. This requirement was included because the evaluation provides additional insight regarding the fraud risks and the potential need to perform additional procedures to support the opinion to be expressed in the auditor's report.

Some commenters indicated that the requirement in Appendix C seems to indicate that the auditor is required to determine if each item identified during the audit individually affects the assessment of fraud risks, which appears to be inconsistent with paragraph 28. Those commenters suggested revisions to the first sentence of Appendix C. After considering these comments, the first sentence of Appendix C has been revised to

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369/ Paragraph 25 of Auditing Standard No. 14.

370/ Paragraph 28 of Auditing Standard No. 14.

state that if the matters listed in the appendix are identified during the audit, the auditor should take into account these matters in the evaluation of the assessment of fraud risks, as discussed in paragraph 28.[371]

One commenter suggested including in Appendix C specific procedures that the auditor could perform to evaluate fraud risk, such as evaluating journal entries with round numbers or amounts slightly below a specified threshold. This type of procedure could be appropriate for selecting journal entries for testing, but it is different in nature from the matters listed in Appendix C.

Auditing Standard No. 14 includes a requirement for the engagement partner to determine whether there has been appropriate communication with the other engagement team members throughout the audit regarding information or conditions that are indicative of fraud risks.[372] This requirement is adapted from the existing PCAOB standards.[373]

n. Evaluating Financial Statement Disclosures

The reproposed standard included a requirement, adapted from AU sec. 431, for the auditor to evaluate whether the financial statements contain the required disclosures

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[371] Paragraph C1 of Appendix C to Auditing Standard No. 14.

[372] Paragraph 29 of Auditing Standard No. 14.

[373] AU sec. 316.18.

and, if the required disclosures are not included in the financial statements, to express a qualified or adverse opinion in accordance with AU sec. 508, Reports on Audited Financial Statements. The reproposed standard also stated that evaluation of disclosures includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth. These requirements were included in the reproposed standard because of the importance of disclosures to the fair presentation of financial statements.

Some commenters stated that the requirements regarding evaluation of disclosures should be qualified based on materiality considerations. Auditing Standard No. 14 states that the auditor should evaluate whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework, which is aligned with an analogous requirement in AU sec. 508.41.[374/] AU sec. 411 discusses the concept of materiality regarding the auditor's opinion that financial statements are presented fairly.[375/]

Another commenter questioned whether the statement that "Evaluation of disclosures includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the

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374/ Paragraph 31 of Auditing Standard No. 14.

375/ AU sec. 411.04.

terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth" is a requirement. The statement in the reproposed standard, which is retained in Auditing Standard No. 14, explains that the scope of the auditor's required evaluation of the information disclosed in the financial statements includes matters such as the form, arrangement, and content of the financial statements.[376/]

o. Evaluating the Sufficiency and Appropriateness of Audit Evidence

The reproposed standard required the auditor to conclude on whether sufficient appropriate audit evidence has been obtained to support his or her opinion on the financial statements. The reproposed standard also presented a list of factors that are relevant to the auditor's conclusion on whether sufficient appropriate audit evidence has been obtained. Consideration of the listed factors is essential to reaching an informed conclusion about whether sufficient appropriate audit evidence has been obtained. Accordingly, both the requirement and the list of factors contained in the reproposed standard have been retained.[377/]

A commenter suggested that corrected adjustments also should be considered in concluding whether sufficient appropriate audit evidence has been obtained. Auditing Standard No. 14 already requires the auditor to evaluate the results of audit procedures in

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376/ Paragraph 31 of Auditing Standard No. 14.

377/ Paragraphs 33-34 of Auditing Standard No. 14.

evaluating whether sufficient appropriate evidence has been obtained, and this would include misstatements identified by the auditor, regardless of whether they were corrected by management.[378/]

The reproposed standard expanded the requirements regarding situations in which the auditor has not obtained sufficient appropriate audit evidence to include situations in which the auditor has substantial doubt about a relevant assertion. This additional provision was adapted from AU sec. 326. A commenter suggested that the requirement be revised to state that the auditor should attempt to obtain additional evidence if the auditor has not obtained sufficient appropriate evidence about a relevant assertion. The requirement has been retained as stated in the reproposed standard because it covers situations in which the evidence is inadequate and situations in which the auditor has concerns about whether an assertion is misstated.[379/]

p. Evaluating the Results of the Audit of Internal Control

The reproposed standard included a section relating to evaluating audit results in the audit of internal control, which references Auditing Standard No. 5 for the requirements on evaluating the results of the audit of internal control.[380/] A commenter suggested removing this paragraph from the reproposed standard. Auditing Standard No.

378/ Paragraph 34 of Auditing Standard No. 14.

379/ Paragraph 35 of Auditing Standard No. 14.

380/ Paragraph 37 of Auditing Standard No. 14.

14 retains this paragraph, although it does not impose additional requirements. Including this paragraph emphasizes that, in integrated audits, the evaluation of audit results is an integrated process that affects both audits.

10. Auditing Standard No. 15 – Audit Evidence

a. Background

Auditing Standard No. 15 explains what constitutes audit evidence, establishes requirements regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence to support the opinion in the auditor's report, and discusses methods for selecting items for testing.

b. Nature of Audit Evidence

The reproposed standard stated that audit evidence is all the information, whether obtained from audit procedures or other sources, that is used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence consists of both information that supports and corroborates management's assertions regarding the financial statements or internal control over financial reporting and any information that contradicts such assertions.

One commenter indicated that the meaning of the phrase "and any information that contradicts such assertions" was unclear. The commenter suggested that the Board clarify whether the requirement meant the auditor should look for such contradictory information, or if the requirement should apply only when such information comes to the auditor's attention.

PCAOB standards require the auditor to plan and perform the audit to obtain sufficient appropriate evidence to support an opinion about whether the financial statements are free of material misstatement and, in the audit of internal control, whether material weaknesses exist.[381/] Thus, the auditor is required to perform the audit procedures necessary to test the accounts and controls, regardless of whether the results of those procedures support or contradict the assertions. The requirement in Auditing Standard No. 15 means that when contradictory evidence is obtained, the auditor should evaluate it when forming a conclusion on the financial statements and, in integrated audits, on internal control over financial reporting. To clarify the requirement, Auditing Standard No. 15 omits the word "any."[382/]

c. Objective

The objective in the reproposed standard acknowledged the auditor's responsibility to plan and perform the audit to obtain sufficient appropriate audit evidence to support the opinion expressed in the auditor's report. Commenters suggested revising the wording in paragraph 4 of the reproposed standard to be consistent with the objective

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[381/] Paragraph 3 of Auditing Standard No. 8 and paragraph 3 of Auditing Standard No. 5, respectively.

[382/] Paragraph 2 of Auditing Standard No. 15.

in paragraph 3 of the reproposed standard. The requirement in paragraph 4 of Auditing Standard No. 15 has been revised to be consistent with the objective of the standard.

d. Sufficient Appropriate Audit Evidence

The reproposed standard explained the meaning of the words "sufficient" and "appropriate" as used in the phrase "sufficient appropriate audit evidence." Commenters suggested that the Board provide formal definitions for terms like "sufficiency" and "appropriate" so the terms can be easily located within the standards. Adding definitions is unnecessary because Auditing Standard No. 15 already describes the terms "sufficiency" and "appropriateness" and explains the relevant characteristics of each.[383/]

Commenters stated that the term "persuasive" was used in the reproposed standard, The Auditor's Responses to the Risks of Material Misstatement, and recommended that the Board clarify in the reproposed audit evidence standard the manner in which the persuasiveness of evidence affects the evaluation of audit evidence. The concept of "persuasiveness of evidence" is discussed in Auditing Standard No. 13.[384/]

e. Relevance and Reliability

The reproposed standard contained a discussion about the relevance and reliability of audit evidence. The reproposed standard stated that the audit evidence must be both

383/ Paragraphs 5-6 of Auditing Standard No. 15.

384/ Paragraph 39 of Auditing Standard No. 13.

relevant and reliable to support the auditor's conclusions about the subject of the audit procedure. The reproposed standard stated that "[e]vidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized, or otherwise converted into electronic form, the reliability of which depends on the controls over the conversion and maintenance of those documents."

One commenter suggested that the standard be revised to indicate that electronic information, subject to proper controls, is in many ways more reliable than physical documentation. The language from the reproposed standard was retained in Auditing Standard No. 15.[385/] Although evidence sometimes is available only in electronic form and the reliability of electronic evidence depends on the controls over that information, an authentic original document generally is more reliable than an electronic form of that document.

The reproposed standard stated that the relevance of audit evidence refers to its relationship to the assertion or to the objective of the control being tested. The relevance of audit evidence depends on (a) the design of the audit procedure used to test the assertion or control, and (b) the timing of the audit procedure used to test the assertion or control. One commenter recommended the description of the term "relevance" should be expanded to include the following statements:

385/ Paragraph 8 of Auditing Standard No. 15.

Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, when appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing.

Auditing Standard No. 15 retains the description included in the reproposed standard because it is clearer than the suggested revision.[386/]

The reproposed standard indicated that "[t]he auditor is not expected to be an expert in document authentication. However, if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor should modify the planned audit procedures or perform additional audit procedures to respond to those conditions and should evaluate the effect, if any, on the other aspects of the audit."

One commenter suggested that the requirement for the auditor to modify the planned audit procedures or perform additional audit procedures in response to concerns about the authenticity of documents should be linked to professional skepticism. The commenter also stated that many modifications are routine. The requirement was not meant to require the auditor to perform unlimited procedures but, rather, to perform the procedures necessary to address the issue in the circumstances. Auditing Standard No. 15

386/ Paragraph 7 of Auditing Standard No. 15.

retains this requirement as reproposed.[387] Although professional skepticism is important in these situations, it is not the only factor that determines the procedures necessary to address the matter.

f. Financial Statement Assertions

In representing that the financial statements are presented fairly in conformity with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of the various elements of financial statements and related disclosures. Financial statement assertions are an important consideration for audits performed in accordance with PCAOB standards. For example, AU sec. 319 required auditors to perform substantive procedures for relevant assertions in audits of financial statements. Auditing Standard No. 5 requires auditors to obtain evidence about the design and operating effectiveness of controls over relevant assertions in audits of internal control.

The reproposed standard retained the five categories of financial statement assertions in AU sec. 326 and Auditing Standard No. 5. Two commenters suggested that the Board use different descriptions for financial statement assertions. One commenter suggested using other standard-setters' descriptions of financial statement assertions. The other commenter suggested using a different description of assertions. Auditing Standard

[387] Paragraph 9 of Auditing Standard No. 15.

No. 15 retains the categories of assertions as reproposed.[388/] Like Auditing Standard No. 5,[389/] Auditing Standard No. 15 allows auditors the flexibility to use categories of assertions that differ from the assertions listed in the standard under specified conditions.[390/]

g. Inquiry

The reproposed standard stated that inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control. One commenter suggested that the note to paragraph 17 of the reproposed standard be revised to include "design and operating effectiveness of a control" and that the auditor should perform audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Auditing Standard No. 15 retains the language from the reproposed standard. The phrase "effectiveness of a control" encompasses both design and operating effectiveness. It is not considered necessary to add that the auditor should perform additional procedures, since Auditing Standard No. 15 states that inquiry, by itself, does not provide sufficient audit evidence.[391/]

388/ Paragraph 11 of Auditing Standard No. 15.

389/ See the note to paragraph 28 of Auditing Standard No. 5.

390/ Paragraph 12 of Auditing Standard No. 15.

391/ Paragraph 17 of Auditing Standard No. 15.

h. Confirmation

The reproposed standard stated that a confirmation represents audit evidence obtained by the auditor as a direct response to the auditor from a third party. Some commenters suggested that the reproposed standard clarify that a confirmation be written. Auditing Standard No. 15 has been revised to state that a confirmation response represents a particular form of audit evidence obtained by the auditor from a third party in accordance with PCAOB standards.[392/] The Board has a separate standards-setting project on confirmations that, among other things, will address the use of written confirmation or other alternative forms of confirmation.[393/]

i. Analytical Procedures

The reproposed standard described analytical procedures as an audit procedure for obtaining evidence. One commenter suggested adding "scanning" as part of analytical procedures. Scanning is a means for selecting items for testing, not a separate audit procedure. The description of analytical procedures in Auditing Standard No. 15 is retained as reproposed.[394/]

392/ Paragraph 18 of Auditing Standard No. 15.

393/ PCAOB Release No. 2010-003, Proposed Auditing Standard Related to Confirmation and Related Amendments to PCAOB Standards (July 13, 2010).

394/ Paragraph 21 of Auditing Standard No. 15.

j. Selecting Items for Testing to Obtain Audit Evidence

Auditing Standard No. 15 contains a section on selecting items for testing that is adapted from an auditing interpretation of AU sec. 350.[395/] The standard also states that the auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure.[396/]

The reproposed standard defined audit sampling as the application of an audit procedure to less than 100 percent of the occurrences of a control or items comprising an account for the purpose of evaluating some characteristic of the control or account. One commenter stated that the definition in the standard should be conformed to AU sec. 350. Auditing Standard No. 15 reflects revisions that align the standard with AU sec. 350.

k. Other Changes

As noted in the reproposing release, certain topics that were included in AU sec. 326 were not carried forward to the reproposed standard and Auditing Standard No. 15. AU sec. 326 discussed the use of audit objectives, and an appendix to that standard illustrated how auditors might use assertions to develop audit objectives and substantive tests of inventory. Such a discussion is not necessary because the auditing standards do

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395/ AU sec. 9350, Audit Sampling: Auditing Interpretations of AU sec. 350.

396/ Paragraph 22 of Auditing Standard No. 15.

not require auditors to establish audit objectives to link assertions to substantive procedures. However, omission of this discussion would not preclude auditors from using audit objectives in designing their audit procedures.

11. Amendments to PCAOB Standards

a. Amendments to Auditing Standard No. 3

In the release accompanying the original proposed standards, the Board sought comment on the need for specific documentation requirements regarding the risk assessment procedures. Responses from commenters were mixed. Some commenters supported adding specific documentation requirements, other commenters stated that the requirements in Auditing Standard No. 3, Audit Documentation, were adequate, and one commenter was ambivalent.

After consideration of these comments and additional analysis, the amendments accompanying the reproposed standards included certain amendments to Auditing Standard No. 3 to (a) specify certain required documentation regarding the auditor's risk assessments and related responses, (b) align certain terms and provisions of Auditing Standard No. 3 with the risk assessment standards, and (c) incorporate the principles for documentation of disagreements among engagement team members. For example, the amendments indicated that the auditor's documentation should include the following:

- A summary of the identified risks of misstatement and the auditor's assessment of risks of material misstatement at the financial statement and assertion levels; and

- The auditor's responses to the risks of material misstatement, including linkage of the responses to those risks.

Also, the requirements regarding documentation of significant findings or issues and related matters were expanded to require documentation regarding the significant risks identified and the results of the auditing procedures performed in response to those risks.

A commenter indicated that the additional documentation requirement will result in "unnecessary linkage" and "a matrix-like mentality" to the audit documentation. The documentation requirements are intended to enhance the auditor's ability to link identified and assessed risks to appropriate responses and could help reviewers understand the areas of greatest risk and the auditor's responses to those risks. In addition to these documentation requirements, the auditor would continue to be responsible for preparing documentation as required by other provisions of Auditing Standard No. 3, e.g., to demonstrate that the engagement complied with the standards of the PCAOB.[397/]

[397/] Paragraph 5.a. of Auditing Standard No. 3.

Some commenters suggested placing the documentation requirements in the respective risk assessment standards rather than amending Auditing Standard No. 3. The risk assessment standards are foundational standards; therefore, the required documentation related to the risk assessment standards is included in Auditing Standard No. 3.[398/] Future decisions about the placement of new documentation requirements will be made during the course of the respective standards-setting projects.

b. Amendments to Auditing Standard No. 4

The amendment to Auditing Standard No. 4, Reporting on Whether a Previously Reported Material Weakness Continues to Exist, is limited to changing the word "competent" to "appropriate" when that word is used in reference to audit evidence.

c. Amendments to Auditing Standard No. 5

The amendments to Auditing Standard No. 5 that accompanied the reproposed standards were limited to changing the phrase "any assistants" to "the members of the engagement team," changing the word "competent" to "appropriate" when that word is used in reference to audit evidence, and updating references to auditing standards that are being superseded or amended. These amendments are retained as reproposed.

One commenter suggested a series of additional amendments to Auditing Standard No. 5, which primarily involved removing certain paragraphs from Auditing

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398/ Paragraphs 9, 12, and 19 of Auditing Standard No. 3, as amended.

Standard No. 5 that relate to risk assessment procedures or other requirements that are included in the risk assessment standards. The Board is not removing the requirements regarding risk assessment procedures from Auditing Standard No. 5 because those requirements are important to understanding the other provisions of Auditing Standard No. 5 for performing an audit of internal control.

d. Amendments to Auditing Standard No. 6

The amendments to Auditing Standard No. 6, Evaluating Consistency of Financial Statements, are limited to removing a footnote stating that the term "error" as used in Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections ("SFAS No. 154"), is equivalent to "misstatement" as used in the auditing standards and updating a reference to a standard that is being superseded. This technical change is made because the footnote regarding misstatements in Auditing Standard No. 6 refers to SFAS No. 154, whereas the definition of "misstatement" in Auditing Standard No. 14 on evaluating audit results is neutral regarding the financial reporting framework. However, this technical change does not alter the fact that an error under accounting standards generally accepted in the United States is a misstatement under Auditing Standard No. 14.

e. Amendments to Auditing Standard No. 7

The amendments to Auditing Standard No. 7, Engagement Quality Review, update footnote 3 and the note to paragraph 10 to replace a reference to an interim standard that is superseded and to update the definitions of the terms "engagement partner" and "significant risk" to conform to the definitions in the risk assessment standards.

f. Amendments to Interim Auditing Standards

(i). Superseded Sections

The risk assessment standards supersede the following sections of PCAOB interim auditing standards:

- AU sec. 311, Planning and Supervision
- AU sec. 312, Audit Risk and Materiality in Conducting an Audit
- AU sec. 313, Substantive Tests Prior to the Balance Sheet Date
- AU sec. 319, Consideration of Internal Control in a Financial Statement Audit
- AU sec. 326, Evidential Matter
- AU sec. 431, Adequacy of Disclosure in Financial Statements

Similarly, the auditing interpretations of AU secs. 311, 312, and 350 have been incorporated into the risk assessment standards and thus are superseded. The auditing interpretations of AU sec. 326, except for Interpretation No. 2 (AU secs. 9326.06-.23), also are superseded.[399/]

(ii). AU sec. 316, Consideration of Fraud in a Financial Statement Audit

The relevant requirements regarding identifying and assessing fraud risks, principally AU secs. 316.14-.45; responding to fraud risks, principally AU secs. 316.46-.50; and evaluating audit results, principally AU secs. 316.68-.78, have been incorporated into Auditing Standard Nos. 12, 13, and 14, respectively. The remaining portions of AU sec. 316 describe important principles regarding the auditor's responsibility with respect to fraud and more detailed requirements regarding the auditor's responses to fraud risks. Topics covered in the remaining portions of AU sec. 316, as amended, include the following:

- A description of fraud and its characteristics,
- The importance of exercising professional skepticism,
- Examples of fraud risk factors,

[399/] Interpretation No. 2 relates in part to AU sec. 336 and AU sec. 337, Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments, and it will be evaluated in connection with standards-setting projects related to those standards.

- Examples of audit procedures performed to respond to fraud risks involving fraudulent financial reporting and misappropriation of assets, and

- Requirements regarding procedures to further address the risk of material misstatement due to fraud involving management override of controls, including examining journal entries and other adjustments for evidence of possible material misstatement due to fraud; reviewing accounting estimates for biases that could result in material misstatement due to fraud; and evaluating the business rationale for significant unusual transactions.

(iii). AU sec. 329, Analytical Procedures

The discussion in AU sec. 329 regarding analytical procedures performed during audit planning, principally AU secs. 329.03 and 329.06-.08, is incorporated into Auditing Standard No. 12. Similarly, the requirements regarding analytical procedures in the overall review, principally AU secs. 329.23-.24, are incorporated into Auditing Standard No. 14. The remaining portion of AU sec. 329 relates to analytical procedures performed as substantive procedures. Therefore, AU sec. 329 is retitled, Substantive Analytical Procedures, which more accurately reflects the content of the amended standard.

A standard that focuses solely on substantive analytical procedures highlights more clearly the requirements that apply to analytical procedures performed for that purpose, including, the higher degree of precision in substantive analytical procedures needed to provide the necessary level of assurance. The Board has observed instances in which auditors performed substantive procedures to test accounts without meeting the requirements in AU sec. 329 for substantive analytical procedures.[400]

(iv). AU sec. 336, Using the Work of a Specialist

The text of footnote 1 to paragraph .01 and of paragraph .05 were amended to clarify that AU sec. 336 does not apply to situations in which persons who participate in the audit have specialized skills or knowledge in accounting or auditing (e.g., IT specialists and income tax specialists) and to specialists employed by the firm. Auditing Standard No. 10 applies to those situations. Those clarifications were previously included in the reproposed standard on audit planning and supervision.

(v). AU sec. 350, Audit Sampling

The discussion in AU sec. 350 regarding audit risk and tolerable misstatement has been amended to align more closely with the terminology used in the risk assessment standards.

The reproposed standards included amendments to AU secs. 350.23 and 350.38, which explained more specifically the principles in the standard for determining sample sizes when nonstatistical sampling approaches are used. Some commenters expressed

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[400] See, e.g., PCAOB Release 2007-010, Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms (October 22, 2007).

concern that the reproposed amendments would have required auditors who use nonstatistical sampling methods to compute sample sizes under both statistical and nonstatistical methods to demonstrate that the sample size under the nonstatistical method equaled or exceeded the sample size determined using a statistical method.

Commenters suggested that the standard should state that it is not necessary to compute sample sizes using statistical methods. Including such a sentence in the standard might be misunderstood by auditors and weaken the requirement of the amended standard. The reproposed amendments do not require auditors to compute sample sizes using statistical methods in all instances to demonstrate compliance with the requirements. For example, the use of a nonstatistical sampling methodology that is adapted appropriately from a statistical sampling method also could demonstrate compliance. However, calculating a sample size that is not based on the relevant factors in AU sec. 350 is not in compliance with the standard. Accordingly, the amendments are retained as reproposed.

(vi). AU sec. 543, Part of Audit Performed by Other Independent Auditors, and interpretations

A note was added to paragraph .01 to clarify that Auditing Standard No. 10 applies to situations not covered by AU sec. 543 in which the auditor engages other accounting firms or other accountants to participate in the audit. Paragraph .12 was amended to align AU sec. 543 with related amendments to Auditing Standard No. 3.

Footnote 4 to paragraph .16 of AU sec. 9543, Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543, is deleted because it refers to an interim standard that is being superseded.

(vii). Other Amendments to the Interim Auditing Standards

For the following interim auditing standards, the amendments are limited to conforming terminology to the risk assessment standards and updating references to auditing standards that are being superseded or amended:

- AU sec. 110, Responsibilities and Functions of the Independent Auditor
- AU sec. 150, Generally Accepted Auditing Standards
- AU sec. 210, Training and Proficiency of the Independent Auditor
- AU sec. 230, Due Professional Care in the Performance of Work
- AU sec. 310, Appointment of the Independent Auditor
- AU sec. 315, Communications Between Predecessor and Successor Auditors
- AU sec. 317, Illegal Acts by Clients
- AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.

- AU sec. 324, Service Organizations
- AU sec. 328, Auditing Fair Value Measurements and Disclosures
- AU sec. 330, The Confirmation Process
- AU sec. 332, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities
- AU sec. 333, Management Representations
- AU sec. 334, Related Parties, and AU sec. 9334, Related Parties: Auditing Interpretations of Section 334
- AU sec. 9336, Using the Work of a Specialist: Auditing Interpretations of Section 336
- AU sec. 341, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern
- AU sec. 342, Auditing Accounting Estimates, and AU sec. 9342, Auditing Accounting Estimates: Auditing Interpretations of Section 342
- AU sec. 380, Communication With Audit Committees
- AU sec. 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles

- AU sec. 508, Reports on Audited Financial Statements, and AU sec. 9508, Reports on Audited Financial Statements: Auditing Interpretations of Section 508
- AU sec. 530, Dating of the Independent Auditor's Report
- AU sec. 722, Interim Financial Information

g. **Amendments to Interim Ethics Standards**

In the interim ethics standards, ET sec. 102, Integrity and Objectivity, the amendments are limited to updating references to auditing standards that are being superseded or amended.

12. Effective Date

In its reproposal of the proposed rules, the Board stated that it expects the standards would be effective for audits of fiscal years beginning on or after December 15, 2010, subject to approval by the Commission, and the Board requested comment on the proposed effective date. Several commenters stated that the Board should establish sufficient time for auditing firms to make changes to their methodologies and train their staff on the new risk assessment standards.

After considering the comments received and the timing of the adoption of the standards, the Board has determined that the accompanying standards and related amendments will be effective, subject to Commission approval, for audits of fiscal periods beginning on or after December 15, 2010. In its determination, the Board considered that many auditors already employ risk-based audit methodologies, which should facilitate the methodology changes and training necessary to implement the standards by the effective date.

13. Other Topics Not Related to the Reproposed Standards

The comment letters on the reproposed standards included certain comments that relate to standards-setting matters other than the reproposed standards. The following paragraphs discuss those comments.

a. Standards-setting Process

Some commenters suggested changes to the Board's standards-setting process. These comments primarily relate to the extent to which the Board uses the standards of the IAASB and ASB in its standards-setting and the use of external task forces in drafting standards.

In previous releases on its proposed risk assessment standards, the Board has stated that it has sought to eliminate unnecessary differences with the risk assessment standards and those of other standards-setters. However, because the Board's standards must be consistent with the Board's statutory mandate,[401/] differences will continue to exist between the Board's standards and the standards of the IAASB and ASB e.g., when

[401/] E.g., Section 101 of the Sarbanes-Oxley Act of 2002 (the "Act"), 15 U.S.C. § 7211.

the Board decides to retain an existing requirement in PCAOB standards that is not included in IAASB or ASB standards. Also, certain differences are often necessary for the Board's standards to be consistent with relevant provisions of the federal securities laws or other existing standards or rules of the Board. Also, the Board's standards-setting activities are informed by and developed to some degree, in response to observations from its oversight activities.

The Board has a number of means available to seek additional comments from external parties regarding its standards-setting activities, including meetings with its Standing Advisory Group ("SAG"), issuing concept releases or reproposing standards or rules, and conducting public roundtables. Although these are not the only means available to the Board, they have been used because they offer the Board the ability to obtain comments from a diverse group of interested parties through a public process.

The Board continually endeavors to improve its processes, including its standards-setting process, and considers comments from the public as it does so. For example, the Board has undertaken certain steps to enhance the transparency of its standards-setting process, including maintaining on its Web site its standards-setting agenda and discussing the status of projects in public meetings with the SAG. This release has also been expanded to provide additional discussion of and explanation for the Board's conclusions regarding the risk assessment standards. Some commenters acknowledged the Board's efforts to increase the transparency of its process.

b. Other Standards-setting Projects

Commenters on the reproposed standards also recommended a number of additional standards-setting or standards-related projects for the Board. Examples of such projects included creating a codification of the Board's standards; creating a glossary of terms used in the Board's standards, issuing a concept release for the review of the Board's interim standards, developing a standard describing the overall objectives of the audit, similar to ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing, and developing guidance related to how the Board would evaluate the reasonableness of judgments based on PCAOB auditing standards.

The Board continually assesses its standards-setting and related projects based upon the need for improvements in standards or additional guidance in response to current developments, observations from the Board's oversight activities, comments received from the public, and other factors. As mentioned previously, the Board's standards-setting agenda is maintained on the Board's website. The Board is considering these comments as it assesses its agenda.

c. Comparison with and the Standards of the International Auditing and Assurance Standards Board the Auditing Standards Board of the American Institute of Certified Public Accountants

Some commenters on the reproposed standards stated that the Board should provide more information about its requirements, including how the requirements are expected to affect audits. Commenters requested information about how the Board's standards compare to the standards of other standards-setters. Some commenters also requested more explanation for certain requirements in the Board's reproposed standards.

In developing its original proposed standards, the Board took into account, among other things, the risk assessment standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board of the American Institute of Certified Public Accountants ("ASB"). The release accompanying the reproposed standards included a comparison of the objectives and requirements of the reproposed standards to the analogous standards of the IAASB and ASB.

Some commenters requested additional details about differences between the reproposed standards and the IAASB or ASB standards or clarifications regarding specific requirements in the reproposed standards for which the language was not identical to IAASB or ASB standards.

In analyzing comments on the appendix to the reproposed standards that compared the reproposed standards to the analogous standards of the IAASB and ASB, the Board observed that a number of the explanations sought by commenters, e.g., the reasons for the differences in certain requirements were discussed elsewhere in the release accompanying the reproposed standards, e.g., in Appendix 9 to that release.

The discussion below discusses certain differences between the objectives and requirements of the PCAOB standards and the analogous standards of the IAASB and ASB. When a difference between the Board's standards and the analogous standards of the IAASB and ASB is noted, the discussion contains a reference to the discussion of the Board's requirements in this release. This analysis may not represent the views of the IAASB or ASB regarding their standards.

Auditing Standard No. 8 – Audit Risk

Analogous discussions of the components of audit risk are included in the IAASB's International Standard on Auditing ("ISA") 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing and the ASB's clarified Statement on Auditing Standards ("SAS"), Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards, respectively.

(i) Audit Risk and Reasonable Assurance

PCAOB

Auditing Standard No. 8 states that to form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.[402/]

Auditing Standard No. 8 uses the phrase "appropriately low level" because the term "appropriately" is aligned more closely with the concept of reasonable assurance whereas "acceptable level" might be misunderstood as allowing auditors to vary the audit efforts based upon their personal tolerance for risk. This release contains additional discussion regarding the use of the phrase "appropriately low level."[403/]

[402/] AU sec. 110, Responsibilities and Functions of the Independent Auditor, and AU sec. 230, Due Professional Care in the Performance of Work, provide further discussion of reasonable assurance.

[403/] Section II.C.3.b.

Auditing Standard No. 8 also clarifies that obtaining sufficient appropriate audit evidence is part of applying due professional care. This release provides additional discussion regarding due professional care and sufficient appropriate audit evidence.[404/]

IAASB and ASB

The ISA states:

> To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

The SAS includes a requirement similar to the ISA's requirement.

(ii) Detection Risk and Substantive Procedures

PCAOB

Auditing Standard No. 8 states that as the appropriate level of detection risk decreases, the evidence from substantive procedures that the auditor should obtain increases. This requirement was adapted from AU sec. 319, Consideration of Internal Control in a Financial Statement Audit,[405/] and it parallels a requirement in Auditing

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404/ Section II.C.3.c.

405/ AU sec. 319 is superseded by the risk assessment standards.

Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.[406] This release contains additional discussion regarding detection risk.[407]

IAASB and ASB

The ISA and the SAS do not include an analogous requirement.

Auditing Standard No. 9 – Audit Planning

In this section, the analogous IAASB and ASB standards are, unless indicated otherwise, ISA 300, Planning an Audit of Financial Statements, and the clarified SAS, Planning an Audit, respectively.

(i). Planning an Audit

PCAOB

Auditing Standard No. 9 contains a requirement to properly plan the audit. This requirement is consistent with the first standard of fieldwork in AU sec. 150, Generally Accepted Auditing Standards.

406/ Paragraph 37 of Auditing Standard No. 13.

407/ Section II.C.3.e.

IAASB and ASB

The ISA and the SAS do not include an analogous requirement, although planning the audit is referenced in the objectives of the standards.

(ii). Audit Strategy and Audit Plan

PCAOB

Auditing Standard No. 9 requires the auditor to establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan. When developing the audit strategy and audit plan, the standard requires the auditor to evaluate whether certain matters specified in the standard are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures As discussed in this release, these matters are adapted from Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, and are important for both the audit of financial statements and an audit of internal control over financial reporting ("audit of internal control").[408/]

In establishing the overall audit strategy, Auditing Standard No. 9 also requires the auditor to take into account certain matters, such as the reporting objectives and the factors that are significant in directing the activities of the engagement team, results of

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408/ Section II.C.4.e.

preliminary engagement activities and the auditor's evaluation of the important matters in accordance with paragraph 7, and the nature, timing, and extent of resources necessary to perform the engagement. This release discusses this requirement with more detail.[409/]

Auditing Standard No. 9 requires the auditor to develop and document an audit plan that includes a description of the planned nature, timing, and extent of risk assessment procedures; tests of controls, substantive procedures, and other audit procedures. The audit plan required by Auditing Standard No. 9 encompasses all of the audit procedures to be performed, i.e., it is not limited to procedures at the assertion level. This release contains additional discussion regarding developing the audit strategy and audit plan.[410/]

IAASB and ASB

The ISA and the SAS require the auditor to establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan. Those standards do not have a requirement analogous to the Auditing Standard No. 9 requirement to evaluate specific matters in developing the audit strategy and audit plan.

The ISA states:

> In establishing the overall audit strategy, the auditor shall:

409/ Section II.C.4.f.

410/ Ibid.

(a) Identify the characteristics of the engagement that define its scope;

(b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;

(c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;

(d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and

(e) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

The SAS includes a requirement similar to the ISA's requirement.

Both the ISA and the SAS require the auditor to develop an audit plan that shall include a description of the nature, timing, and extent of planned further auditor procedures at the assertion level.

(iii). Multi-location Engagements

PCAOB

Auditing Standard No. 9 states that the auditor should determine the extent to which auditing procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. This includes determining the locations or business units at which to perform audit procedures, as well as the nature, timing, and extent of the audit procedures to be performed at those individual locations or business units. The auditor should assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit. Auditing Standard No. 9 also provides a list of factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures.

The provisions in Auditing Standard No. 9 are applicable to all multi-location audits. This release discusses the basis for the requirements and explains how the requirements should be applied in audits in which part of the work is performed by other auditors of financial statements of individual locations or business units that are included in the consolidated financial statements.[411/]

IAASB and ASB

ISA 600, Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors), and the proposed SAS, Audits of Group Financial Statements (Including the Work of Component Auditors), apply to group audits. Under ISA 600, group audits are defined as the audit of group financial statements, which are financial statements that include the financial information of more than one component, and the component auditor is an auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

ISA 600 and the proposed SAS describe the scope of audit procedures to be performed at individual components, depending upon, among other things, whether the components are significant components as described in the respective standards.

Auditing Standard No. 10 – Supervision of the Audit Engagement

In this section, unless indicated otherwise, the analogous IAASB standards are ISA 300, Planning an Audit of Financial Statements, and ISA 220, Quality Control for an Audit of Financial Statements, (collectively referred to in this section as "the ISAs"); and

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[411/] Section II.C.4.g.

the analogous ASB standards are the clarified SAS, Planning an Audit, and the proposed SAS, Quality Control for an Audit of Financial Statements, (collectively referred to in this section as "the SASs").

(i). Supervision

PCAOB

Auditing Standard No. 10 states that the engagement partner is responsible for supervising other engagement team members and may seek assistance from appropriate engagement team members. Auditing Standard No. 10 also requires the engagement partner, and engagement team members who assist the engagement partner in supervision, to properly supervise the members of the engagement team, describes the necessary elements of proper supervision, and describes the factors that affect the necessary extent of supervision. These requirements are adapted from AU sec. 311, Planning and Supervision.[412/] This release provides additional discussion regarding these requirements.[413/]

The requirements in the ISAs and the SASs do not describe the elements of supervision or factors that affect supervision.

412/ AU sec. 311 is superseded by Auditing Standard No. 9 and Auditing Standard No. 10.

413/ Section II.C.5.d.

IAASB and ASB

The ISAs and the SASs require the auditor to plan the nature, timing, and extent of direction and supervision of engagement team members and review their work. The ISAs and SASs require the engagement partner to "take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements and for the auditor's report being appropriate in the circumstances."

(ii). Supervision of Engagement Team Members

PCAOB

Auditing Standard No. 10 requires the engagement partner and other engagement team members performing supervisory activities to: (a) inform engagement team members of their responsibilities, including the objectives of the procedures that they are to perform; the nature, timing and extent of procedures they are to perform; and matters that could affect the procedures to be performed or the evaluation of the results of those procedures, (b) direct engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervising activities, and (c) review the work of engagement team members to evaluate whether the work was performed, the objectives of the procedures were achieved, and the results of the work support the conclusions. This release contains additional discussion regarding this requirement.[414/]

IAASB

The ISAs state:

> The engagement partner shall take responsibility for:
>
> (a) The direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory and legal requirements; and
>
> (b) The auditor's report being appropriate in the circumstances.
>
> The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures.
>
> On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

414/ Section II.C.5.e.

> The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

ASB

The SAS includes requirements similar to the ISAs' requirements.

(iii). Extent of Supervision

PCAOB

To determine the extent of supervision necessary for engagement team members to perform their work as directed and form appropriate conclusions, Auditing Standard No. 10 requires the engagement partner and other engagement team members performing supervisory activities to take into account the nature of company, the nature of the assigned work for each team member, the risks of material misstatement, and the knowledge, skill, and ability of each engagement team member. This release contains additional discussion regarding this requirement.[415]

IAASB and ASB

The ISAs and SASs do not have an analogous requirement for the auditor to determine the extent of supervision necessary for engagement team members.

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[415] Ibid.

Auditing Standard No. 11 – Consideration of Materiality in Planning and Performing an Audit

In this section, the analogous IAASB and ASB standards are ISA 320, Materiality in Planning and Performing an Audit, and the clarified SAS, Materiality in Planning and Performing an Audit, and the proposed SAS, Audits of Group Financial Statements (Including the Work of Component Auditors), respectively.

- **Definition of Materiality**

PCAOB

Auditing Standard No. 11 requires the auditor to establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances, including consideration of the company's earnings and other relevant factors. The requirement in Auditing Standard No. 11 is based on the concept of materiality that is articulated by the courts in interpreting the federal securities laws. This release discusses the concept of materiality used in Auditing Standard No. 11.[416/]

IAASB and ASB

The ISA states, "When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole."

[416/] Section II.C.6.b.

The SAS has a requirement similar to the ISA's requirement.

- **Materiality in the Context of an Audit**

PCAOB

Auditing Standard No. 11 requires the auditor to plan and perform audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial statements in order to obtain reasonable assurance about whether the financial statements are free of material misstatement. This release discusses the concept of materiality in the context of an audit.[417]

IAASB

ISA 200 states:

> In conducting an audit of financial statements, the overall objectives of the auditor are:
>
> a. To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements

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[417] Ibid.

are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

b. To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings.

ASB

The SAS includes an objective similar to the ISA's objective.

- **Tolerable Misstatement and Performance Materiality**

PCAOB

Auditing Standard No. 11 requires the auditor to determine tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level. Auditing Standard No. 11 uses the term "tolerable misstatement," which is also used in other PCAOB standards.[418/] this release discusses the use of the term "tolerable misstatement" in more detail.[419/]

418/ Paragraph .18 of AU sec. 350, Audit Sampling.

419/ Section II.C.6.e.

IAASB and ASB

The ISA and SAS require the auditor to determine "performance materiality" for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures.

- **Determining Tolerable Misstatement**

PCAOB

Auditing Standard No. 11 contains a requirement to take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods when determining tolerable misstatement and planning and performing audit procedures. This requirement is adapted from AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*. This release contains further discussion regarding this requirement.[420/]

IAASB and ASB

The ISA and SAS do not have an analogous requirement.

[420/] Ibid.

- **Multi-location Determination of Tolerable Misstatement**

PCAOB

In multi-location engagements, Auditing Standard No. 11 requires the auditor to determine tolerable misstatement for the individual locations or business units at an amount that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the consolidated financial statements. The standard also requires the tolerable misstatement at an individual location to be less than the established materiality level for the financial statements as a whole. This release provides further discussion regarding consideration of materiality for multi-location engagements.[421/]

IAASB

ISA 600 requires the group engagement team to determine, among other things, component materiality. The ISA states:

> Component materiality for those components where component auditors will perform an audit or a review for purposes of the group audit. To reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a

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[421/] Section II.C.6.f.

whole, component materiality shall be lower than materiality for the group financial statements as a whole.

ASB

Proposed SAS, Audits of Group Financial Statements (Including the Work of Component Auditors), requires the group engagement team to determine among other things, component materiality. The proposed SAS states:

> Component materiality for those components on which an audit or other specified audit procedures will be performed. To reduce the risk that the aggregate of detected and undetected misstatements in the group financial statements exceeds the materiality for the group financial statements as a whole, component materiality should be lower than the materiality for the group financial statements as a whole.

- **Reevaluating Materiality and Tolerable Misstatement**

PCAOB

Auditing Standard No. 11 requires the auditor to reevaluate the established materiality level or levels and tolerable misstatement when there is a substantial likelihood that misstatements of amounts that differ significantly from the materiality level or levels that were established initially would influence the judgment of a reasonable investor. The requirement reflects the perspective of a reasonable investor, whereas the analogous requirements in the ISA and SAS reflect an auditor's perspective. This release contains additional discussion regarding materiality from the perspective of a reasonable investor[422/] and the reevaluation of materiality.[423/]

IAASB and ASB

The ISA and the SAS require the auditor to "revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances, or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially."

Auditing Standard No. 12 – Identifying and Assessing Risks of Material Misstatement

In this section, the analogous IAASB standards are ISA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment, and ISA 240, The Auditor's Responsibilities Relating to Fraud In An Audit of Financial Statements (collectively referred to in this section as "the ISAs"). The analogous ASB standards are the clarified SAS, Understanding the Entity and its Environment and Assessing the Risks of Material Misstatements (Redrafted) and

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422/ Section II.C.6.b.

423/ Section II.C.6.g.

proposed SAS, Consideration of Fraud in a Financial Statement Audit (Redrafted) (collectively referred to in this section as "the SASs").[424/]

(i). Objective

PCAOB

The objective of Auditing Standard No. 12 is to identify and appropriately assess the risks of material misstatement, thereby providing a basis for designing and implementing responses to the risks of material misstatement. Auditing Standard No. 12 requires the auditor to perform other risk assessment procedures in addition to obtaining an understanding of the company and its environment. This release contains additional discussion regarding the objective of the standard.[425/]

IAASB and ASB

The ISAs state:

> The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the

[424/] In June 2010, the ASB adopted as a final standard the SAS, Consideration of Fraud in a Financial Statement Audit (Redrafted). However, the ASB has not yet published this standard.

[425/] Section II.C.7.b.

> entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

The SASs include an objective similar to the ISAs' objective.

(ii). Performing Risk Assessment Procedures

PCAOB

Auditing Standard No. 12 states that the auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud, and designing further audit procedures. The requirement establishes a principle for determining the sufficiency of the necessary risk assessment procedures, and it also links the risk assessment procedures to the design of the tests of controls and substantive procedures to be performed to respond to the risks. This release includes additional discussion regarding performing risk assessment procedures.[426/]

IAASB and ASB

The ISAs state:

426/ Section II.C.7.c.

> The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.

The SASs include a requirement similar to the ISAs' requirement.

(iii). Obtaining an Understanding of the Company and Its Environment

PCAOB

Auditing Standard No. 12 includes a requirement to evaluate, while obtaining an understanding of the company, whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement. This release includes additional discussion regarding obtaining an understanding of the company and its environment.[427/]

IAASB and ASB

The ISAs and SASs do not include an analogous requirement.

427/ Section II.C.7.d.

(iv). Additional Procedures to Understand the Company

PCAOB

Auditing Standard No. 12 requires the auditor to consider performing certain procedures as part of obtaining an understanding of the company as required by paragraph 7 of the standard. These procedures include reading public information about the company, observing or reading transcripts of earnings calls, obtaining an understanding of compensation arrangements with senior management, and obtaining information about trading activity in the company's securities and holdings in the company's securities by significant holders. This release includes additional discussion regarding this requirement.[428/]

IAASB and ASB

The ISAs and SASs do not include an analogous requirement.

(v). Selection and Application of Accounting Principles, Including Related Disclosures

PCAOB

Auditing Standard No. 12 requires the auditor to develop expectations about the disclosures that are necessary for the company's financial statements to be presented

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[428/] Ibid.

fairly in conformity with the applicable financial reporting framework to identify and assess the risks of material misstatement related to omitted, incomplete, or inaccurate disclosures.[429/] The standard also requires engagement team members to discuss how fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures.[430/] Additionally Auditing Standard No. 12 requires the auditor's evaluation of fraud risk factors to include how fraud could be perpetrated or concealed by presenting incomplete or inaccurate disclosures or by omitting disclosures that are necessary for the financial statements to be presented fairly in conformity with the applicable financial reporting framework.[431/] This release includes additional discussion regarding these requirements.[432/]

IAASB and ASB

The ISAs and SASs do include analogous requirements regarding the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework.

429/ Paragraph 12 of Auditing Standard No. 12.

430/ Paragraph 52 of Auditing Standard No. 12.

431/ Paragraph 67 of Auditing Standard No. 12.

432/ Section II.C.7.d., h. and j. respectively.

(vi). Obtaining an Understanding of Internal Control Over Financial Reporting

PCAOB

Auditing Standard No. 12 requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements; (b) assess the factors that affect the risks of material misstatement; and (c) design further auditor procedures. This requirement relates to the sufficiency of the required understanding of internal control over financial reporting. This release contains additional discussion of this requirement.[433/]

IAASB and ASB

The ISAs state:

> The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

The SASs include requirements similar to the ISAs' requirements.

433/ Section II.C.7.e.

(vii). Control Environment

PCAOB

Auditing Standard No. 12 requires the auditor to assess the following matters as part of obtaining an understanding of the control environment:

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

This requirement is aligned with a similar requirement in Auditing Standard No. 5. This release includes additional discussion regarding this requirement.[434/]

Paragraph 25 of Auditing Standard No. 12 states that "[i]f the auditor identifies a control deficiency in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor." This release

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434/ Section II.C.7.e.(ii).

includes additional discussion regarding the auditor's evaluation of an identified control deficiency in the control environment.[435/]

IAASB and ASB

The ISAs state:

> The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
>
> (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
>
> (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment.

The SASs include requirements similar to the ISAs' requirements.

[435/] Ibid.

The ISAs and SASs do not have a requirement analogous to paragraph 25 of Auditing Standard No. 12.

(viii). The Company's Risk Assessment Process

PCAOB

Auditing Standard No. 12 states that:

> The auditor should obtain an understanding of management's process for:
>
> (a) Identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud ("fraud risks"),
>
> (b) Assessing the likelihood and significance of misstatements resulting from those risks, and
>
> (c) Deciding about actions to address those risks.
>
> The standard also states that obtaining an understanding of the company's risk assessment process includes obtaining an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.

Those requirements focus on the matters that are important to the auditor's understanding of the company's internal control and on the auditor's risk assessments. Although the auditor can be informed by the company's risk assessment process, the auditor is still required to perform risk assessment procedures that are sufficient for identifying and assessing the risks of material misstatement rather than relying on the company's process.

This release includes additional discussion regarding the company's risk assessment process.[436/]

IAASB and ASB

The ISAs state:

> The auditor shall obtain an understanding of whether the entity has a process for (a) Identifying business risks relevant to financial reporting objectives; (b) Estimating the significance of the risks; (c) Assessing the likelihood of their occurrence; and (d) Deciding about actions to address those risks.
>
> If the entity has established such a process (referred to hereafter as the "entity's risk assessment process"), the auditor shall obtain an understanding of it, and the results thereof. If the auditor identifies risks of material misstatement that management failed to identify,

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436/ Section II.C.7.e.(iii).

> the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity's risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity's risk assessment process.
>
> If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant deficiency in internal control.

The SASs include requirements similar to the ISAs' requirements.

(ix). Information and Communication

PCAOB

Auditing Standard No. 12 requires the auditor to obtain an understanding of how IT affects the company's flow of transactions. The standard also states that the identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the approach used to identify significant accounts and disclosures and their relevant assertions and, when applicable, to select the controls to test, as well as to assess risk and allocate audit effort. This release contains additional discussion of this requirement.[437/]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(x). Control Activities

PCAOB

Auditing Standard No. 12 requires the auditor to obtain an understanding of control activities that is sufficient to assess the factors that affect the risks of material misstatement and to design further audit procedures. Auditing Standard No. 12 requires the auditor to use his or her knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control over financial reporting in determining the extent to which it is necessary to devote additional attention to obtaining an understanding of control activities to assess the factors that

[437/] Section II.C.7.e.(iv).

affect the risks of material misstatement and to design further audit procedures. This release includes additional discussion of this requirement.[438/]

IAASB

The ISAs state:

> The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them.

ASB

The SASs state:

> The auditor should obtain an understanding of control activities relevant to the audit, which are those control activities the auditor judges it necessary to understand in order to assess the risks of

438/ Section II.C.7.e.(v).

material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. However, the auditor should obtain an understanding of the process of reconciling detailed records to the general ledger for material account balances.

(xi). Relationship of Understanding of Internal Control to Tests of Controls

PCAOB

Auditing Standard No. 12 requires the auditor to take into account the evidence obtained from understanding internal control when assessing control risk and, in the audit of internal control, forming conclusions about the effectiveness of controls. Auditing Standard No. 12 also requires the auditor to take into account the evidence obtained from understanding internal control when determining the nature, timing, and extent of procedures necessary to support the auditor's conclusions about the effectiveness of entity-level controls in the audit of internal control. This release includes additional discussion of these requirements.[439/]

439/ Section II.C.7.e.(vii).

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(xii). Considering Information from the Client Acceptance and Retention Evaluation, Audit Planning Activities, Past Audits, and Other Engagements

PCAOB

Auditing Standard No. 12 requires the auditor to evaluate whether information obtained during a review of interim financial information in accordance with AU sec. 722, Interim Financial Information, is relevant to identifying risks of material misstatement in the year-end audit. The ISAs and SASs do not include an analogous requirement.

Auditing Standard No. 12 also states that the auditor should obtain an understanding of the nature of the services that have been performed for the company by the auditor or affiliates of the firm[440/] and should take into account relevant information obtained from those engagements in identifying risks of material misstatement. The requirement in Auditing Standard No. 12 applies to services performed by the firm and

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[440/] See PCAOB Rule 3501(a)(i), which defines "affiliate of the accounting firm."

affiliates of the firm and is not limited to services performed by the engagement partner. This release contains additional discussion regarding these requirements.[441/]

IAASB and ASB

The ISAs state, "[i]f the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying risks of material misstatement."

The SASs include a requirement similar to the ISAs' requirement.

(xiii). Performing Analytical Procedures

PCAOB

Auditing Standard No. 12 contains a series of requirements regarding performing analytical procedures as risk assessment procedures. These requirements were adapted from AU sec. 329, Analytical Procedures. Auditing Standard No. 12 requires the auditor to:

- Perform analytical procedures that are designed to (a) enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior year end; and (b) identify areas that might represent specific risks relevant to the audit,

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441/ Section II.C.7.f.(ii).

including the existence of unusual transactions and events, and amounts, ratios, and trends that warrant investigation.

- Perform analytical procedures regarding revenue as risk assessment procedures with the objective of identifying unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including material misstatement due to fraud.

- Take into account analytical procedures performed in accordance with AU sec. 722 when designing and applying analytical procedures as risk assessment procedures. This requirement is unique to PCAOB standards.

- Use his or her understanding of the company to develop expectations about plausible relationships among the data to be used in the procedure.[442/]

- Take into account unusual or unexpected differences from the auditor's expectations that are identified while performing analytical procedures as risk assessment procedures.

This release contains additional discussion of these requirements.[443/]

442/ Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data.

443/ Section II.C.7.g.

IAASB

The ISAs state:

- The risk assessment procedures shall include...[a]nalytical procedures…

  The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

ASB

The SASs state:

- The risk assessment procedures should include...[a]nalytical procedures…

- Based on analytical procedures performed as part of risk assessment procedures and as part of substantive procedures, the auditor should evaluate whether unusual or unexpected relationships that have been identified indicate risks of material misstatements due to fraud. To the extent not already included, the analytical procedures and evaluation thereof should include procedures relating to revenue accounts.

(xiv). Communication among Engagement Team Members

PCAOB

Auditing Standard No. 12 requires that the communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change. This release contains additional discussion of this requirement.[444/]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(xv). Discussion of the Potential for Material Misstatement Due to Fraud

PCAOB

Auditing Standard No. 12 requires a discussion among the key engagement team members of specified matters regarding fraud, including how and where the company's financial statements might be susceptible to material misstatement due to fraud, known

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444/ Section II.C.7.h.(ii).

fraud risk factors, the risk of management override of controls, and possible responses to fraud risks.

Auditing Standard No. 12 requires all key engagement team members to participate in the discussion. Auditing Standard No. 12 also states that key engagement team members include the engagement partner and other engagement team members with significant engagement responsibilities.

Auditing Standard No. 12 also includes a requirement to emphasize certain matters to all engagement team members, including the need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, to be alert for information or other conditions that might affect the assessment of fraud risks, and actions to be taken if information or other conditions indicate that a material misstatement due to fraud might have occurred.

This release includes additional discussion of these requirements.[445/]

IAASB

The ISAs state:

> The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to

[445/] Section II.C.7.h.

> material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion.
>
> ...This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur.

<u>ASB</u>

The SASs have requirements similar to the ISAs' requirements. However, the SASs also include a requirement that the discussion regarding fraud include an exchange among engagement team members about how and where the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. The SASs also include a requirement to emphasize certain matters to all engagement team members, but those matters identified are less extensive than those required by PCAOB standards.

(xvi). Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement

PCAOB

Auditing Standard No. 12 requires the auditor to make specified inquiries of management and the audit committee regarding tips or complaints about the company's financial reporting. This release includes additional discussion of this requirement.[446/]

IAASB and ASB

The ISAs and the SASs do not specify the nature of the required inquiries, except for certain inquiries regarding fraud, which are less extensive than those required by PCAOB standards.

(xvii). Nature of Inquiries

PCAOB

Auditing Standard No. 12 requires the auditor to use his or her knowledge of the company and its environment, as well as information from other risk assessment procedures, to determine the nature of inquiries about risks of material misstatement. This release includes additional discussion of this requirement.[447/]

446/ Section II.C.7.i.

447/ Ibid.

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(xviii). Evaluating Management Responses to Inquiries

PCAOB

Auditing Standard No. 12 requires the auditor to take into account the fact that management is often in the best position to commit fraud when evaluating management's responses to inquiries about fraud risks. Auditing Standard No. 12 also requires the auditor to obtain evidence to address inconsistencies in response to the inquiries. This release includes additional discussion of these requirements.[448/]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

448/ Ibid.

(xix). Identifying and Assessing the Risks of Material Misstatement

PCAOB

Auditing Standard No. 12 requires the auditor to evaluate how risks at the financial statement level could affect risks of material misstatement at the assertion level. This release includes additional discussion of this requirement.[449/]

IAASB and ASB

The ISAs and the proposed SAS do not include an analogous requirement.

(xx). Identifying Significant Accounts and Disclosures and Their Relevant Assertions

PCAOB

Auditing Standard No. 12 requires the auditor to identify significant accounts and disclosures and their relevant assertions in identifying and assessing risks of material misstatement. PCAOB standards require auditors to perform substantive procedures for relevant assertions of significant accounts and disclosures in the audit of financial statements and tests of controls over relevant assertions of significant accounts and

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449/ Section II.C.7.j.

disclosures in the audit of internal control. This release includes additional discussion regarding identifying significant accounts and disclosures and relevant assertions.[450/]

IAASB and ASB

The ISAs and SASs do not have an analogous requirement.

(xxi). Significant Risks

PCAOB

Auditing Standard No. 12 defines significant risk as a "risk of material misstatement that requires special audit consideration." This definition is different from the ISAs' definition because it omits two qualifying phrases, "an identified and assessed" and "in the auditor's judgment." This release includes additional discussion regarding the definition of significant risks.[451/]

IAASB and ASB

The ISAs and SASs define significant risk as "an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration."

450/ Ibid.

451/ Section II.C.7.k.

Auditing Standard No. 13 – The Auditor's Responses to the Risks of Material Misstatement

In this section, the analogous IAASB standards are ISA 330, The Auditor's Responses to Assessed Risks, and ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements (collectively referred to in this section as "the ISAs"). The analogous ASB standards are the clarified SAS, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (Redrafted), and the proposed SAS, Consideration of Fraud in a Financial Statement Audit (Redrafted) (collectively referred to in this section as "the SASs").

(i). Objective

PCAOB

The objective of the auditor in Auditing Standard No. 13 is "to address the risks of material misstatement through appropriate overall audit responses and audit procedures." The objective in the proposed standard emphasizes the auditor's responsibility for responding to the risks of material misstatements. This release contains additional discussion regarding the objective of the standard.[452/]

[452/] Section II.C.8.b.

IAASB and ASB

The objective in the ISAs and the SASs is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

(ii). Overall Responses to Risks

PCAOB

Auditing Standard No. 13 requires the auditor to design and implement certain overall responses (e.g., making appropriate assignments of specific engagement responsibilities, providing an appropriate extent of supervision, incorporating elements of unpredictability in selecting auditing procedures, and evaluating the company's selection and application of significant accounting principles) to address risks of material misstatement. These responses are not limited to addressing risks at the financial statement level. They are also intended to address risks at the significant account or disclosure level due to the nature of these specific overall responses. This release contains additional discussion of this requirement.[453/]

[453/] Section II.C.8.c.

IAASB and ASB

The ISAs and the SASs include requirements to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level and requirements for particular types of responses to the risks of material misstatement due to fraud at the financial statement level.

(iii). Determination of the Need for Pervasive Changes

PCAOB

Auditing Standard No. 13 requires the auditor to determine whether it is necessary to make pervasive changes to the nature, timing, or extent of audit procedures to adequately address the assessed risk of material misstatement. Examples of such pervasive changes include modifying the audit strategy to increase the substantive testing of the valuation of numerous significant accounts at year end because of significantly deteriorating market conditions and to obtain more pervasive audit evidence from substantive procedures due to the identification of pervasive weaknesses in the company's control environment. This release includes detailed discussions regarding making pervasive changes as an overall response to risks of material misstatement.[454/]

[454/] Ibid.

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(iv). Application of Professional Skepticism

PCAOB

Auditing Standard No. 13 states that due professional care requires the auditor to exercise professional skepticism, requires that the auditor apply professional skepticism in gathering and evaluating audit evidence in response to risks of material misstatement, and provides examples of the appropriate application of professional skepticism. This release includes additional discussion regarding application of professional skepticism.[455/]

IAASB and ASB

The ISAs state

> ...the auditor shall maintain an attitude of professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance.

455/ Ibid.

The SASs include a requirement similar to the ISAs' requirement.

(v). Evidence about the Effectiveness of Controls

PCAOB

In discussing testing controls in an audit of financial statements, Auditing Standard No. 13 establishes the principle that the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The greater the reliance on a control, the more persuasive evidence the auditor is required to obtain from the tests of controls.

In addition, the standard requires the auditor to obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls. This release includes additional discussions of these requirements.[456/]

IAASB and ASB

The ISAs and the SASs include a requirement for the auditor to obtain more persuasive audit evidence the greater the reliance he or she plans to place on the effectiveness of a control, but they do not have an analogous requirement regarding situations in which the audit approach consists primarily of tests of controls.

[456/] Section II.C.8.f.(iii).

(vi). Testing the Operating Effectiveness of a Control

PCAOB

Auditing Standard No. 13 requires the auditor to determine whether the control selected for testing is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. The standard also discusses the procedures the auditor performs in testing operating effectiveness. To help facilitate the tests of controls in an integrated audit, the standard continues to use language similar to that of Auditing Standard No. 5 when describing analogous terms and concepts relating to the testing of controls. This release includes additional discussion regarding this requirement.[457]

IAASB

The ISAs do not include an analogous requirement to determine whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

ASB

The SASs state:

In designing and performing tests of controls, the auditor should:

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[457] Section II.C.8.f.(iv).

a. perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including ...by whom or by what means they were applied, including, when applicable, whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

(vii). Tests of Controls in an Integrated Audit

PCAOB

Auditing Standard No. 13 requires the auditor to perform tests of controls in integrated audits to meet the objectives of both the audit of financial statements and the audit of internal control. This release includes additional discussion of this requirement.[458/]

IAASB and ASB

The ISAs and the SASs do not include an analogous requirement.

[458/] Section II.C.8.d.

(viii). Rotational Testing of Controls

PCAOB

Auditing Standard No. 13 requires the auditor to obtain evidence during the current year audit about the design and operating effectiveness of controls upon which the auditor relies. This release includes additional discussion of this requirement.[459]

IAASB and ASB

The ISAs and the SASs include requirements that apply to the use of evidence about controls obtained in prior audits and allow rotational testing of controls under certain conditions set forth in those standards.

(ix). Assessing Control Risk

PCAOB

Auditing Standard No. 13 requires the auditor to assess control risk for relevant assertions by evaluating the evidence from all sources, including the auditor's testing of controls for the audit of internal control and the audit of financial statements, misstatements detected during the financial statement audit, and any identified control deficiencies. The standard also requires that control risk be assessed at the maximum level for relevant assertions (1) for which controls necessary to sufficiently address the

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[459] Section II.C.8.f.(vi).

assessed risk of material misstatement in those assertions are missing or ineffective or (2) when the auditor has not obtained sufficient appropriate audit evidence to support a control risk assessment below the maximum level. This release includes additional discussion of these requirements.[460/]

IAASB and ASB

The ISAs and the SASs include requirements regarding evaluating the operating effectiveness of controls and identified control deviations, but those standards do not require a specific assessment of control risk.

(x). Substantive Procedures

PCAOB

Auditing Standard No. 13 requires the auditor to perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk. This requirement reflects the principle that the auditor needs to implement appropriate responses to address assessed risks of material misstatement. This release contains additional discussion of this requirement.[461/]

460/ Section II.C.8.f.(vii).

461/ Section II.C.8.g.

IAASB

The ISAs state, "Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure."

ASB

The SASs state, "Irrespective of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure."

The requirements in the ISAs and the SASs focus on the accounts and disclosures that are material, regardless of whether they are associated with identified risks of material misstatement.

(xi). Consideration of Confirmations

PCAOB

Auditing Standard No. 13 requires the auditor to perform substantive procedures for each relevant assertion of each significant account and disclosure. The standard also discusses how to determine the types and combination of substantive audit procedures necessary to detect material misstatements in relevant assertions.

AU sec. 330, The Confirmation Process, establishes requirements regarding the use of confirmation procedures.[462] The risk assessment standards discuss the auditor's responsibilities for designing and performing the substantive procedures necessary to address the risks of material misstatement.

IAASB and ASB

ISA 330 specifically requires the auditor to consider whether external confirmation procedures are to be performed as substantive audit procedures. The ASB has proposed to amend the SASs to require the auditor to consider whether external confirmation procedures are to be performed as substantive audit procedures and to require the use of external confirmation procedures for material accounts receivable.

(xii). Determining Whether to Perform Interim Substantive Procedures

PCAOB

Auditing Standard No. 13 requires the auditor to take into account a series of factors when determining whether it is appropriate to perform substantive procedures at an interim date. This release includes provides additional discussion regarding timing of substantive procedures.[463]

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[462] The Board has a separate standards-setting project on confirmations.

[463] Section II.C.8.h.

IAASB and ASB

The ISAs and the SASs do not include an analogous requirement for the auditor to take into account the factors listed in Auditing Standard No. 13 when determining whether it is appropriate to perform substantive procedures at an interim date.

(xiii). Substantive Procedures Covering the Remaining Period

PCAOB

Auditing Standard No. 13 states, "When substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end." The standard contains a specific requirement to compare relevant information about the account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual. This release includes additional discussion of this requirement.[464/]

IAASB and ASB

The ISAs and the SASs include requirements to cover the period between the interim testing date and year end by performing substantive procedures, combined with

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464/ Ibid.

tests of controls for the intervening period, or by performing further substantive procedures only if the auditor determines that doing so would be sufficient. The ISAs and SASs do not include an analogous requirement regarding the specific procedures to be performed.

(xiv). Response to Significant Risks

PCAOB

Auditing Standard No. 13 requires the auditor to perform substantive procedures, including tests of details, that are specifically responsive to significant risks. This release contains additional discussion of this requirement.[465/]

IAASB and ASB

The ISAs state:

> If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

465/ Section II.C.8.i.

The SASs include requirements similar the ISAs' requirements.

(xv). Dual-purpose Tests

PCAOB

Auditing Standard No. 13 states that, when dual-purpose tests are performed, the auditor should design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested. This release contains additional discussion of this requirement.[466]

IAASB and ASB

The ISAs and the SASs do not include analogous requirements.

Auditing Standard No. 14 – Evaluating Audit Results

In this section, the analogous IAASB standards are ISA 450, Evaluation of Misstatements Identified During the Audit, ISA 330, The Auditor's Responses to Assessed Risks, ISA 520, Analytical Procedures, ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements, ISA 540, Auditing Accounting Estimates Including Fair Value Accounting Estimates, and Related Disclosures, and ISA

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[466] Section II.C.8.j.

700, Forming an Opinion and Reporting on Financial Statements (collectively referred to in this section as "the ISAs"). The analogous ASB standards are clarified SAS Evaluation of Misstatements Identified During the Audit, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (Redrafted), Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement (Redrafted), and proposed SAS Consideration of Fraud in a Financial Statement Audit (Redrafted), Analytical Procedures (Redrafted), and Forming an Opinion and Reporting on Financial Statements (collectively referred to in this section as "the SASs").

(i). Performing Analytical Procedures in the Overall Review

PCAOB

In the overall review, Auditing Standard No. 14 contains specific requirements for the auditor to read the financial statements and disclosures and perform analytical procedures to (a) evaluate the auditor's conclusions formed regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement. These requirements were adapted from existing requirements in PCAOB standards.[467/] The conclusions formed from the results of the overall review of the audit are intended to inform the auditor's conclusions

[467/] AU sec. 329.23.

regarding significant accounts and disclosures and the opinion on the financial statements. This release includes additional discussion of these requirements.[468/]

IAASB

The ISAs state:

> The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

ASB

The SASs state:

> The auditor should design and perform analytical procedures near the end of the audit that are intended to corroborate audit evidence obtained during the audit of financial statements to assist the auditor in drawing reasonable conclusions on which to base the auditor's opinion.

468/ Section II.C.9.c.

(ii). Evaluating Evidence from Analytical Procedures

PCAOB

Auditing Standard No. 14 contains a requirement, which was adapted from an existing requirement in PCAOB standards,[469/] for the auditor, as part of the overall review to evaluate whether (a) the evidence gathered in response to unusual or unexpected transactions, events, amounts or relationships previously identified during the audit is sufficient and (b) unusual or unexpected transactions, events, amounts, or relationships indicate risks of material misstatement that were not identified previously, including, in particular, fraud risks. Auditing Standard No. 14 also specifically requires the auditor to evaluate whether the evidence gathered during the audit is sufficient as part of the overall review.

Also, the requirements in Auditing Standard No. 14 relate to risks of material misstatement due to error or fraud, whereas the requirements in the ISAs and SASs are limited to fraud risks. This release includes additional discussion of these requirements in Auditing Standard No. 14.[470/]

IAASB

The ISAs state:

469/ AU sec. 329.23.

470/ Section II.C.9.c.

> The auditor shall evaluate whether analytical procedures that are performed near the end of the audit, when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment, indicate a previously unrecognized risk of material misstatement due to fraud.

<u>ASB</u>

The SASs state:

> The auditor should evaluate whether the accumulated results of auditing procedures, including analytical procedures, that are performed during the audit, in the overall review stage, or in both stages, when forming an overall conclusion concerning whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment, indicate a previously unrecognized risk of material misstatement due to fraud.

(iii). Analytical Procedures Regarding Revenue

PCAOB

Auditing Standard No. 14 includes a requirement, adapted from an existing requirement in AU sec. 316, for the auditor to perform analytical procedures relating to revenue through the end of the period. These procedures are intended to identify unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including material misstatement due to fraud. This release includes additional discussion of this requirement.[471/]

IAASB

The ISAs state:

> The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

The ISAs do not specifically require the auditor to perform analytical procedures related to revenue through the end of the period.

471/ Ibid.

ASB

The SASs require the auditor to perform analytical procedures related to revenue.

(iv). Corroborating Management Explanations

PCAOB

Auditing Standard No. 14 requires the auditor to corroborate management's explanations regarding significant unusual or unexpected transactions, events, amounts, or relationships. Auditing Standard No. 14 also states that if management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail to be useful, the auditor should perform procedures to address the matter. Unlike the ISAs, Auditing Standard No. 14 specifically requires the auditor to corroborate management's explanations regarding significant matters. This release includes additional discussion regarding corroborating management's explanations.[472]

IAASB and ASB

The ISAs and the SASs require the auditor to investigate the identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount by (a) inquiring of management and

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[472] Ibid.

obtaining appropriate audit evidence relevant to management's responses and (b) performing other audit procedures as necessary in the circumstances. The ISAs and the SASs also include a requirement to investigate inconsistent responses to inquiries from management and those charged with governance.

(v). Communication of Accumulated Misstatements

PCAOB

Auditing Standard No. 14 requires the auditor to communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them. Unlike the ISAs and the SASs, Auditing Standard No. 14 does not require the auditor to request management to correct the misstatements. Instead, PCAOB standards focus on communicating the misstatements to management, performing procedures to determine whether management corrected them, understanding the reasons why management might not have corrected the misstatements, and evaluating the effect of uncorrected misstatements on the financial statements and the audit. This release includes additional discussion of this requirement.[473/]

IAASB and ASB

The ISAs and the SASs include requirements to communicate on a timely basis all misstatements accumulated during the audit to an appropriate level of management

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473/ Section II.C.9.j.

and to request that management correct those misstatements.

(vi). Correction of Misstatements

PCAOB

Auditing Standard No. 14 requires that if management has made corrections to accounts or disclosures in response to misstatements detected by the auditor, the auditor should evaluate management's work to determine whether the corrections have been appropriately recorded and determine whether uncorrected misstatements remain. This release includes additional discussion of this requirement.[474/]

IAASB and ASB

The ISAs and the SASs contain a requirement to perform additional audit procedures to determine whether misstatements remain, if at the auditor's request management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected.

The ISAs do not require the auditor to evaluate whether the misstatements that were communicated by the auditor to management have been appropriately corrected by management.

474/ Section II.C.9.f.

(vii). Evaluating Misstatements – Effect on Risk Assessments

PCAOB

Auditing Standard No. 14 contains a requirement to evaluate the nature and the effects of individual misstatements accumulated during the audit on the assessed risks of material misstatement in determining whether the risk assessments remain appropriate. This release includes additional discussion of this requirement.[475/]

IAASB and ASB

The ISAs and the SASs do not include an analogous requirement.

(viii). Evaluating Whether Misstatements Might Be Indicative of Fraud

PCAOB

Auditing Standard No. 14 requires the auditor to perform procedures to obtain additional audit evidence to determine whether fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report if the auditor believes that a misstatement is or might be intentional, and if the effect on the

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475/ Section II.C.9.i.

financial statement cannot be readily determined. This release includes additional discussions of this requirement.[476/]

IAASB and ASB

The ISAs require the auditor to evaluate the implications for the audit if the auditor confirms that or is unable to conclude whether financial statements are materially misstated as a result of fraud. The ISA does not explicitly require the auditor to perform audit procedures to obtain additional audit evidence to determine the effect of the misstatement on the financial statements.

The SASs include a requirement similar to the ISAs' requirement.

(ix). Communications Regarding Fraud

PCAOB

Auditing Standard No. 14 requires the auditor to determine his or her responsibility under AU secs. 316.79-.82A, AU sec. 317, Illegal Acts by Clients, and Section 10A of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j-1, if the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred. AU sec. 316 requires that whenever the auditor has determined that there is evidence that fraud may exist, the auditor should bring that matter to the attention

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476/ Ibid.

of an appropriate level of management.[477] This release includes additional discussion of this requirement.[478]

IAASB and ASB

The ISAs state that if the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management.

The SASs include a requirement similar to the ISAs' requirement.

(x). Evaluating the Qualitative Aspects of the Company's Accounting Practices

PCAOB

Auditing Standard No. 14 states that if the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, the auditor should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements. The standard also contains a requirement for the auditor to evaluate whether the auditor's risk

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477/ AU sec. 316.79.

478/ Section II.C.9.k.

assessments, including the assessment of fraud risks, and the related responses remain appropriate. This release includes additional discussion of these requirements.[479]

IAASB and ASB

The ISAs and the SASs contain a requirement for the auditor to evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

(xi). Management's Identification of Offsetting Adjusting Entries

PCAOB

If management identifies adjusting entries that offset misstatements accumulated by the auditor, Auditing Standard No. 14 requires the auditor to perform procedures to determine why the misstatements were not identified previously and to evaluate the implications on the integrity of management and the auditor's risk assessments, including fraud risk assessments. Auditing Standard No. 14 also requires the auditor to perform

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479/ Section II.C.9.l.

additional procedures as necessary to address the risk of further undetected misstatements. This release includes additional discussion of these requirements.[480/]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(xii). Evaluating Conditions Relating to Assessment of Fraud Risks

PCAOB

Auditing Standard No. 14 requires the engagement partner to determine whether there has been appropriate communication with other engagement team members throughout the audit regarding information or conditions that are indicative of fraud risks. This release includes additional discussion of this requirement.[481/]

IAASB

The ISAs require a discussion among the engagement team members and a determination by the engagement partner of matters to be communicated to those team members not involved in the discussion.

480/ Ibid.

481/ Section II.C.9.m.

ASB

The SASs contain a requirement for the engagement partner to ascertain that appropriate communication exists about the need for the discussion of fraud risks among team members throughout the audit.

Auditing Standard No. 15 – Audit Evidence

In this section, the analogous IAASB and ASB standards are ISA 500, Audit Evidence, and the clarified SAS, Audit Evidence (Redrafted), respectively.

(i). Objective and Overarching Requirement

PCAOB

The objective of the auditor in Auditing Standard No. 15 is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report. The objective of the standard, together with the related requirement regarding audit evidence, articulates the linkage between the auditor's responsibility to obtain sufficient appropriate audit evidence and to support his or her opinion. This release includes additional discussion regarding the objective of the standard.[482/]

[482/] Section II.C.10.c.

IAASB and ASB

The ISA states:

> The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

The ISA also states:

> The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

The SAS includes an objective and a requirement similar to the ISA's objective and requirement.

(ii). Document Authentication

PCAOB

Auditing Standard No. 15 states that the auditor is not expected to be an expert in document authentication. However, if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor is required to modify the planned audit procedures or perform additional audit procedures to respond to those conditions and to evaluate the effect, if any, on the other aspects of the audit. Auditing Standard No. 15 omits protective language, such as "[u]nless the auditor has reason to believe the contrary, the auditor may accept records and document as genuine" that would weaken the requirement. This release includes additional discussion regarding this requirement.[483/]

IAASB and ASB

The ISA states:

> Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further.

The SAS includes a requirement similar to the ISA's requirement.

483/ Section II.C.10.e.

(iii). Selecting Items for Testing to Obtain Audit Evidence

PCAOB

Auditing Standard No. 15 states that the auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure. This requirement links the selection of items for testing to the sufficiency of the audit evidence. This release includes additional discussion of this requirement.[484/]

IAASB and ASB

The ISA states:

> When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure.

The SAS includes a requirement similar to the ISA's requirement.

III. Date of Effectiveness of the Proposed Rules and Timing for Commission Action

Pursuant to Section 19(b)(2)(A)(ii) of the Securities Exchange Act of 1934 ("Exchange Act"), and based on its determination that an extension of the period set forth

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484/ Section II.C.10.j.

will post all comments on the Commission's Internet website (http://www.sec.gov/rules/pcaob/shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule that are filed with the Commission, and all written communications relating to the proposed rule between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File No. PCAOB-2010-01 and should be submitted on or before [insert 21 days from publication in the Federal Register].

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Walter and Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62915 / September 15, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14048

In the Matter of **David G. Rose,** **Respondent.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against David G. Rose ("Rose" 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 Public Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Rose, age 59, orchestrated a fraud through his company, Berkshire Resources, L.L.C. ("Berkshire"), a Wyoming Limited Liability Company established in April 2006, which purported to develop and operate gas and oil properties. Berkshire was the managing partner of several limited partnerships that purported to engage in the same line of business. Berkshire, with the assistance of sales agents operating out of boiler rooms, sold "units of participation" in the limited partnerships and one joint venture to the public. Rose directed Berkshire to pay the agents sales-based commissions for their efforts.

2. On September 2, 2010, a final judgment was entered by consent against Rose, permanently enjoining him from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5, and Section 15(a) of the Exchange Act, in the civil action entitled Securities and Exchange Commission v. Berkshire Resources, L.L.C., et al., Civil Action Number 09-CV-704, in the United States District Court for the Southern District of Indiana.

3. The Commission's complaint alleged that, among other things, from at least April 2006 through December 2007, Rose used Berkshire to carry out an offering fraud and sell unregistered securities. Although his son was put forward as the public face of the company, Rose, who has an extensive disciplinary history, ran the company behind the scenes. The complaint further alleged that Berkshire raised approximately $15.5 million from approximately 265 investors in the US and Canada. The complaint also alleged that Berkshire misled defendants, among other things, about the use of investor proceeds, the experience of Rose's son, Rose's role at the company, and the expected rate of return.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b) of the Exchange Act, that Respondent Rose be, and hereby is barred from association with any broker or dealer.

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Walter and
Commissioner Aguilar
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62916 / September 15, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14049

In the Matter of **Mark D. Long,** **Respondent.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Mark D. Long ("Long" 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 Public Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Long, age 53, lives in Louisville, Kentucky. From about July 2006 through August 2007, Long was the head of sales at Berkshire Resources, L.L.C. ("Berkshire"), a Wyoming Limited Liability Company established in April 2006, which purported to develop and operate gas and oil properties. Long ran a "boiler room" operation out of Berkshire's Jeffersonville, Indiana office which sold "units of participation" in Berkshire's limited partnerships and one joint venture to the public. Long earned transaction-based commissions in connection with the sales of these units of participation in the Berkshire entities.

2. On September 2, 2010, a final judgment was entered by consent against Long, permanently enjoining him from future violations of Sections 5(a) and (c) of the Securities Act of 1933, Section 15(a) of the Exchange Act, in the civil action entitled Securities and Exchange Commission v. Berkshire Resources, L.L.C., et al., Civil Action Number 09-CV-704, in the United States District Court for the Southern District of Indiana.

3. The Commission's complaint alleged that, among other things, from at least April 2006 through December 2007, Berkshire carried out an offering fraud and sold unregistered securities. The complaint further alleged that Berkshire raised approximately $15.5 million from approximately 265 investors in the US and Canada. The complaint also alleged that Berkshire misled defendants, among other things, about the use of investor proceeds, Berkshire's management's experience, and the expected rate of return. The complaint also alleged that Long ran one of two boiler room operations that used teams of sales agents to sell units of participation to the public.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b) of the Exchange Act, that Respondent Long be, and hereby is barred from association with any broker or dealer.

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Walter and Commissioner Aguilar not participating.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62917 / September 15, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14050

In the Matter of **Jason T. Rose,** **Respondent.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Jason T. Rose ("Rose" 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 Public Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Rose, age 36, was held out as the "managing member" of Berkshire Resources, L.L.C. ("Berkshire"), a Wyoming Limited Liability Company established in April 2006, which purported to develop and operate gas and oil properties. Berkshire was the managing partner of several limited partnerships that purported to engage in the same line of business. Berkshire, with the assistance of sales agents operating out of boiler rooms, sold "units of participation" in the limited partnerships and one joint venture to the public.

2. On September 2, 2010, a final judgment was entered by consent against Rose, permanently enjoining him from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5, and Section 15(a) of the Exchange Act, in the civil action entitled Securities and Exchange Commission v. Berkshire Resources, L.L.C., et al., Civil Action Number 09-CV-704, in the United States District Court for the Southern District of Indiana.

3. The Commission's complaint alleged that, among other things, from at least April 2006 through December 2007, Rose and his father used Berkshire to carry out an offering fraud and sell unregistered securities. Although Rose was the public face of the company, his father, who has an extensive disciplinary history, ran the company behind the scenes. The complaint further alleged that Berkshire raised approximately $15.5 million from approximately 265 investors in the US and Canada. The complaint also alleged that Berkshire misled defendants, among other things, about the use of investor proceeds, Rose's experience, his father's role at the company, and the expected rate of return.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b) of the Exchange Act, that Respondent Rose be, and hereby is barred from association with any broker or dealer.

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62920 / September 15, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14051

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

I.

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

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. At various times from October 1981 through December 2002, which includes a portion of the time in which he engaged in the conduct underlying the indictment described below, Respondent was a registered representative with broker-dealers registered with the Commission. Respondent, 65 years old, was a resident of Marietta, Georgia. He is currently incarcerated at the Georgia Diagnostic and Classification Prison located in Jackson, Georgia.

B. RESPONDENT'S CRIMINAL CONVICTION

2. On February 3, 2010, following a jury trial, Constantino was found guilty in State of Georgia v. Frank Constantino, Criminal Action File No.: 09-9-5301-42, in the Superior

Court of Cobb County, Georgia of, among other things, six counts of violations of the Georgia Securities Act involving the offer and sale of securities. Constantino was also found guilty of three counts of theft by taking an investor's funds. On February 18, 2010, he was sentenced to twenty years in prison and ordered to pay restitution of $2.5 million.

3. The counts of the criminal indictment to which Constantino was found guilty alleged, among other things, that Constantino made material misrepresentations and omissions in connection with the offer and sale of securities of several business ventures allegedly located in the Country of Belize, offered and sold unregistered securities, and offered and sold securities while not being registered as a securities dealer, limited dealer, salesman, or limited salesman 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 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; and

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

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

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 210, 229 and 249

[RELEASE NOS. 33-9142; 34-62914]

INTERNAL CONTROL OVER FINANCIAL REPORTING IN EXCHANGE ACT PERIODIC REPORTS OF NON-ACCELERATED FILERS

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is adopting amendments to its rules and forms to conform them to Section 404(c) of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"), as added by Section 989G of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Section 404(c) provides that Section 404(b) of the Sarbanes-Oxley Act shall not apply with respect to any audit report prepared for an issuer that is neither an accelerated filer nor a large accelerated filer as defined in Rule 12b-2 under the Securities Exchange Act of 1934 (the "Exchange Act").

EFFECTIVE DATE: [insert date of publication in the Federal Register]

FOR FURTHER INFORMATION CONTACT: Steven G. Hearne, Special Counsel, Office of Rulemaking, Division of Corporation Finance, at (202) 551-3430, Steven Jacobs, Associate Chief Accountant, Division of Corporation Finance, at (202) 551-3400, or John Offenbacher, Senior Associate Chief Accountant, or Annemarie Ettinger, Senior Special Counsel, Office of the Chief Accountant, at (202) 551-5300, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are adopting conforming amendments to Rule 2-02[1] of

[1] 17 CFR 210.2-02.

Regulation S-X,[2] Item 308[3] of Regulation S-K,[4] Item 15 of Form 20-F,[5] and General Instruction B.(6) of Form 40-F.[6]

I. DESCRIPTION OF AMENDMENTS

The Commission is adopting amendments to its rules and forms to conform them to new Section 404(c) of the Sarbanes-Oxley Act,[7] as added by Section 989G of the Dodd-Frank Act.[8] Section 404(c) provides that Section 404(b) of the Sarbanes-Oxley Act shall not apply with respect to any audit report prepared for an issuer that is neither an accelerated filer nor a large accelerated filer as defined in Rule 12b-2[9] under the Exchange Act.[10] Prior to enactment of the Dodd-Frank Act, a non-accelerated filer[11] would have been required, under existing Commission rules, to include an attestation report of its registered public accounting firm on internal control over financial reporting in

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[2] 17 CFR Part 210.

[3] 17 CFR 229.308.

[4] 17 CFR Part 229.

[5] 17 CFR 249.220f.

[6] 17 CFR 249.240f.

[7] 15 U.S.C. 7201 et seq.

[8] Pub. L. No. 111-203 (July 21, 2010).

[9] 17 CFR 240.12b-2.

[10] 15 U.S.C. 78a et seq.

[11] Although the term "non-accelerated filer" is not defined in Commission rules, we use it throughout this release to refer to a reporting company that does not meet the definition of either an "accelerated filer" or a "large accelerated filer" under Exchange Act Rule 12b-2. Under Exchange Act Rule 12b-2, an accelerated filer is an issuer that "had an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $75 million or more, but less than $700 million, as of the last business day of the issuer's most recently completed second fiscal quarter" and a large accelerated filer is an issuer that "had an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $700 million or more, as of the last business day of the issuer's most recently completed second fiscal quarter". In addition, for both definitions, the issuer needs to have been subject to reporting requirements for at least twelve calendar months, have filed at least one annual report, and not be eligible to use the requirements for smaller reporting companies for its annual and quarterly reports.

the filer's annual report filed with the Commission for fiscal years ending on or after June 15, 2010.[12]

To conform the Commission's rules to Section 404(c) of the Sarbanes-Oxley Act, these amendments remove the requirement for a non-accelerated filer to include in its annual report an attestation report of the filer's registered public accounting firm.[13] We are also adopting a conforming change to our rules concerning management's disclosure in the annual report regarding inclusion of an attestation report to provide that the disclosure only applies if an attestation report is included.[14] Lastly, we are making a conforming change to Rule 2-02(f) of Regulation S-X to clarify that an auditor of a non-accelerated filer need not include in its audit report an assessment of the issuer's internal control over financial reporting.

All issuers, including non-accelerated filers, continue to be subject to the requirements of Section 404(a) of the Sarbanes-Oxley Act. Section 404(a) and its implementing rules require that an issuer's annual report include a report of management on the issuer's internal control over financial reporting.[15]

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[12] See Release No. 33-9072 (Oct. 13, 2009) [74 FR 53628]. Consistent with Sections 404(a) and 404(b) of the Sarbanes-Oxley Act, on June 5, 2003, the Commission adopted initial amendments to its rules and forms requiring companies, other than registered investment companies, to include in their annual reports filed with the Commission a report of management and an accompanying auditor's attestation report on the effectiveness of the company's internal control over financial reporting. See Release No. 33-8238 (June 5, 2003) [68 FR 36636]. Subsequent to the adoption of those rules, the Commission postponed the Section 404(b) auditor attestation requirement for non-accelerated filers, such that the auditor's attestation report for these filers would have first been required for annual reports filed with the Commission for fiscal years ending on or after June 15, 2010. The amendments in this Release will not affect the transition rules applicable for non-accelerated filers with fiscal years ending prior to June 15, 2010.

[13] An issuer that is an accelerated filer or a large accelerated filer continues to be subject to the requirements of Section 404(b) of the Sarbanes-Oxley Act.

[14] See new Item 308(a)(4) of Regulation S-K.

[15] See 17 CFR 229.308(a). For further guidance on management's report, see Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, Release No. 33-8810 (June 20, 2007) [72 FR 35324]. All such reports for non-accelerated filers for fiscal years ending on or after June 15, 2010 will be considered "filed" under the Exchange Act. Although there are many different ways to conduct an evaluation of the effectiveness of internal control over financial reporting, an evaluation that is conducted in accordance with this interpretive guidance is one way to satisfy the requirements for the evaluation.

II. PROCEDURAL AND OTHER MATTERS

Under the Administrative Procedure Act, a notice of proposed rulemaking is not required when the agency, for good cause, finds that notice and public comment are impracticable, unnecessary, or contrary to the public interest.[16] These amendments merely conform certain rules and forms to a newly enacted statute, Section 404(c) of the Sarbanes-Oxley Act, as amended by the Dodd-Frank Act, so the Commission finds that it is unnecessary to publish notice of these amendments.[17] These amendments revise the Commission's rules and forms to make them consistent with the internal control reporting requirements for non-accelerated filers in the Sarbanes-Oxley Act, as amended by the Dodd-Frank Act, and should therefore minimize potential confusion of issuers and investors.

The Administrative Procedure Act also requires publication of a rule at least 30 days before its effective date unless the agency finds otherwise for good cause.[18] The Commission finds there is good cause for the amendments to take effect on [insert date of publication in the Federal Register] because the Commission's current applicable rules and forms do not conform to Section 404(c) of the Sarbanes-Oxley Act.

The Commission is taking this action to implement the Dodd-Frank Act. Thus, any costs and benefits to the economy resulting from these amendments are mandated by the Dodd-Frank Act. Section 23(a)(2) of the Exchange Act requires the Commission, in adopting rules under the Exchange Act, to consider the competitive effects of such rules, if any, and to refrain from adopting a rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of

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[16] 5 U.S.C. 553(b).

[17] This finding also satisfies the requirements of 5 U.S.C. 808(2), allowing the rule amendment to become effective notwithstanding the requirement of 5 U.S.C. 801 (if a federal agency finds that notice and public comment are "impractical, unnecessary or contrary to the public interest," a rule "shall take effect at such time as the federal agency promulgating the rule determines"). For similar reasons, the amendments do not require analysis under the Regulatory Flexibility Act. See 5 U.S.C. 601(2) (for purposes of Regulatory Flexibility Act analysis, the term "rule" means "any rule for which the agency publishes a general notice of proposed rulemaking").

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

the Exchange Act.[19] Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and must consider or determine if an action is necessary or appropriate in the public interest, to consider if the action will promote efficiency, competition, and capital formation.[20] We do not anticipate any competitive or capital formation effects from these amendments as they merely conform certain rules and forms to new Section 404(c) of the Sarbanes-Oxley Act. We do not anticipate that these conforming amendments will impose any costs, and they may promote efficiency by eliminating potential confusion that may otherwise result from a discrepancy between our rules and the statute.

New Section 404(c) of the Sarbanes-Oxley Act will have an effect on the "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[21] The current burden estimates for the relevant forms include 0.5 hours for approximately 4,700 non-accelerated filers attributable to the burden of filing the auditor attestation report and related disclosure, but not the audit work. As a result of the statutory change, those non-accelerated filers no longer are required to include that attestation.[22]

III. STATUTORY BASIS AND TEXT OF AMENDMENTS

The amendments described in this release are made under the authority set forth in Section 19 of the Securities Act, Sections 3, 12, 13, 15, and 23 of the Exchange Act, and Sections 3(a) and 404 of the Sarbanes-Oxley Act.

List of Subjects

17 CFR Part 210

Accountants, Accounting, Reporting and recordkeeping requirements, Securities.

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[19] 15 U.S.C. 78w(a)(2).

[20] 15 U.S.C. 78c(f).

[21] 44 U.S.C. 3501 et seq.

[22] We are issuing a separate notice regarding the impact of this change on paperwork burdens.

17 CFR Parts 229 and 249

Reporting and recordkeeping requirements, Securities.

TEXT OF AMENDMENTS

In accordance with the foregoing, 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), 77nn(25), 77nn(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w, 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. In Section 210.2-02, paragraph (f) is amended by revising paragraph (f) to read as follows:

* * * * *

(f) Attestation report on internal control over financial reporting. (1) Every registered public accounting firm that issues or prepares an accountant's report for a registrant, other than a registrant that is neither an accelerated filer nor a large accelerated filer (as defined in § 240.12b-2 of this chapter) or an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), that is included in an annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) containing an assessment by management of the effectiveness of the registrant's internal control over financial reporting must include an attestation report on internal control over financial reporting.

(2) If an attestation report on internal control over financial reporting is included in an annual

report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), it shall clearly state the opinion of the accountant, either unqualified or adverse, as to whether the registrant maintained, in all material respects, effective internal control over financial reporting, except in the rare circumstance of a scope limitation that cannot be overcome by the registrant or the registered public accounting firm which would result in the accounting firm disclaiming an opinion. The attestation report on internal control over financial reporting shall be dated, signed manually, identify the period covered by the report and indicate that the accountant has audited the effectiveness of internal control over financial reporting. The attestation report on internal control over financial reporting may be separate from the accountant's report.

* * * * *

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.

* * * * *

4. Section 308 is amended by revising paragraphs (a)(4) and (b) to read as follows:

§ 229.308 (Item 308) Internal control over financial reporting.

(a) * * *

(4) If the registrant is an accelerated filer or a large accelerated filer (as defined in § 240.12b-2 of this chapter), or otherwise includes in its annual report a registered public accounting firm's attestation report on internal control over financial reporting, a statement that the registered

public accounting firm that audited the financial statements included in the annual report containing the disclosure required by this Item has issued an attestation report on the registrant's internal control over financial reporting.

(b) Attestation report of the registered public accounting firm. If the registrant is an accelerated filer or a large accelerated filer (as defined in § 240.12b-2 of this chapter), provide the registered public accounting firm's attestation report on the registrant's internal control over financial reporting in the registrant's annual report containing the disclosure required by this Item.

* * * * *

PART 249 – FORMS, SECURITIES EXCHANGE ACT OF 1934

5. The authority citation for Part 249 continues to read, in part, as follows:

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

* * * * *

6. Form 20-F (referenced in § 249.220f) is amended by revising paragraphs (b)(4) and (c) of Item 15 to read as follows:

Note: The text of Form 20-F does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 20-F

* * * * *

PART II

* * * * *

Item 15. Controls and Procedures.

* * * * *

(b) * * *

(4) If an issuer is an accelerated filer or a large accelerated filer (as defined in § 240.12b-2

of this chapter), or otherwise includes in its annual report a registered public accounting firm's attestation report on internal control over financial reporting, a statement that the registered public accounting firm that audited the financial statements included in the annual report containing the disclosure required by this Item has issued an attestation report on management's assessment of the issuer's internal control over financial reporting.

(c) Attestation report of the registered public accounting firm. If an issuer is an accelerated filer or a large accelerated filer (as defined in § 240.12b-2 of this chapter), and where the Form is being used as an annual report filed under Section 13(a) or 15(d) of the Exchange Act, provide the registered public accounting firm's attestation report on management's assessment of the issuer's internal control over financial reporting in the issuer's annual report containing the disclosure required by this Item.

* * * * *

7. Form 40-F (referenced in § 249.240f) is amended by revising paragraphs (c)(4) and (d) in General Instruction B.(6) to read as follows:

Note: The text of Form 40-F does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 40-F

* * * * *

GENERAL INSTRUCTIONS

* * * * *

B. Information To Be Filed on this Form

* * * * *

(6) * * *

(c)(4) If an issuer is an accelerated filer or a large accelerated filer (as defined in 17 CFR

240.12b-2), or otherwise includes in its annual report a registered public accounting firm's attestation report on internal control over financial reporting, a statement that the registered public accounting firm that audited the financial statements included in the annual report containing the disclosure required by this Item has issued an attestation report on management's assessment of the issuer's internal control over financial reporting.

(d) Attestation report of the registered public accounting firm. If an issuer is an accelerated filer or a large accelerated filer (as defined in § 240.12b-2 of this chapter), and where the Form is being used as an annual report filed under Section 13(a) or 15(d) of the Exchange Act, provide the registered public accounting firm's attestation report on management's assessment of the issuer's internal control over financial reporting in the issuer's annual report containing the disclosure required by this Item.

* * * * *

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: September 15, 2010

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 201

[RELEASE NO. 34-62921]

Rescission of Rules Pertaining to the Payment of Bounties for Information Leading to the Recovery of Civil Penalties for Insider Trading

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[1] repealed former Section 21A(e) of the Securities Exchange Act of 1934, which had authorized the Securities and Exchange Commission ("Commission") to make monetary awards to persons who provided information leading to the recovery of civil penalties for insider trading violations. Because the statutory basis for the insider trading bounty program has been removed, the Commission is rescinding rules promulgated to administer the program.

EFFECTIVE DATE: [Insert date of publication in the Federal Register].

FOR FURTHER INFORMATION CONTACT: Kenneth H. Hall, Assistant Chief Counsel, (202) 551-4936, Office of Chief Counsel, Division of Enforcement, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6553.

SUPPLEMENTARY INFORMATION: The Insider Trading and Securities Fraud Enforcement Act of 1988 authorized the Commission to award bounties to persons who provided information leading to the recovery of civil penalties for insider trading violations; the bounty provision was codified as former Section 21A(e) of the Securities Exchange Act of 1934 ("Exchange Act"). In 1989, the Commission adopted procedural rules to administer the insider

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[1] Public Law 111-203, 124 Stat. 1376 (July 21, 2010).

trading bounty program. See Applications for Bounty Awards on Civil Penalties Imposed in Insider Trading Litigation, Exchange Act Release No. 26994 (June 30, 1989).

The Dodd-Frank Act created a new and broader program for making monetary awards to whistleblowers, codified as Section 21F of the Exchange Act.[2] Under the new whistleblower program, the Commission is authorized to make awards to persons who voluntarily provide the Commission with "original information" about a violation of the federal securities laws that leads to the successful enforcement of a "covered judicial or administrative action," or a "related action," as those terms are defined by the Dodd-Frank Act. Unlike the insider trading bounty program, awards may be paid in connection with original information concerning any violation of the federal securities laws. Awards may range from 10 to 30 percent of the amounts collected as monetary sanctions imposed in the covered judicial or administrative action or related actions.

In connection with enactment of the new whistleblower provision, Congress repealed Section 21A(e).[3] Because that statutory provision is no longer available as a basis for awarding bounties in insider trading cases, the Commission is rescinding its rules for administration of the insider trading bounty program.

Procedural and Other Matters

The Administrative Procedure Act ("APA") generally requires an agency to publish notice of a proposed rulemaking in the Federal Register.[4] This requirement does not apply, however, if the agency "for good cause" finds ... that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest."[5] Because the statutory authority for the insider trading bounty program has been repealed, the Commission is removing the rules

[2] Section 922 of the Dodd-Frank Act.
[3] Section 923(b) of the Dodd-Frank Act.
[4] See 5 U.S.C. § 553(b).
[5] 5 U.S.C. § 553(b).

administering the program from the Federal Register. These rules no longer have any practical effect, and their continued inclusion in the Federal Register might lead to public confusion. For these reasons, the Commission finds that good cause exists to dispense with public notice and comment because notice and comment would be unnecessary, impracticable and contrary to the public interest.[6] For similar reasons the Commission finds good cause for this action to be effective immediately.[7]

Section 23(a)(2) of the Exchange Act requires the Commission to consider the competitive effects of rulemaking under the Exchange Act. Further, Section 3(f) of the Exchange Act 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. Because Congress has repealed the insider trading bounty program, our removal of the procedural rules related to that program will not create any competitive advantages or disadvantages, or affect efficiency, competition, and capital formation.

Statutory Authority and Text of Amendments

The Commission is removing regulations pursuant to authority provided by Section 23(a) of the Exchange Act.

List of Subjects in 17 CFR Part 201

Administrative practice and procedure.

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6 Similarly, the amendments do not require analysis under the Regulatory Flexibility Act. See 5 U.S.C. §§ 601(2) and 603(a) (for purposes of Regulatory Flexibility Act analysis, the term "rule" means any rule for which the agency publishes a general notice of proposed rulemaking).

7 Additionally, this finding satisfies the requirements for immediate effectiveness under the Small Business Regulatory Enforcement Fairness Act. See 5 U.S.C. § 808(2); see also 5 U.S.C. § 801(a)(4).

TEXT OF AMENDMENTS

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

PART 201—RULES OF PRACTICE

1. The authority citation for part 201 continues to read as follows:

Authority: 15 U.S.C. 77s, 77sss, 78w, 78x, 80a-37, and 80b-11; 5 U.S.C. 504(c)(1).

Subpart C – [Removed and Reserved]

2. Remove and reserve Subpart C.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Date: September 15, 2010

Commissioner Walter
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3084 / September 16, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14053

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

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against David R. Slaine ("Slaine" or "Respondent").

II.

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

III.

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

1. Slaine, 51 years old, is a resident of New York, New York.

2. In 2002, Slaine was a portfolio manager at the investment adviser DSJ International Resources Ltd. (d/b/a Chelsey Capital).

3. On September 16, 2010, a final judgment was entered by consent against Slaine, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, in the civil action entitled Securities and Exchange Commission v. David R. Slaine, 10-CV-754 (DAB), filed in the United States District Court for the Southern District of New York.

4. The Commission's complaint alleged, inter alia, that in 2002, Slaine was tipped material, nonpublic information concerning upcoming analyst recommendations by UBS Securities LLC, and that he engaged in illegal insider trading by using this information to purchase and sell securities in his personal account and on behalf of Chelsey Capital.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 203(f) of the Advisers Act, that Respondent Slaine be, and hereby is barred from association with any investment adviser.

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.

Respondent acknowledges that the Commission is not imposing a civil penalty based upon his cooperation in a Commission investigation and related enforcement action. If at any time following the entry of the Order, the Division of Enforcement ("Division") obtains information indicating that Respondent knowingly provided materially false or misleading information or materials to the Commission or in a related proceeding, the Division may, at its sole discretion and without prior notice to the Respondent, petition the Commission to reopen this matter and seek an order directing that the Respondent pay a civil money penalty. Respondent may not, by way of defense to any resulting administrative proceeding: (1) contest the findings in the Order; or (2) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT COMPANY ACT OF 1940
Release No. 29417 / September 17, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14055

In the Matter of **DAXOR CORPORATION,** **Respondent.**	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 9(f) OF THE INVESTMENT COMPANY ACT OF 1940**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 9(f) of the Investment Company Act of 1940 ("Investment Company Act" or "the Act") against Daxor Corporation ("Daxor," "the Company," or "Respondent").

II.

After an investigation, the Division of Enforcement alleges that:

SUMMARY

1. Daxor, a public company, claims to be a medical device manufacturing company, but it is, and has been for many years, an investment company as defined by Section 3(a)(1)(C) of the Investment Company Act, because it engages in the business of investing and trading in securities and 40% or more of its total assets (other than Government securities and cash items) consist of investment securities. Although its principal product has been developed and available for sale since at least 1998, Daxor has never realized an operating profit or even significant operating revenue. Instead, Daxor has sustained itself throughout its history on the considerable income generated by its investment securities, which, as of June 30, 2010, had a reported market value of approximately $49 million and constituted 96% of the company's assets. Over the last five and a half years, Daxor's investment securities have consistently constituted more than 90% of its assets and its net investment income has amounted to more than 750% of its gross operating revenues.

2. Daxor's securities portfolio is invested entirely in equities and actively traded. The portfolio has turned over two times per year on average since 2006. The Company also trades options and maintains short positions up to 15% of the portfolio value, and it finances its investment activity with margin loans that on occasion have amounted to as much as 18% of the total value of its portfolio.

3. Daxor is not exempted or excluded from the requirements of the Investment Company Act. Yet it has never registered with the Commission as an investment company, in violation of Section 7(a) of the Act.

RESPONDENT

4. **Daxor** is a publicly-traded company headquartered in New York, New York. The Company also maintains facilities in Oakridge, Tennessee. Daxor's common stock is registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 and trades on the American Stock Exchange under the symbol "DXR." As of August 9, 2010, Daxor had 4.24 million shares outstanding. Daxor's fiscal year ends on December 31. As of February 22, 2010, the Company reportedly had a labor force of forty-one.

FACTS

Background

5. Daxor purports to be a "medical device manufacturing company with additional biotechology services." It was founded in 1970 to engage in the business of cryobanking – the freezing and preservation at low temperatures of blood and semen – and raised $2 million in an initial public offering in 1971. The Company continues to engage in cryobanking, but for the past fifteen years its major focus has been on the development and marketing of what it calls the BVA-100® Blood Volume Analyzer, an instrument that reportedly measures human blood volume.

6. In 1985, the Company raised approximately $7.2 million for the development of the blood volume analyzer through a second registered offering. In the registration statement, Daxor stated that it expected to use $5,325,000 of the net proceeds to repay the Company's margin borrowings in full and that it would "not make additional margin borrowings in the foreseeable future." The Company further stated that to fund its development activities, it planned to liquidate its marketable securities portfolio, which, in October 1984 had a market value of approximately $9 million, "when and to the extent advantageous to it," in light of market conditions and credit terms available to it, and invest the proceeds not needed for development in U.S. government securities.

7. The Company did not liquidate its marketable securities or invest in government securities after the follow-on offering. Instead, it continued to generate income from its investment securities and used this income to offset expenses, to buy other securities, and, on occasion, to pay dividends. In 2008 and 2009, the Company paid total dividends of $1.50 and $1.35 per share, respectively.

8. Although the BVA-100® received Food and Drug Administration approval in 1997 and the associated test kits were approved in 1998, the product has not been commercially successful. Only one, four and six units were sold in 2009, 2008 and 2007, respectively.

Daxor's Assets Are Comprised Almost Entirely of Investment Securities and Those Securites Are the Source of All Its Income

9. Daxor's assets are comprised almost entirely of investment securities and those securities generate all of its net income and almost all of its gross revenue.[1] As Table 1 shows, for the last five-and-a-half years, Daxor's investment securities have ranged from a low of 91% of assets at December 31, 2009 to a high of almost 98% at the end of 2005.

Table 1 – Nature of Daxor's Assets

	6-30-10	12-31-09	12-31-08	12-31-07	12-31-06	12-31-05
Investment Securities	$48,806,148	$53,270,726	$68,339,143	$74,919,193	$66,968,446	$57,246,006
Operating Assets	$1,870,908	$5,286,837	$5,655,059	$4,741,481	$4,095,103	$1,300,111
Total Assets[2]	$50,677,056	$58,557,563	$73,994,202	$79,660,674	$71,063,549	$58,546,117
% Investment Securities	96.3%	91.0%	92.4%	94.0%	94.2%	97.8%

10. Daxor's revenues and income derive almost entirely from its investment securities. The Company's operating revenue has not exceeded $1.9 million in any of the past five and a half years. By contrast, during the same period, Daxor's net investment income ranged from approximately $3.6 million to $24.9 million and its total net investment income ($67.5 million) was 757% of its total gross operating revenues ($8.9 million). As reflected in Table 2, Daxor's investment income significantly reduced the Company's net loss for the years 2005 and 2006 and was the key factor in its (positive) net income in 2007, 2008, 2009 and the first half of 2010.

1 "Investment securities" refers to "all securities except (A) government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which (i) are not investment companies, and (ii) are not relying on the exception of investment company in paragraph (1) or (7) of subsection (c) of this section." Comparisons of Daxor's investment securities to its "total assets," are based on the amount of total assets exclusive of "government securities" and "cash items," reported in Daxor's consolidated financial statements. "Total assets" excludes "other receivables" – a cash item representing unsettled trades receivables (e.g., cash due from brokers for trades executed but not settled) and money market accounts.

2 "Total assets" excludes "other receivables" – a cash item representing unsettled trades receivables (e.g., cash due from brokers for trades executed but not settled) and money market accounts. If "other receivables" and "money market accounts" are not excluded, the proportion of investment securities to total assets as June 30, 2010 and at year-end 2009, 2008 and 2007 is 60.8%, 70.9%, 89.0%, 73.0%, respectively.

Table 2 – Daxor's Gross Revenue, Operating Losses and Investment Income

	YTD 10*	FY 09	FY 08	FY 07	FY 06	FY 05
Medical Devices Revenue	$590,728	$1,343,610	$1,381,105	$1,453,201	$1,055,706	$751,071
Cryobanking Revenue	$173,876	$345,216	$379,950	$416,578	$430,743	$592,467
Total Operating Revenue	$764,604	$1,688,826	$1,761,055	$1,869,779	$1,486,449	$1,343,538
Net Operating Loss	$(2,847,226)	$(5,109,188)	$(5,207,152)	$(5,430,870)	$(5,436,671)	$(4,915,193)
Net Investment Income	$3,487,309	$12,261,060	$24,888,385	$17,389,110	$4,651,140	$3,579,212
Income Taxes**	$(544,146)	$(1,329,114)	$(4,557,964)	$(1,311,024)	-	-
Net Income (Loss)	$95,937	$5,822,758	$15,123,269	$10,647,216	$(785,531)	$(1,335,981)

* "YTD" means as of June 30th.

** Daxor began paying income taxes in 2007.

11. Daxor's investment income dwarfs its operating revenue. It is not primarily an operating medical device manufacturing or biotechnology company. It is also not a research-and-development company. For the four quarters ended June 30, 2010, the Company's net income from securities was $8,120,018, more than 2.5 times its reported expenses for research and development.[3] Rather, Daxor is an investment company.

<u>Daxor's Investment Policy and Strategy Puts the Company's Capital At Risk</u>

12. Daxor's stated investment goals are "capital preservation, maintaining returns on capital with a high degree of safety and generating income from dividends and option sales to help offset operating losses."

13. In pursuit of those goals, Daxor's investment portfolio, which is managed directly by the Company's chief executive officer, is invested entirely in equities and actively traded. Daxor's management of its investment portfolio puts the Company's capital at risk.

14. The portfolio generates three types of income: dividend income, gain (or loss) on the sale of investments, and gain (or loss) on the Company's options transactions and short positions. As reflected in Table 3 below, since 2005, the percentage of total net investment income derived from the sale of securities and options transactions has increased significantly, to nearly 80% in 2009.

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3 "Net income from securities" is a pre-tax amount that does not include "Other revenues" or "Interest expense."

Table 3 – Nature of Daxor's Investment Income

	YTD 10*	FY 09	FY 08	FY 07	FY 06	FY 05
Dividend Income	$1,087,266	$2,936,976	$2,509,966	$2,419,476	$2,273,737	$2,511,054
% to total**	31%	20%	10%	14%	45%	65%
Sales of Investments	$11,892,159	$9,689,425	$17,249,716	$14,853,934	$3,316,710	$1,515,653
% to total**	341%	78%	69%	84%	66%	40%
Short positions***	$(9,416,999)	$(79,755)	$5,364,215	$357,337	$(544,629)	$(204,225)
% to total**	(270)%	(2)%	21%	2%	-11%	-5%
Other	$(75,117)	$(285,586)	$(235,512)	$(241,637)	$(394,678)	$(243,270)
Net Investment Income	$ 3,487,309	$ 12,261,060	$24,888,385	$17,389,110	$ 4,651,140	$3,579,212

* "YTD" means as of June 30th.
** denotes % of total Investment Income minus "Other."
*** reflects market value of open short positions at end of reporting period.

15. Daxor's investment policy, approved by the Company's board of directors, has generally been to maintain a minimum of 80% of its portfolio in securities of electric utilities; in 2009, the board approved lowering the minimum "temporarily" to 70%. The policy also permits the sale of covered call options on up to 20% of the value of the portfolio and the sale of put options on stocks the company is willing to own. In addition, the policy permits investments in "speculative issues, including short sales," to a maximum of 15% of the portfolio currently, and 20% in 2008.

16. At year-end 2009, in addition to related receivables, Daxor's investment securities consisted of 85% utility common stock, 8.2% non-utility common stock and 6.8% preferred stock. In recent years, the Company has also traded in securities of energy and financial services companies, including USEC, Inc., Dynergy, Citigroup, Inc., Bank of America, and AIG.

17. Daxor's portfolio is actively managed. Since 2006, portfolio turnover has averaged 200% per year and net investment income increased from approximately $4.7 million in 2006 to almost $25 million in 2008 and $12.3 million in 2009, most of it coming from sales of investments, which as a percentage of investment income (net of expenses and other revenue and investment recovery), ranged from 77% to 84% in 2007, 2008 and 2009. The cash flow from the sales of put and call options has increased from $7 million in 2006 to $34 million in 2008 and over $26 million in 2009, contributing significantly to the Company's cash flow. From 2005 through the first half of 2010, the company generated $93.0 million of net cash proceeds from the purchase and sale of options (compared to $37.8 million in negative net cash flow from its long securities purchases and sales), which represents over 400% of the cash flows used for the company's operating activities, and over 300% of the cash flows used by the company's financing activities (payments of dividends, purchase of treasury stock and pay-down of margin loans).

18. The Company finances its investment activity with margin loans and through the use of options, short sales, and other borrowings. As of December 31, 2009, Daxor's short positions constituted 55% of the Company's total liabilities.

VIOLATIONS

19. As a result of the conduct described above, Daxor violated Section 7(a) of the Investment Company Act, which makes it unlawful for an unregistered investment company to, among other things, "directly or indirectly offer for sale, sell or deliver after sale by use of the mails or any means or instrumentality of interstate commerce, any security or interest in a security" or "engage in any business in interstate commerce."

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it appropriate that 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. Whether, pursuant to Section 9(f) of the Investment Company Act, Daxor should be ordered to cease and desist from committing or causing violations of and any future violations of Section 7(a) of the Investment Company Act and should be ordered to comply, or take steps to effect compliance with, Section 7(a) of the Investment Company Act, upon such terms and conditions and within such time as are appropriate.

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

This Order shall be served forthwith upon 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.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62936 / September 17, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13199

In the Matter of **CORNERSTONE CAPITAL MANAGEMENT, INC., and LAURA JEAN KENT,** **Respondents.**	**CORRECTED** **ORDER DIRECTING DISBURSEMENT OF DISGORGEMENT FUND**

On December 18, 2009, the United States Securities and Exchange Commission ("Commission") issued a Notice of Proposed Plan of Distribution and Opportunity for Comment (Exchange Act Rel. No. 61208) pursuant to Rule 1103 of the Commission's Rules on Fair Funds and Disgorgement Plans, 17 C.F.R. §201.1103. The Notice advised parties they could obtain a copy of the Distribution Plan at www.sec.gov. The Notice also advised that all persons desiring to comment on the Distribution Plan could submit their comments, in writing, no later than 30 days from the date of Notice. No comments were received by the Commission in response to the Notice. On March 5, 2010, the Commission issued an Order Approving Plan and Appointing a Plan Administrator (Exchange Act Rel. No. 61653).

The Distribution Plan provides that the Plan Administrator will compile the necessary information regarding the Harmed Investors to be submitted to the Financial Management Service ("FMS") in the required file format, and Commission staff will then obtain authorization from the Commission to disburse pursuant to SEC Rule 1101(b)(6).

Accordingly, it is ORDERED that the Commission staff shall transmit the electronic file containing the necessary information regarding the Harmed Investors to FMS for the transfer and distribution of $119,899.54 in funds to Harmed Investors in accordance with the Distribution Plan.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 229 and 249

Release Nos. 33-9143; 34-62932; File No. S7-22-10

RIN 3235-AK72

SHORT-TERM BORROWINGS DISCLOSURE

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: We are proposing amendments to enhance the disclosure that registrants provide about short-term borrowings. Specifically, the proposals would require a registrant to provide, in a separately captioned subsection of Management's Discussion and Analysis of Financial Condition and Results of Operations, a comprehensive explanation of its short-term borrowings, including both quantitative and qualitative information. The proposed amendments would be applicable to annual and quarterly reports, proxy or information statements that include financial statements, registration statements under the Securities Exchange Act of 1934, and registration statements under the Securities Act of 1933. We are also proposing conforming amendments to Form 8-K so that the Form would use the terminology contained in the proposed short-term borrowings disclosure requirement.

In a companion release, we are providing interpretive guidance that is intended to improve overall discussion of liquidity and capital resources in Management's Discussion and Analysis of Financial Condition and Results of Operations in order to facilitate understanding by investors of the liquidity and funding risks facing the registrant.

DATES: Comments should be received on or before [insert date 60 days after publication in the Federal Register].

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml);
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-22-10 on the subject line; or
- Use the Federal Rulemaking ePortal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

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

All submissions should refer to File Number S7-22-10. 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 website (http://www.sec.gov/rules/proposed.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 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: Christina L. Padden, Attorney Fellow in the Office of Rulemaking, at (202) 551-3430, or Stephanie L. Hunsaker, Associate Chief Accountant, at (202) 551-3400, in the Division of Corporation Finance; or Wesley R. Bricker, Professional

Accounting Fellow, Office of the Chief Accountant at (202) 551-5300; U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are proposing amendments to Item 303[1] of Regulation S-K[2] and amendments to Forms 8-K[3] and 20-F[4] under the Securities Exchange Act of 1934 ("Exchange Act").[5]

The proposed amendments include:

- a new disclosure requirement in Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") relating to short-term borrowings that would be designated as Item 303(a)(6) of Regulation S-K;
- amendments to Item 303(b) of Regulation S-K that would require interim period disclosure of short-term borrowings with the same level of detail as is proposed for annual presentation;
- conforming amendments to Item 5 of Form 20-F to add short-term borrowings disclosure requirements;
- conforming amendments to the definition of "direct financial obligations" in Items 2.03 and 2.04 of Form 8-K; and
- revisions to Item 303 of Regulation S-K and Item 5 of Form 20-F to update the references to United States generally accepted accounting principles ("U.S. GAAP") to reflect the

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1 17 CFR 229.303.

2 17 CFR 229.10 et al.

3 17 CFR 249.308.

4 17 CFR 249.220f.

5 15 U.S.C. 78a et seq.

release by the Financial Accounting Standards Board ("FASB") of its FASB Accounting Standards Codification ("FASB Codification").

TABLE OF CONTENTS

VII. SMALL BUSINESS REGULATORY ENFORCEMENT FAIRNESS ACT

VIII. INITIAL REGULATORY FLEXIBILITY ACT ANALYSIS

A. Reasons for, and Objectives of, the Proposed Action

B. Legal Basis

C. Small Entities Subject to the Proposed Action

D. Reporting, Recordkeeping, and other Compliance Requirements

E. Duplicative, Overlapping, or Conflicting Federal Rules

F. Significant Alternatives

G. Solicitation of Comments

IX. STATUTORY AUTHORITY AND TEXT OF THE PROPOSED AMENDMENTS

I. BACKGROUND AND SUMMARY

Over the past several years, we have provided guidance and have engaged in rulemaking initiatives to improve the presentation of information about funding and liquidity risk.[6] As we have emphasized in past guidance, MD&A disclosure relating to liquidity and capital resources is critical to an assessment of a company's prospects for the future and even the likelihood of its survival.[7] We believe that leverage and liquidity continue to be significant areas of focus for investors,[8] particularly as many failures in the financial crisis arose due to liquidity constraints.[9]

A critical component of a company's liquidity and capital resources is often its access to short-term borrowings for working capital and to fund its operations.[10] Traditional sources of

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6 See, e.g., Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments, Release No. 33-8144 (Nov. 4, 2002) [67 FR 68054] (the "OBS Proposing Release"); Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments, Release No. 33-8182 (Jan. 28, 2003) [68 FR 5982] (the "OBS Adopting Release") (adopting rules for disclosure in MD&A of off-balance sheet arrangements and aggregate contractual obligations); and Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8350 (Dec. 19, 2003) [68 FR 75056] (the "2003 Interpretive Release") (providing interpretive guidance on disclosure in MD&A, including liquidity and capital resources).

7 See 2003 Interpretive Release, supra note 6, at 75062. See also Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8056 (Jan. 22, 2002) [67 FR 3746] (the "2002 Interpretive Release") and the OBS Adopting Release, supra note 6.

8 See L. H. Pedersen, When Everyone Runs for the Exit, 5 INT'L J. CENT. BANKING 177 (2009) ("[t]he global crisis that started in 2007 provides ample evidence of the importance of liquidity risk....[t]he crisis spilled over to other credit markets, money markets, convertible bonds, stocks and over-the-counter derivatives."); M. Brunnermeier, Deciphering the Liquidity and Credit Crunch 2007-2008, 23 J. ECON. PERSP. 77 (2009); M. Brunnermeier & L. Pedersen, Market Liquidity and Funding Liquidity, 22 REV. FIN. STUD. 2201 (2009); R. Huang, How Committed Are Bank Lines of Credit? Evidence from the Subprime Mortgage Crisis, (working paper) (Aug. 2010), available at http://www.phil.frb.org/research-and-data/publications/working-papers/2010/wp10-25.pdf; P. Strahan et al., Liquidity Risk Management and Credit Supply in the Financial Crisis, (working paper) (May 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1601992.

9 See, e.g., K. Ayotte & D. Steele, Bankruptcy or Bailouts?, 35 J. CORP. L. 469 (2010) (discussing illiquidity and insolvency for financial institutions in the context of the recent financial crisis); When the River Runs Dry, ECONOMIST, Feb. 11, 2010 ("Many of those clobbered in the crisis were struck down by a sudden lack of cash or funding sources, not because they ran out of capital.").

10 See D. Booth & J. Renier, Fed Policy in the Financial Crisis: Arresting the Adverse Feedback Loop, FRBD Economic Letter (Sept. 2009), available at http://www.dallasfed.org/research/eclett/2009/el0907.html ("Many

funding, such as trade credit, bank loans, and long-term or medium-term debt instruments, remain important for many types of businesses.[11] However, other short-term financing techniques, including commercial paper, repurchase transactions and securitizations, have become increasingly common among financial institutions and industrial companies alike.[12]

Recent events have shown that these types of arrangements can be impacted, sometimes severely and rapidly, by illiquidity in the markets as a whole.[13] When market liquidity is low, short-term borrowings present increased risks: that financing rates will increase or terms will become unfavorable, that it will be more costly or impossible to roll over short-term borrowings, or for financial institutions, that demand depositors will withdraw funds.[14]

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businesses were hampered by the squeeze on short-term financing, a key source of working capital needed to prevent deeper reductions in inventories, jobs and wages.").

11 See, generally, B. Becker & V. Ivashina, Cyclicality of Credit Supply: Firm Level Evidence (May 2010) (Harvard Working Paper); C. M. James, Credit Market Conditions and the Use of Bank Lines of Credit, FRBSF Economic Letter 2009-27 (Aug. 2009), available at http://www.frbsf.org/publications/economics/letter/2009/el2009-27; M. Campello et al., Liquidity Management and Corporate Investment During a Financial Crisis (July 2010) (working paper) (examining how non-financial companies choose among various sources of liquidity), available at http://faculty.fuqua.duke.edu/~charvey/Research/Working_Papers/W99_Liquidity_management_and.pdf; V. Ivashina & D. Scharfstein, Bank Lending During the Financial Crisis of 2008, J. FIN. ECON. (forthcoming), available at http://ssrn.com/abstract=1297337 (examining the increase in draw-downs or threats of draw-downs of existing credit lines by commercial and industrial firms and the related impact on bank lending).

12 See S. Sood, Is the Ride Coming to an End?, GLOBAL INVESTOR, May 1, 2009 ("Treasurers need to look harder at a broader range of funding alternatives, e.g., debt factoring, invoice factoring and trade finance which are essentially forms of collateralized financing"); M. Lemmon et al., The Use of Asset-backed Securitization and Capital Structure in Industrial Firms: An Empirical Investigation (May 2010), available at http://www.fma.org.

13 See J. Tirole, Illiquidity and All Its Friends (Bank for International Settlements, Working Paper No. 303, 2010), available at http://www.bis.org ("[t]he recent crisis, we all know, was characterized by massive illiquidity." In addition, "Overall there has been a tremendous increase in the proportion of short-term liabilities in the financial sector"). See also, e.g., P. Eavis, Lehman's Racy Repo, WALL ST. J., Mar. 12, 2010 (suggesting that repo financing "is highly vulnerable in times of panic, as the credit crisis showed"); A. Martin et al., Repo Runs, FRBNY Staff Report No. 444 (Apr. 2010) (demonstrating that institutions funded by short-term collateralized borrowings are subject to the threat of runs similar to those faced by commercial banks).

14 See, e.g., Brunnermeier, supra note 8, at 79-80; see also C. Borio, Market Distress and Vanishing Liquidity: Anatomy and Policy Options (Bank for International Settlements, Working Paper No. 158, 2004), available at http://www.bis.org ("Under stress, risk management practices, funding liquidity constraints, and in the most severe cases, concerns with counter-party risk become critical.").

Moreover, short-term financing arrangements can present complex accounting and disclosure issues, even when market conditions are stable.[15] Due to their short-term nature, a company's use of such arrangements can fluctuate materially during a reporting period, which means that presentation of period-end amounts of short-term borrowings alone may not be indicative of that company's funding needs or activities during the period. For example, a bank that routinely enters into repurchase transactions during the quarter might curtail that activity at quarter-end,[16] resulting in a period-end amount of outstanding borrowings that does not necessarily reflect its business operations or related risks. Likewise, a retailer may have significant short-term borrowings during the year to finance inventory that is sold by year-end (and where those short-term borrowings are repaid by year-end). In that case, where the need to finance inventory purchases fluctuates, impacted by the timing and volume of inventory sales, the ability to have access to short-term borrowings may be very important to the company. Therefore, although the financial services sector has been in the spotlight, the issues arising from short-term borrowings are not limited to that sector.[17]

Recent events have suggested that investors could benefit from additional transparency about companies' short-term borrowings, including particularly whether these borrowings vary

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15 See, e.g., the Division of Corporation Finance, Sample Letter Sent to Public Companies Asking for Information Related to Repurchase Agreements, Securities Lending Transactions, or Other Transactions Involving the Transfer of Financial Assets (Mar. 2010) (the "2010 Dear CFO Letter"), available at http://www.sec.gov/divisions/corpfin/guidance/cforepurchase0310.htm.

16 See V. Kotomin & D. Winters, Quarter-End Effects in Banks: Preferred Habitat or Window Dressing?, 29 J. FIN. RES. 1 (2006); M. Rappaport & T. McGinty, Banks Trim Debt, Obscuring Risks, WALL ST. J., May 25, 2010.

17 See, e.g., W. Dudley, President & CEO, FRBNY, Remarks at the Center for Economic Policy Studies Symposium: More Lessons From the Crisis, (Nov. 13, 2009), available at http://newyorkfed.org/newsevents/speeches/2009/dud091113.html (noting "[a] key vulnerability turned out to be the misplaced assumption that securities dealers and others would be able to obtain very large amounts of short-term funding even in times of stress."); J. Lahart, U.S. Firms Build Up Record Cash Piles, WALL ST. J., June 10, 2010 ("In the darkest days of late 2008, even large companies faced the threat that they wouldn't be able to do the everyday, short-term borrowing needed to make payrolls and purchase inventory.").

materially during reporting periods compared to amounts reported at period-end without investor appreciation of those variations.[18] Although current MD&A rules generally require disclosure of a registrant's use of short-term borrowing arrangements and the registrant's exposure to related risks and uncertainties,[19] without a specific requirement to disclose information about intra-period short-term borrowings, investors may not have access to sufficient information to understand companies' actual funding needs and financing activities or to evaluate the liquidity risks faced by companies during the reporting period. To address these issues, we are proposing to amend the MD&A requirements to enhance disclosure that registrants provide regarding the use and impact of short-term financing arrangements during each reporting period. The principal aspects of the proposals are outlined below.

First, the proposed amendments would add new disclosure requirements relating to short-term borrowings, similar to the provisions for annual disclosure of short-term borrowings that are currently applicable to bank holding companies in accordance with the disclosure guidance set forth in Industry Guide 3, Statistical Disclosure by Bank Holding Companies ("Guide 3").[20] The proposed amendments would codify the Guide 3 provisions for disclosure of short-term borrowings in Regulation S-K, would require disclosure on an annual and quarterly basis, and would be expanded to apply to all companies that provide MD&A disclosure, not only to financial institutions. If the proposals are adopted, we expect to authorize the Commission's staff to

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18 See, e.g., Financial Crisis Inquiry Commission, Hearing on "The Shadow Banking System" (May 5, 2010) (transcript available at http://www.fcic.gov/hearings/pdfs/2010-0505-Transcript.pdf).

19 See Item 303(a)(1) and (2) of Regulation S-K and Instruction 5 to paragraph 303(a) [17 CFR 229.303] (noting that liquidity generally shall be discussed on both a long-term and short-term basis); see also 2002 Interpretive Release, supra note 7 (providing interpretive guidance on MD&A, noting "registrants should consider describing the sources of short-term funding and the circumstances that are reasonably likely to affect those sources of liquidity").

20 See 17 CFR 229.801, Item VII.

eliminate the corresponding provisions of Guide 3 to avoid redundant disclosure requirements.[21]

Second, we are proposing amendments to the requirements applicable to "foreign private issuers" in the "Operating and Financial Review and Prospects" item in Form 20-F to add short-term borrowings disclosure requirements, which would be substantially similar to the proposed amendments to MD&A, but without the requirement for quarterly reporting since foreign private issuers are not subject to quarterly reporting requirements.

Third, we are proposing conforming amendments to the definition of "direct financial obligations" in Items 2.03 and 2.04 of Form 8-K.

Finally, the proposed amendments would update the references to U.S. GAAP in Item 303 of Regulation S-K and Item 5 of Form 20-F to reflect the FASB Codification.

Over time, to enhance the information provided to investors through MD&A we have supplemented the principles-based disclosure requirements governing MD&A with more detailed and specific MD&A disclosure requirements, such as the contractual obligations table and the off-balance sheet arrangements disclosure requirements.[22] Our proposal to require quantitative and qualitative information about short-term borrowings is similarly designed to enhance investor understanding of a company's financial position and liquidity. We emphasize, however, that the addition of these specific disclosure requirements to MD&A supplements, and is not a substitute

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21 Guide 3, as originally promulgated in 1968 under the designations Guide 61 and Guide 3, served as an expression of the policies and practices of the Commission's Division of Corporation Finance in order to assist issuers in the preparation of their registration statements and reports. See Guides for Preparation and Filing of Registration Statements, Release No. 33-4936 (Dec. 9, 1968) [33 FR 18617]. In 1982, these guides were redesignated as Securities Act Industry Guide 3 and Exchange Act Industry Guide 3, and were included in the list of industry guides in Items 801 and 802 of Regulation S-K, but were not codified as rules. See Rescission of Guides and Redesignation of Industry Guides, Release No. 33-6384 [47 FR 11476], at 11476 ("The list of industry guides has been moved to into Regulation S-K, which serves as the central repository of disclosure requirements under the Securities Act and Exchange Act, in order to more effectively put registrants on notice of their existence. These guides remain as an expression of the policies and practices of the Division of Corporation Finance and their status is unaffected by this change.") If the proposed amendments are adopted, the Commission would authorize its staff to amend Guide 3 to eliminate Item VII in its entirety.

22 See Items 303(a)(4) and (5) of Regulation S-K [17 CFR 229.303(a)(4) and (5)].

for, the required discussion and analysis that enables investors to understand the company's business as seen through the eyes of management.[23]

In a companion release, we are providing interpretive guidance that is intended to improve the overall discussion of liquidity and funding in MD&A in order to facilitate understanding by investors of the liquidity and funding risks facing registrants.

II. DISCUSSION OF THE PROPOSED AMENDMENTS

A. Short-Term Borrowings Disclosure

1. Existing Requirements for Disclosure of Short-Term Borrowings

Existing MD&A requirements call for discussion and analysis of a registrant's liquidity and capital resources. With respect to liquidity, registrants must identify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way.[24] Registrants are also required to identify and separately describe internal and external sources of liquidity.[25] With respect to capital resources, a registrant is required to describe any known material trends, favorable or unfavorable, in its capital resources, indicating any expected material changes in the mix and relative cost of such resources.[26] In its discussion of capital resources, a registrant is also required to consider changes between equity, debt and any off-balance sheet financing arrangements.[27] However, other than in connection with this discussion of liquidity and capital resources under Item 303(a)(1) and (2) of Regulation S-K, companies that do not provide

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23 See 2003 Interpretive Release, supra note 6, at 75056.

24 See Item 303(a)(1) of Regulation S-K [17 CFR 229.303(a)(1)].

25 Id.

26 See Item 303(a)(2)(ii) of Regulation S-K [17 CFR 229.303(a)(2)].

27 Id.

Guide 3 disclosure are not subject to any line item requirements for the reporting of specific data regarding short-term borrowing amounts or information about intra-period borrowing levels.

Registrants that are bank holding companies provide statistical disclosures in accordance with the industry guidance set forth in Guide 3.[28] Guide 3 is primarily intended to provide supplemental data to facilitate analysis and to allow for comparisons of sources of income and evaluations of exposures to risk.[29] One of the important provisions of Guide 3 is annual disclosure of average, maximum month-end, and period-end amounts of short-term borrowings.[30] Registrants that follow the provisions of Guide 3 provide three years of annual data, broken out into three categories of short-term borrowings, namely: federal funds purchased and securities sold under agreements to repurchase, commercial paper, and other short-term borrowings.[31] We believe that this data is useful to show the types of short-term financings constituting a portion of the bank holding company's liquidity profile, as well as to highlight differences between period-end and intra-period short-term financing activity and the overall liquidity risks it faces during the period. Given the utility of this data in analyzing liquidity and funding risks, we are proposing to require all registrants to provide disclosure in their MD&A similar to the short-term borrowings information called for by Guide 3.[32] Further, since liquidity and funding risks can change rapidly

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28 See 17 CFR 229.801. Bank holding companies typically include this disclosure in the MD&A section of their filings.

29 See Proposed Revision of Financial Statement Requirements and Industry Guide Disclosures for Bank Holding Companies, Release No. 33-6417 (July 9, 1982) [47 FR 32158] at 32159.

30 See Item VII of Guide 3.

31 Id. Item VII of Guide 3 calls for the presentation of information for each category of short-term borrowings that is reported in the financial statements pursuant Article 9 of Regulation S-X. Rule 9-03.13(3) of Regulation S-X [17 CFR 210.9-03.13(3)] requires separate balance sheet disclosure of "amounts payable for (1) federal funds purchased and securities sold under agreements to repurchase, (2) commercial paper, and (3) other short-term borrowings."

32 As described below in this release, in codifying the Guide 3 short-term borrowings provisions in Regulation S-K, we are proposing several changes from the existing provisions of Item VII of Guide 3. The changes

over the course of a year, we are proposing to require the information for both annual and interim periods.

We note that, in 1994, in connection with the elimination of various financial statement disclosure schedules, the Commission eliminated a short-term borrowings disclosure requirement for registrants that were not bank holding companies, which was similar to the existing Guide 3 short-term borrowings disclosure guidance.[33] Former Rule 12-10 of Regulation S-X[34] required those registrants to include with their financial statements a schedule of short-term borrowings that disclosed the maximum amount outstanding during the year, the average amount outstanding during the year, and the weighted-average interest rate during the period, with amounts broken out into specified categories of short-term borrowings.[35]

While former Rule 12-10 of Regulation S-X was similar to the short-term borrowing requirements proposed in this release, we believe there are important differences. In proposing to eliminate the schedule, the Commission noted that "the disclosures concerning the registrant's liquidity and capital resources that are required in MD&A would appear to be sufficiently informational to permit elimination of the short-term borrowing schedule."[36] Although we believe that a thorough discussion of liquidity and capital resources under existing MD&A requirements

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include: expanding the categories of short-term borrowings that require disclosure; expanding the applicability to all registrants that are required to provide MD&A disclosure; requiring financial companies to provide disclosure of the daily maximum amount during the period, as well as averages on a daily average basis; requiring a discussion and analysis of short-term borrowings arrangements; and requiring quarterly reporting of short-term borrowings. See "Proposed New Short-Term Borrowings Disclosure in MD&A."

33 See Financial Statements of Significant Foreign Equity Investees and Acquired Foreign Businesses of Domestic Issuers and Financial Schedules, Release No. 33-7118 (Dec. 13, 1994) [59 FR 65632].

34 17 CFR 210.12-10.

35 The categories in former Rule 12-10 were amounts payable to: banks for borrowings; factors or other financial institutions for borrowings; and holders of commercial paper.

36 See Financial Statements of Significant Foreign Equity Investees and Acquired Foreign Businesses of Domestic Issuers and Financial Schedules, Release No. 33-7055 (Apr. 19, 1994) [59 FR 21814], at 21818.

often would provide qualitative information comparable to that elicited by the proposed requirements, we expect that the proposed requirements would serve as a useful framework for the provision of both quantitative and qualitative information about short-term borrowings that would supplement the registrant's discussion of liquidity and capital resources. We also believe that, in contrast to the presentation required in the financial statement schedule that was eliminated in 1994, the information would be more useful to investors if it is provided in MD&A, in tabular form, coupled with a discussion and analysis to provide context for the quantitative data.

Among the primary reasons cited for the repeal of Rule 12-10 were the practical difficulties involved in gathering the data and preparing meaningful disclosure.[37] We note that some of those practical difficulties may be less relevant today because of technological advancements in accounting systems that have become more widely used by companies since 1994. In addition, the requirements proposed today contain a number of features designed to address some of the practical difficulties cited by prior commentators in connection with former Rule 12-10. More importantly, however, recent events suggest that more detailed information about average short-term borrowings would facilitate a better understanding of whether a registrant's period-end figures are indicative of levels during the period. In light of these changes, we believe the balance of factors may have shifted, such that the utility of the disclosure justifies the burden of preparing it.

2. Proposed New Short-Term Borrowings Disclosure in MD&A

Summary of Proposed Requirements

We are proposing to amend our MD&A requirements to include a new section that would provide tabular information about a company's short-term borrowings, as well as a discussion and

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[37] See Release No. 33-7118, supra note 30, at 65635.

analysis of those short-term borrowings. We note that the current Guide 3 disclosure of short-term borrowings does not call for a qualitative discussion of the reasons for use by a registrant of the particular types of financing techniques, or of the drivers of differences between average amounts and period-end amounts outstanding for the period. We believe that including a requirement for a narrative explanation together with tabular data would provide important information so that investors can better understand the role of short-term financing and its related risks to the registrant as viewed through the eyes of management.

The proposed amendments would codify in Regulation S-K the Guide 3 provisions for disclosure of short-term borrowings applicable to bank holding companies and would apply to all companies that provide MD&A disclosure, not only to bank holding companies and other financial institutions. If the proposals are adopted, we expect to authorize the Commission's staff to eliminate the corresponding provisions of Guide 3 in their entirety to avoid redundant disclosure requirements for bank holding companies. As proposed, registrants would be required to provide disclosure in MD&A of:

- the amount in each specified category of short-term borrowings at the end of the reporting period and the weighted average interest rate on those borrowings;
- the average amount in each specified category of short-term borrowings for the reporting period and the weighted average interest rate on those borrowings;
- for registrants meeting the proposed definition of "financial company," the maximum daily amount of each specified category of short-term borrowings during the reporting period; and
- for all other registrants, the maximum month-end amount of each specified category short-term borrowings during the reporting period.

We believe that the largest amount of short-term borrowings outstanding during the period is an important data point for assessing the intra-period fluctuation of short-term borrowings and, thus, of liquidity risk. Given the critical nature of liquidity and funding matters to a financial company's business activities, we believe it may be important for an investor to know the maximum amount that a financial company has borrowed in any given period as an indication of its short-term financing needs. We are proposing that financial companies be required to disclose the maximum daily amount of short-term borrowings outstanding. Both Guide 3 and former Rule 12-10 called for disclosure of the maximum month-end amounts, which is the standard we are proposing to require for registrants that are not "financial companies." As explained below, we are proposing monthly, rather than daily, maximum amounts for non-financial companies in view of the costs that non-financial companies may encounter in recording daily amounts and the information needs of investors.

Definition of Short-Term Borrowings

Under the proposed rule, "short-term borrowings" would be defined by reference to the various categories of arrangements that comprise the short-term obligations reflected in a registrant's financial statements, and all registrants would be required to present information for each category of short-term borrowings.[38] Specifically, as proposed, "short-term borrowings" would mean amounts payable for short-term obligations that are:

- federal funds purchased and securities sold under agreements to repurchase;

[38] Consistent with the approach taken in Guide 3 and in former Rule 12-10 of Regulation S-X, we propose to define "short-term borrowings" by reference to the amounts payable for various categories of short-term obligations that are typically stated separately on the balance sheet in accordance with Regulation S-X. Under U.S. GAAP, short-term obligations are those that are scheduled to mature within one year after the date of an entity's balance sheet or, for those entities that use the operating cycle concept of working capital, within an entity's operating cycle that is longer than one year. See FASB ASC 210-10-20. As such, the proposed definition of short-term borrowings is intended to be a subset of short-term obligations under U.S. GAAP.

- commercial paper;
- borrowings from banks;
- borrowings from factors or other financial institutions; and
- any other short-term borrowings reflected on the registrant's balance sheet.[39]

These categories are derived from the categories of short-term borrowings specified in Guide 3 and Rule 9-03 of Regulation S-X,[40] as well as certain categories of current liabilities set forth in Rule 5-02 of Regulation S-X.[41] Registrants that are bank holding companies and other companies that follow Guide 3 prepare their financial statements in accordance with Article 9 of Regulation S-X and present separate line items for categories of short-term borrowings on the face of their balance sheets under Rule 9-03 of Regulation S-X. Registrants that are commercial or industrial companies prepare their financial statements in accordance with Article 5 of Regulation S-X and present separate categories of current liabilities on the face of their balance sheets under Rule 5-02 of Regulation S-X.[42]

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39 This last category is derived from the balance sheet line item in Rule 9-03.13(3) of Regulation S-X [17 CFR 210.9-03.13(3)] for "other short-term borrowings." Amounts that a registrant includes on its balance sheet under a line item for "other short-term borrowings" that do not fall into one of the other proposed categories would be disclosed under this category.

40 17 CFR 210.9-03.

41 Rule 5-02.19(a) of Regulation S-X [17 CFR 210.5-02.19(a)] also requires separate disclosure in the balance sheet of amounts payable to trade creditors, related parties, and underwriters, promoters and employees (other than related parties). Consistent with the approach taken in former Rule 12-10 of Regulation S-X and in existing Guide 3 provisions, we are proposing to define short-term borrowings more narrowly than "current liabilities" or "short-term obligations."

42 Registrants that are insurance companies follow Article 7 of Regulation S-X, which also incorporates certain standards of Article 5. For example, under Rule 7-03.16(b), insurance companies must include disclosure required by Rule 5-02.19(b), if the aggregate short-term borrowings from banks, factors and other financial institutions and commercial paper issued exceeds five percent of total liabilities. See 17 CFR 210.5-02.19(b) and 17 CFR 210.7-03.16(b).

Categories and Disaggregation

Rather than creating different disclosure categories for registrants based solely on existing financial reporting rules applicable to certain types of entities, the proposed requirement draws on the categories from both Rule 9-03 and Rule 5-02 so that a registrant must present each of the categories that is relevant to the types of short-term financing activities it conducts, even if that category is not required to be reported as a separate line item on its balance sheet under Regulation S-X.[43] As a result, for example, registrants currently subject to Guide 3 would need to provide disclosure for the same categories as all other registrants. We believe this approach will result in more meaningful disclosure, since it will elicit more specific information regarding the borrowing methods actually used by the registrant. Foreign private issuers that do not prepare financial statements under U.S. GAAP would be permitted to provide disclosure of categories that correspond to the classifications used for such types of short-term borrowings under the comprehensive set of accounting principles that the company uses to prepare its primary financial statements, so long as the disclosure is provided at a level of detail that satisfies the objective of the disclosure requirement.[44]

The proposed requirements do not include a quantitative threshold for purposes of disaggregating amounts into categories of short-term borrowings. For bank holding companies, this would be a change from existing Guide 3 instructions, which allow categories to be aggregated

43 In such circumstances, a registrant should consider whether additional information should be provided to identify the financial statement line items where the period-end short-term borrowings amounts are reported.

44 See proposed Instruction 1 to Item 5.H of Form 20-F. This approach is consistent with the existing Instruction 5 to Item 5 of Form 20-F for issuers that file financial statements that comply with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"). It is also consistent with the approach taken for tabular disclosure of contractual obligations in Form 20-F for filers that do not use U.S. GAAP.

where they do not exceed 30% of the company's stockholders' equity at the end of the period.[45] On the one hand, including such a threshold could ease the compliance burden for a company where the distinction among categories of short-term borrowings is not material. On the other hand, including such a quantitative threshold could diminish the comparability of information across companies and, more fundamentally, could defeat the objective of specifically highlighting the types of short-term borrowing arrangements that expose registrants to liquidity risks. Accordingly, the allocation of amounts into the various categories is intended to achieve this purpose so that investors can assess the proportionate exposure to the funding risk and market risk inherent in the borrowing arrangements.

In circumstances where aggregate amounts within a category of short-term borrowings are subject to a wide range of interest rates and exchange rates, we note that disclosure of those aggregate amounts may not be comparable or meaningful. For example, a company with operations outside of the United States may have, for a variety of reasons (such as the need to finance its subsidiaries in local currency or as a hedge against an asset denominated in that currency), foreign currency-denominated borrowings that have a significantly higher interest rate than the rate on its dollar-denominated borrowings. Under those circumstances, combining the dollar-denominated borrowings with the foreign currency-denominated borrowings could distort the presentation of the interest rates for the company, causing the combined weighted average interest rate on the borrowings to be much higher than the company would incur to borrow in U.S. dollars alone. This would be particularly true if the borrowings are denominated in the currency of an economy that has experienced high rates of inflation. To address this issue, the proposal would

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45 See Instruction to Item VII of Guide 3. If the proposals are adopted, we expect to authorize our staff to eliminate Item VII of Guide 3 in its entirety. In that case, a registrant that provides Guide 3 information would need to follow the proposed Item 303(a)(6) for its short-term borrowings disclosure in MD&A.

include a requirement to further disaggregate amounts by currency or interest rate to the extent necessary to promote understanding or to prevent aggregate amounts from being misleading. Additional footnote disclosure describing the method for disaggregation is proposed to be required where necessary to an understanding of the data, stating, for example, the timing and exchange rates used for currency translations and any other pertinent data relating to the calculation of the amounts provided.

Requirements for "Financial Companies" and Other Companies

As noted above, the proposed rule would distinguish between registrants that engage in financial activities as their business and all other registrants for purposes of calculating and reporting maximum amounts outstanding and average amounts outstanding during the reporting period. Registrants that are "financial companies" would be required to compile and report data for the maximum daily amounts outstanding (meaning the largest amount outstanding at the end of any day in the reporting period) and the average amounts outstanding during the reporting period computed on a daily average basis (meaning the amount outstanding at the end of each day, averaged over the reporting period). Registrants that are not "financial companies" would be required to report the maximum month-end amounts outstanding (meaning the largest amount outstanding at the end of the last day of any month in the reporting period) and would be required to disclose the basis used for calculating the average amounts reported. These registrants would not be required to present average outstanding amounts computed on a daily average basis, but, under the proposal, the averaging period used must not exceed a month.

For purposes of the proposed requirement, a "financial company" would mean a registrant that, during the relevant reported period, is engaged to a significant extent[46] in the business of lending, deposit-taking, insurance underwriting or providing investment advice, or is a broker or dealer as defined in Section 3 of the Exchange Act,[47] and includes, without limitation, an entity that is, or is the holding company of, a bank, a savings association, an insurance company, a broker, a dealer, a business development company,[48] an investment adviser, a futures commission merchant, a commodity trading advisor, a commodity pool operator, or a mortgage real estate investment trust.[49] Although this non-exclusive list[50] would be provided in the rule as guidance to

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46 We are not proposing a specific threshold or definition of "significant" for this purpose. As described below, we are proposing an instruction that allows a registrant to present the short-term borrowings attributable to any non-financial operations separately using the reporting rules for non-financial companies.

47 15 U.S.C. 78c. See also proposed Item 303(a)(6)(iv) of Regulation S-K and Item 5.H.4 of Form 20-F.

48 Business development companies are a category of closed-end investment companies that are not registered under the Investment Company Act of 1940, but are subject to certain provisions of that Act. See Section 2(a)(48) and Sections 54-65 of the Investment Company Act of 1940 [15 U.S.C. 80a-2(a)(48) and 80a-53-64].

49 A mortgage real estate investment trust, or mortgage REIT, is a type of real estate investment trust that invests in mortgages and interests in mortgages. Mortgage REITs typically rely on the exemption from registration under the Investment Company Act of 1940 provided by Section 3(c)(5)(C) of that Act. [15 U.S.C. 80a-3(c)(5)(C)].

50 We note that the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Pub. L. No. 111-203) ("Dodd-Frank Act") includes defined terms for "financial institution," "financial company," and "non-bank financial company" which are used in various contexts in that legislation. Our proposed definition of "financial company" is informed by the terms used in the legislation, but is not exactly the same. Because each of those terms has a definition specific to the regulatory purpose of the section of the legislation in which it is used, none is perfectly aligned with the disclosure aim of our proposed requirement. Therefore, in keeping with the over-arching principles-based approach to MD&A requirements, we are proposing a definition of "financial company" based on the types of business activities that expose a company to similar liquidity risks that banks face.

The enumerated examples of entities that would be considered "financial companies" for purposes of the proposed rule are similar to the entities covered by the definition of "financial institution" contained in Sec. 803 of the Dodd-Frank Act, which includes: a depository institution, as defined in Section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813); a branch or agency of a foreign bank, as defined in Section 1(b) of the International Banking Act of 1978 (12 U.S.C. 3101); an organization operating under Section 25 or 25A of the Federal Reserve Act (12 U.S.C. 601–604a and 611 through 631); a credit union, as defined in Section 101 of the Federal Credit Union Act (12 U.S.C. 1752); a broker or dealer, as defined in Section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c); an investment company, as defined in Section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3); an insurance company, as defined in Section 2 of the registrants, the proposed definition itself is intentionally flexible, so that disclosure of maximum daily amount outstanding and the average amount outstanding during the reporting period computed on a daily average basis would be required to be provided by registrants that are engaged to a significant extent in the business of lending, deposit-taking, insurance underwriting, providing investment advice, or are brokers or dealers or any of the other enumerated types of entities, regardless of their nominal industry affiliation, organizational structure or primary regulator.

Some registrants that are engaged in both financial and non-financial businesses may meet the definition of "financial company," such as manufacturing companies that have a subsidiary that provides financing to its customers to purchase its products. For those registrants, the costs involved in providing averages computed on a daily average basis and maximum daily amounts of short-term borrowings may not be justified by the benefit to investors, where only a portion of their activities are financial in nature. To address this, the proposal would provide an instruction that would permit a company to provide separate short-term borrowings disclosure for its financial and non-financial business operations. A company relying on the instruction would be required to provide averages computed on a daily average basis and maximum daily amounts for the short-term borrowings arrangements of its financial operations, and would be permitted to follow the requirements and instructions applicable to non-financial companies for purposes of the short-term borrowings arrangements of its non-financial operations. The instruction would also require the

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Investment Company Act of 1940 (15 U.S.C. 80a–2); an investment adviser, as defined in Section 202 of the Investment Advisers Act of 1940 (15 U.S.C. 80b–2); a futures commission merchant, commodity trading advisor, or commodity pool operator, as defined in Section 1a of the Commodity Exchange Act (7 U.S.C. 1a); and any company engaged in activities that are financial in nature or incidental to a financial activity, as described in Section 4 of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(k)).

In addition, we expect that registrants that meet the existing definition of "bank holding company" in Rule 1-02 of Regulation S-X [17 CFR 210.1-02] would be "financial companies" under the proposed definition.

company to provide an explanatory footnote to the table with information to enable readers to understand how the operations were grouped for purposes of the disclosure.

Although investors could benefit from having all registrants provide data for maximum daily amounts and average amounts computed on a daily average basis, we preliminarily believe that it is appropriate to limit these daily requirements to entities that are engaged in activities that are financial in nature. Because of the nature of their business activities, we believe it may be important for an investor to have information about the daily amounts of borrowings of financial companies, particularly where borrowed funds are invested in assets that contribute to their earnings activities. We believe that most banks would be able to track daily short-term borrowings without unreasonable effort or expense, and some companies that engage in financial businesses may already track this type of information for their own risk management purposes.

We expect that many other non-bank companies that engage in these types of activities do not currently track this information on a daily basis, so this proposed requirement could impose significant costs on these entities. On balance, however, we preliminarily believe that the importance of the information in the financial company setting justifies the increased costs. By contrast, for companies that are not financial companies, we are not proposing to require maximum daily amounts or averages calculated on a daily average basis because we preliminarily believe that the information with respect to those issuers is less important to investors than in the context of financial companies, and that the combination of our existing and proposed requirements should provide sufficient information about their use of short-term borrowings. However, we request comment on this issue below.

Narrative Discussion of Short-Term Borrowings

In order to provide context for the short-term borrowings data, we are also proposing to require a narrative discussion of short-term borrowings arrangements.[51] This narrative discussion is not currently included in Guide 3. The topics proposed to be included would be:

- a general description of the short-term borrowings arrangements included in each category (including any key metrics or other factors that could reduce or impair the registrant's ability to borrow under the arrangements and whether there are any collateral posting arrangements) and the business purpose of those arrangements;[52]
- the importance to the registrant of its short-term borrowings arrangements to its liquidity, capital resources, market-risk support, credit-risk support or other benefits;[53]
- the reasons for the maximum amount for the reporting period, including any non-recurring transactions or events, use of proceeds or other information that provides context for the maximum amount; and
- the reasons for any material differences between average short-term borrowings for the reporting period and period-end short-term borrowings.

This proposed short-term borrowings discussion and analysis is intended to highlight short-term financing activities and to complement the other MD&A requirements relating to liquidity and capital resources, but it is not intended to be repetitive of other disclosures relating to liquidity and capital resources. In preparing the short-term borrowings disclosure, we anticipate that a

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51 See proposed Item 303(a)(6)(ii) of Regulation S-K.

52 A discussion of the business purpose of the arrangements might encompass topics such as the use of proceeds of the borrowings and the reasons for the particular structure of the arrangements.

53 Similar to the existing requirement in Item 303(a)(4)(i)(B) of Regulation S-K, this proposed requirement is intended to provide investors with an understanding of the importance to the registrant of its short-term borrowings as a financial matter and as they relate to the funding of its operations and to its risk management activities.

registrant would need to consider its disclosures of cash requirements presented in the contractual obligations table, its disclosures of off-balance sheet arrangements, as well as its other liquidity and capital resources disclosures.[54] For example, the company may have significant payments under operating leases or may have entered into a significant repurchase agreement that is accounted for as a sale that will be settled shortly after the balance sheet date and that are disclosed in the contractual obligations table. To be able to settle these amounts, the company may plan to use existing short-term financing arrangements that will limit its ability to borrow for other purposes, such as making loans or financing inventory, which in turn can impact operations. In this example, the company should discuss these items together and explain the implications. A registrant would need to consider ways to integrate the proposed disclosures, together with disclosures made under existing MD&A requirements, into a clear, comprehensive description of its liquidity profile. For example, a registrant could consider organizing its discussion to address overall liquidity, and then short-term and long-term borrowings and liquidity needs.

As discussed above, we believe investors would benefit from an expanded discussion and analysis about a company's use of short-term borrowings. We believe that disclosure of a company's short-term borrowings data, with a comprehensive discussion of its overall approach to short-term financings and the role of short-term borrowings in the company's funding of its operations and business plan, can provide investors with additional information necessary to better evaluate a registrant's current short-term liquidity profile and potential future trends in its liquidity and funding risks.

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54 See Item 303(a)(1) and (a)(2) of Regulation S-K.

Request for Comment

1. Is information about short-term borrowings and intra-period variations in the level of short-term borrowings useful to investors? If so, should we require specific line item disclosure of this information in MD&A, as proposed, or would existing MD&A requirements for disclosure of liquidity and capital resources provide sufficient disclosure about these issues? If a specific MD&A requirement would be appropriate, does the proposed requirement capture the type of information about short-term borrowings that is important to investors? If not, how should we change the proposed requirement? For example, should we require disclosure of the weighted average interest rate on the short-term borrowings, as proposed?

2. Consistent with the approach taken in Guide 3 and in former Rule 12-10 of Regulation S-X, we propose to define "short-term borrowings" by reference to the amounts payable for various categories of short-term obligations that are typically reflected as short-term obligations on the balance sheet and stated as separate line items in accordance with Regulation S-X. Is the proposed definition sufficiently clear? If not, what changes should be made to the proposed definition? For example, should the definition refer to "short-term obligations" as defined in U.S. GAAP?[55] In connection with any response, please provide information as to the costs associated with the implementation of any changes to the proposed definition.

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55 See, e.g., FASB ASC 210-10-20 ("Short-term obligations are those that are scheduled to mature within one year after the date of an entity's balance sheet or, for those entities that use the operating cycle concept of working capital described in paragraphs 210-10-45-3 and 210-10-45-7, within an entity's operating cycle that is longer than one year.").

3. Are the proposed categories of short-term borrowings appropriate? If not, why not, and how should we change the proposed requirement? For example, should we apply different categories to Guide 3 companies as compared to other companies, as was the case when former Rule 12-10 of Regulation S-X was in effect? Are the proposed categories appropriately tailored so that companies can monitor and provide the proposed disclosure? In particular, is the category for "any other short-term borrowings reflected on the registrant's balance sheet" too broad? If so, how should it be narrowed? Are there other categories of short-term borrowings that should be broken out? For example, should amounts relating to repurchase arrangements be disaggregated into those that are collateralized by U.S. Treasury securities and those that are collateralized by other assets? If so, please include in your discussion the reasons such information would be meaningful to investors and provide an indication of the costs and burdens associated with providing that level of detail.

4. Is disaggregation by currency or other grouping useful to the understanding of aggregate short-term borrowing amounts? Would the proposed requirement for disaggregation provide an appropriate level of detail? Is it sufficiently clear? Instead, should we prescribe a specified method or threshold for disaggregation? If so, describe it. For example, should we require information to be presented separately by currency where there is a significant amount of borrowings that are not denominated in the company's reporting currency? If so, should we specify a threshold amount (e.g., 5, 15 or 20% of borrowings) and what should that threshold be? Or should the amounts instead be disaggregated into more generalized categories, such as "domestic" and "foreign" borrowings? Please provide details about the costs and

benefits of any alternatives to the proposed disaggregation provision, and discuss whether requiring companies to follow a specific disaggregation method would impose practical difficulties on companies (or particular types of companies) when they are gathering and compiling the proposed short-term borrowings disclosure.

5. We note that Guide 3 currently provides a quantitative threshold for separate disclosure of short-term borrowings by category. The proposed short-term borrowings provision does not contain a specific quantitative disclosure threshold for separate disclosure of amounts in the different categories of short-term borrowings. Should we establish a quantitative disclosure threshold for the separate categories of short-term borrowings, such as above a specified percentage of liabilities or stockholders' equity (e.g., 5, 10, 20, 30 or 40%)? If so, how should the threshold be computed? Should this quantitative disclosure threshold apply to all companies?

6. As proposed, "financial companies" would be required to provide the largest daily amount of short-term borrowings. We understand that banks and bank holding companies track this information on a daily basis in connection with the preparation of reports to banking regulators. We also expect that other non-bank companies engaged in financial businesses that would fall within the scope of the proposed requirement do not currently track this type of information on a daily basis. Is this information useful to investors? What are the burdens and costs of requiring registrants that meet the definition of "financial company" but are not banks to meet that requirement?

7. Is the activities-based definition of "financial company" sufficiently clear? Are the activities identified (lending, deposit taking, insurance underwriting, providing

investment advice, broker or dealer activities) as part of the definition appropriate, or are they overly-inclusive (or under-inclusive)? Should we provide a definition of the term "significant" as used in the proposed definition? If so, should we provide a numerical, threshold-based definition (e.g., 10% of total assets)? If so, what should the threshold be? Should it relate to assets or should it relate to revenues and income? Should we specify certain types of entities in the definition, as proposed? Should other entities be added to or excluded from the definition? If so, please provide details. Are there any circumstances that would cause an entity to come under the proposed definition that should be excluded, and if so, why?

8. Should all registrants that are financial companies be required to provide the maximum daily amount of short-term borrowings, as proposed? Should registrants that are not financial companies be required to provide the maximum daily amount of short-term borrowings, rather than permitting them to provide the maximum month-end amount as is proposed? Do registrants that are not financial companies have systems to track and calculate this information on a daily basis? What are the burdens and costs of requiring companies engaged in non-financial businesses to meet that requirement? Should registrants that are not financial companies be required to disclose each month-end amount rather than the maximum, as proposed? Should registrants also be required to provide the minimum month-end (or daily for financial companies) amount outstanding? What are the burdens and costs of requiring companies to meet those requirements?

9. Is the proposed accommodation for reporting that would allow financial companies to present information about their non-financial businesses on the same basis as other

non-financial companies appropriate? Would this address cost concerns for these companies? Is the proposed instruction to implement this accommodation sufficiently clear?

10. Should registrants be required to provide the largest amount of short-term borrowings outstanding at any time during the reporting period (meaning intra-day as opposed to close of business)? Would this amount be difficult for registrants to track?

11. As proposed, registrants that are financial companies would be required to provide average amounts outstanding computed on a daily average basis. Should averages computed on a daily average basis be required only for certain companies (for example, bank holding companies, banks, savings associations, broker-dealers)? If so, why and which companies? In this connection, please describe whether financial companies that are not banks typically close their books on a daily basis and whether they have the systems to track and calculate this daily balance information used to compute averages on a daily average basis. What are the burdens and costs for a registrant (that is not a bank) to meet the proposed requirement? Are some types of businesses, such as multi-nationals, disproportionately affected by such costs? If so, please explain why. Is there an alternative requirement for such a business that would still meet the disclosure objective?

12. As proposed, registrants that are not financial companies would be permitted to use a different averaging period, such as weekly or monthly, so long as the period used is not longer than a month. Is it appropriate to allow this type of flexibility given the possibility that longer averaging periods could mask fluctuations? Are certain borrowing practices more likely to be impacted than others, such as overdrafts used as

financing? Is there an alternative requirement or instruction that could eliminate this issue while not imposing undue costs and burdens and still meeting the disclosure objective?

13. Should we require a narrative discussion of short-term borrowing arrangements, as proposed? Are the narrative discussion topics useful to investors? Are there other discussion topics that would be useful to investors? If so, what other topics should we require to be discussed? Should we tailor the disclosure to omit information that may be unimportant to investors? If so, what information, and why, and which registrants would be affected?

14. Do the proposed discussion topics provide enough flexibility to companies to fully and clearly describe their short-term borrowings arrangements?

15. If the proposals are adopted, we expect to authorize our staff to amend Guide 3 to eliminate Item VII in its entirety. Are there any other technical amendments that would be appropriate, such as the elimination of cross-references in other Commission rules or forms, if the staff removes Item VII from Guide 3?

3. Reporting Periods

As proposed, the requirements would be applicable to annual and quarterly reports and registration statements. For annual reports, information would be presented for the three most recent fiscal years and for the fourth quarter. In addition, registrants preparing registration statements with audited full-year financial statements would be required to include short-term borrowings disclosure for the three most recent full fiscal year periods and interim information for any subsequent interim periods, consistent in each case with general MD&A requirements and instructions applicable to the relevant registration statement form requirements. For quarterly reports, information would be presented for the relevant quarter, without a requirement for comparative data. For registrants that are not subject to Guide 3, we are proposing a yearly phase-in of the requirements for comparative annual data until all three years are included in the annual presentation. This is described under the heading "Transition" in this release. Notwithstanding this transitional accommodation, all registrants would be permitted to provide three full years during the transition period.

A principal objective of the proposed disclosure is to provide transparency about intra-period borrowings activity, as a supplement to disclosure of period-end amounts. To achieve this purpose in each reporting period, we are proposing that disclosure in quarterly reports and interim period disclosure in registration statements include short-term borrowings information presented with the same level of detail as would be provided for annual periods.[56] Companies would need to include the full presentation of quantitative and qualitative information for short-term borrowings during the interim period, rather than <u>only</u> disclosing material changes that have occurred since the previous balance sheet date. In addition, registrants would be required to identify material changes from previously reported disclosures in the discussion and analysis, so that any material changes would be highlighted. This layered approach is intended to enhance transparency of short-term borrowing activities during the specific quarterly period, while still emphasizing material changes so that investors can more easily understand how the exposures have evolved from past reporting periods.

In addition, registrants would be required to provide quarterly short-term borrowings information for the fourth fiscal quarter in their annual report. Because the disclosure is intended

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[56] We are proposing to revise the "Instructions to Paragraph 303(b)" in Item 303 of Regulation S-K to accomplish this change to interim period reporting requirements. The proposed instructions would only apply to disclosure pursuant to Item 303(a)(6). <u>See</u> 17 CFR 229.303(b).

to provide additional transparency about a registrant's short-term borrowing practices, including the ability of the registrant to obtain financing to conduct its business, and the costs of that financing, during the year, we believe that short-term borrowings data for the fourth quarter would be useful to investors. As this type of reporting requirement would be a departure from our long-standing approach to the presentation of fourth quarter financial information in MD&A contained in annual reports, we specifically request comment below on this issue, and particularly whether material information as to short-term borrowing activities prior to year-end would be lost without separate quarterly disclosure for the fourth quarter.

As proposed, interim period disclosures would be presented without comparative period data.[57] We believe that this data is most meaningful to show changes from annual borrowing amounts and any intra-period variations from period-end amounts. In addition, because any seasonal trends in the information should generally already be disclosed under existing MD&A requirements, we preliminarily do not believe it is necessary to specifically require prior period comparisons to identify seasonality in borrowing levels. Moreover, other than the presentation of short-term borrowings information for the fourth fiscal quarter, registrants would not be required to include a quarterly breakdown of short-term borrowings information in their annual report. Because quarterly information would be available in Forms 10-Q for all quarters other than the fourth quarter, we do not believe that repeating that quarterly information in the annual report would be useful to investors.

These interim period requirements would not apply to registrants that are foreign private issuers or smaller reporting companies. In addition, smaller reporting companies would be

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57 Proposed Instruction 8 to Paragraph 303(b) would require the registrant to include narrative discussion that highlights any material changes from prior periods. In doing so, registrants should consider whether including comparative period data would make the presentation of those material changes more clear.

permitted to disclose two fiscal years rather than three, in accordance with existing disclosure accommodations for small entities. For a discussion of the treatment of these types of entities, see the discussion under "Treatment of Foreign Private Issuers and Smaller Reporting Companies" in this release.

Request for Comment

16. Are the proposed reporting periods appropriate? Should we require annual short-term borrowings information in annual reports, as proposed? Should annual reports instead include a quarterly breakdown of short-term borrowings information? Should annual reports include quarterly information for the fourth fiscal quarter in addition to annual information, as proposed? For example, would disclosure of information for the fourth fiscal quarter be necessary to highlight any efforts to reduce borrowings at year-end, below the levels prevailing throughout the fourth fiscal quarter? Is the presentation of this information for the fourth fiscal quarter, in isolation without corresponding quarterly financial statements and MD&A for that period, potentially misleading? If so, what additional information should be required? Should quarterly reports be required to include quarterly information, as proposed? Should registration statements be required to include annual and interim information, as proposed? In each case, explain the reasons for requiring the applicable reporting periods and provide information as to whether investors would find the information useful. Please also include details about additional costs involved.

17. Should we require quarterly disclosure at the same level of detail as annual period disclosure, as proposed? Does the proposed presentation provide information that

is useful to investors? Describe in detail the costs and benefits of providing full (rather than material changes) interim period disclosures of the proposed short-term borrowings information. Instead, should we require quarterly reports to include disclosure of material changes only? If so, why? How would disclosure of material changes address the issue of transparency of intra-period borrowings?

18. For annual periods, should we require, as proposed, three years of comparative data? Or would data for the current year, without historical comparison periods, provide investors with adequate information? Describe in detail the costs and benefits of providing comparative period disclosures in this context.

19. Is the proposed disclosure for the current interim period sufficient, or should we also require comparative period data? If so, which comparative periods would be most useful? Explain how prior period comparisons would be useful to investors; for example, would prior period comparisons be needed to identify seasonality in borrowing levels? If so, instead of requiring comparative data, should we specifically require companies to qualitatively describe trends or seasonality in borrowing levels? Describe in detail the costs and benefits of providing comparative period disclosures in this context.

20. Should we require year-to-date information in addition to quarterly information for interim periods? Would year-to-date information be useful to investors? Describe in detail the costs and benefits of providing year-to-date information in this context.

4. Application of Safe Harbors for Forward-Looking Statements

In some instances, the disclosure provided in response to the proposed short-term borrowings narrative discussion requirements could include disclosure of forward-looking information.[58] We are not, however, proposing to extend the safe harbor in Item 303(c) of Regulation S-K to include disclosures of forward-looking information made pursuant to proposed Item 303(a)(6). This safe harbor was adopted in connection with the adoption of Items 303(a)(4) and (a)(5) and explicitly applies the statutory safe harbors of Sections 27A[59] of the Securities Act and 21E[60] of the Exchange Act to those Items in order to remove possible ambiguity about whether the statutory safe harbors would be available for that information.[61] The disclosure required by Items 303(a)(4) and (a)(5) consists primarily of forward-looking information, and as such, issuers and market participants expressed particular concerns about the application of existing safe harbors to that disclosure.[62] In the proposing release for Item 303(c), we requested comment as to whether the safe harbor in Item 303(c) should be expanded to cover all forward-looking information in MD&A.[63] We declined to adopt such an expansion. We preliminarily believe that the proposed short-term borrowings disclosure requirements, which primarily concern disclosure of historical amounts together with qualitative information about the registrant's use of short-term borrowings, would not present any distinctive issues under the application of the statutory safe harbor, and, accordingly, we are not proposing to provide any specific provision or guidance as to its

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58 See generally proposed Item 303(a)(6)(ii)(B), (C) and (D) of Regulation S-K.

59 15 U.S.C. 77z-2.

60 15 U.S.C. 78u-5.

61 See OBS Adopting Release, supra note 6, at 5993.

62 See, e.g., Letter of Committee on Federal Regulation of Securities of the American Bar Association's Section of Business Law in Response to the OBS Proposing Release, available at http://www.sec.gov/rules/proposed/s74202.shtml ("[B]ecause of the inherent predictive nature of disclosures of contingent liabilities and commitments....[W]e are concerned that the failure to include that provision would lead to a negative inference that such disclosure is not covered by the safe harbor.").

In the OBS Adopting Release, the Commission emphasized that notwithstanding the safe harbor provided in Item 303(c) of Regulation S-K, the statutory safe harbor, by its terms, as well as the safe harbor rules under Securities Act Rule 175 [17 CFR 230.175] and Exchange Act Rule 3b-6 [17 CFR 240.3b-6] may be available for the forward-looking disclosure required by Items 303(a)(4) and (5) of Regulation S-K.

63 See OBS Proposing Release, supra note 6, at 68065-68066.

application to this information. Companies would need to treat forward-looking information disclosed pursuant to proposed Item 303(a)(6) in the same manner as other MD&A disclosure for purposes of the statutory safe harbor. We further note that nothing in the proposed requirements would limit (or expand) the scope of the statutory safe harbor, the safe harbor rules under Securities Act Rule 175 or Exchange Act Rule 3b-6, or Item 303(c) of Regulation S-K.

Request for Comment:

21. Is there any need for further guidance from the Commission with respect to the application of either the statutory or the rule-based safe harbors to the information called for by the proposed short-term borrowings disclosure requirement? If so, please provide details as to the potential ambiguity in the application of existing safe harbors. In particular, what information called for by the proposed requirements raises doubt as to the applicability of the statutory safe harbor or the safe harbor rules under Securities Act Rule 175 or Exchange Act Rule 3b-6?

22. Should Item 303(c) of Regulation S-K be revised to also cover forward-looking information disclosed pursuant to the proposed short-term borrowings disclosure requirement?

B. Treatment of Foreign Private Issuers and Smaller Reporting Companies

1. Foreign Private Issuers (other than MJDS filers)

The proposed amendments would apply to foreign private issuers that are not MJDS filers.[64] The existing MD&A-equivalent disclosure requirements in Form 20-F[65] currently mirror

64 The term "MJDS filers" refers to registrants that file reports and registration statements with the Commission in accordance with the requirements of the U.S.-Canadian Multijurisdictional Disclosure System (the "MJDS"). The definition for "foreign private issuer" is contained in Exchange Act Rule 3b-4(c) [17 CFR 240.3b-4(c)]. A foreign private issuer is any foreign issuer other than a foreign government, except for an issuer that has more than 50% of its outstanding voting securities held of record by U.S. residents and any of

the substantive MD&A requirements for U.S. companies, and we believe that our proposed changes to the MD&A requirements for U.S. companies would provide important disclosure to investors that should also be provided by foreign private issuers. Accordingly, we are proposing a new paragraph H under Item 5 (Operational and Financial Review and Prospects) in Form 20-F covering short-term borrowings.

Because foreign private issuers using a comprehensive set of accounting principles other than U.S. GAAP might capture data and prepare their financial statements using different categories of short-term borrowings, we propose to include an instruction to paragraph H that would permit a foreign private issuer to base the categories of short-term borrowings used in the rule on the classifications for such types of short-term borrowings under the comprehensive set of accounting principles which the company uses to prepare its primary financial statements, so long as the disclosure is provided in a level of detail that satisfies the objective of the Item 5.H

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the following: a majority of its officers and directors are citizens or residents of the United States, more than 50% of its assets are located in the United States, or its business is principally administered in the United States.

65 Form 20-F is the combined registration statement and annual report form for foreign private issuers under the Exchange Act. It also sets forth disclosure requirements for registration statements filed by foreign private issuers under the Securities Act.

In designing the integrated disclosure regime for foreign private issuers the Commission endeavored to "design a system that parallels the system for domestic issuers but also takes into account the different circumstances of foreign registrants." Integrated Disclosure System for Foreign Private Issuers, Release No. 33-6360 (Nov. 20, 1981) [46 FR 58511]. As such, the requirements of Item 5 of Form 20-F are analogous to those in Item 303 of Regulation S-K. Although the wording is not identical, we interpret Item 5 as requiring the same disclosure as Item 303 of Regulation S-K. See Rules, Registration and Annual Report for Foreign Private Issuers, Release No. 34-16371 (Nov. 29, 1979) [44 FR 70132] (adopting Form 20-F and stating that the Commission would consider revisions when MD&A requirements in Regulation S-K were adopted); Integrated Disclosure System for Foreign Private Issuers, Release No. 33-6360 (revising Form 20-F to add requirements consistent with the MD&A requirements in Regulation S-K); International Disclosure Standards, Release No. 33-7745 (Sept. 28, 1999)[64 FR 53900] (adopting revisions to Form 20-F to conform to international disclosure standards endorsed by the International Organization of Securities Commissions in 1998); see also OBS Adopting Release, supra note 6, at 5992 n. 135.

disclosure requirement.[66] This approach is consistent with the approach to contractual obligations disclosure in Item 5.F, for which foreign private issuers are instructed to base their tabular disclosure on the classifications of obligations used in the generally accepted accounting principles under which the company prepares its primary financial statements.[67] Similarly, in connection with references to FASB pronouncements used in Item 5 of Form 20-F, issuers that file financial statements that comply with IFRS as issued by the IASB are instructed to "provide disclosure that satisfies the objective of Item 5 disclosure requirements."[68] Other than this instruction regarding the categorization of short-term borrowings, the short-term borrowings disclosure requirement proposed for Form 20-F is substantially similar to the proposed provision applicable to U.S. issuers.

The reporting periods applicable to U.S. issuers are proposed to also apply to foreign private issuers, except with respect to quarterly reporting. For annual reports on Form 20-F, foreign private issuers would present three years of annual short-term borrowings data, subject to the proposed transition accommodation applicable to all registrants that are not bank holding companies. Foreign private issuers preparing registration statements with audited full-year financial statements would be required to include short-term borrowings disclosure for the three most recent full fiscal year periods and quarterly information for any subsequent interim periods included in the registration statement in accordance with the requirements of the relevant registration statement form. The proposed amendments for U.S. issuers would require quarterly disclosure of short-term borrowings in quarterly reports on Form 10-Q.[69] Foreign private issuers,

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66 See proposed Instruction 1 to Item 5.H of Form 20-F.

67 See Instruction 2 to Item 5.F of Form 20-F.

68 See Instruction 5 to Item 5 of Form 20-F.

69 17 CFR 249.308a. See proposed Instruction 8 to Item 303(b) of Regulation S-K [17 CFR 229.303(b)].

however, are not required to file quarterly reports with the Commission, and therefore the proposed amendments would not apply to Form 6-K[70] reports submitted by foreign private issuers.[71] Thus, unless a foreign private issuer (other than an MJDS filer) files a Securities Act registration statement that must include interim period financial statements and related MD&A-equivalent disclosure,[72] it would not be required to update its disclosure under proposed Item 5.H of Form 20-F more than annually.

Request for Comment

23. Should we apply the proposed amendments to foreign private issuers' annual reports on Form 20-F, as proposed? Or should we exclude these annual reports from the scope of the amendments? If so, why?

24. Should we apply the proposed amendments to foreign private issuers' registration statements, as proposed? Or should these registration statements be excluded from the scope of the proposed rules? In particular, should we not require the interim period short-term borrowings information to be included in the registration statements of foreign private issuers? If not, why?

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70 17 CFR 249.306. A foreign private issuer must furnish under cover of Form 6-K material information that it: makes public or is required to make public under its home country laws, files or is required to file with a stock exchange on which its securities are traded and which was made public by that exchange under the rules of the stock exchange or distributes or is required to distribute to security holders. In instances where a foreign private issuer is furnishing interim information on short-term borrowings under those circumstances, we would encourage the foreign private issuer to consider providing an update to its annual short-term borrowings disclosure, although it would not be required to do so.

71 This treatment is consistent with the approach we took when adopting off-balance sheet arrangements and contractual obligations disclosure. See OBS Adopting Release, supra note 6, at 5992 n. 139.

72 The proposed amendments would apply to Securities Act registration statements on Forms F-1 [17 CFR 239.31], F-3 [17 CFR 239.33] and F-4 [17 CFR 239.34]. Each of these registration statements references the disclosure requirements in Form 20-F.

25. Should we limit the application of the new disclosure requirements to foreign private issuers that are banks or bank holding companies, or that are financial companies? If so, why?

26. Is the instruction to proposed Item 5.H regarding the categories of short-term borrowings appropriate? Is the instruction clear? If not, how can it be clarified?

2. MJDS Filers

The proposed amendments would not affect MJDS filers. The disclosure provided by Canadian issuers is generally that which is required under Canadian law, and we do not propose to depart from our approach with respect to financial disclosure provided by MJDS filers. Accordingly, we are not proposing to further amend Form 40-F at this time.

Request for Comment

27. Should we amend Form 40-F to include the new short-term borrowings disclosure requirements? If so, why?

3. Smaller Reporting Companies

Smaller reporting companies currently provide disclosure pursuant to Item 303, subject to the special accommodation provided in Item 303(d) that, among other things, permits the exclusion of tabular disclosure of contractual obligations under Item 303(a)(5). The proposed short-term borrowings disclosure requirements would apply to smaller reporting companies, except that quarterly disclosures would not be required unless material changes have occurred during that interim period (as is the case under existing requirements for interim period disclosure) and information for the fourth fiscal quarter would not be required in annual reports. To this end, we propose to amend Item 303(d) to clarify that smaller reporting companies need only provide the proposed Item 303(a)(6) information on an annual basis and, in interim periods, if any material changes have occurred.[73] In addition, for smaller reporting companies providing financial information on net sales and revenues and on income from continuing operations for only two years, only two years of short-term borrowings information would be required, consistent with the scaled MD&A disclosure requirement for smaller reporting companies under existing Item 303(d).

This accommodation for interim period disclosure is intended to balance the practical impact of the disclosure requirement with the need to enhance disclosure of liquidity risks facing smaller reporting companies. While liquidity risks, particularly those arising from short-term borrowings, are equally important for smaller reporting companies, we also believe that smaller reporting companies are likely to have fewer complex financing alternatives available. Accordingly, we believe that smaller reporting companies would not likely have as many significant changes to the liquidity profile presented in periodic reports as other reporting companies. Thus, we do not believe that the burden of preparing expanded interim period reporting is justified by the incremental information that would be provided compared to that provided under the existing interim updating model applicable to smaller reporting companies.

Request for Comment

28. Does the proposal strike the proper balance between imposing proportional costs and burdens on smaller reporting companies while providing adequate information to investors? Would the proposed new short-term borrowings disclosure be useful to investors in smaller reporting companies? Are there any features of the proposed requirements that would impose unique difficulties or significant costs for smaller

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73 Proposed "Instruction 8 to Paragraph 303(b)" would exclude smaller reporting companies from the requirement to provide all the information specified in paragraph (a)(6) in interim periods. As proposed, Item 303(d) would state that smaller reporting companies are only required to provide material changes to the information specified in proposed Item 303(a)(6) in interim periods. The proposed revisions to Item 303(d) would not affect the existing accommodation for disclosure of Item 303(a)(5) information.

reporting companies? If so, how should we change the requirements to reduce those difficulties or costs while still achieving the disclosure objective?

29. Should we provide the proposed exemption for interim period updating to smaller reporting companies? If not, please discuss whether the expanded level of interim period disclosure by smaller reporting companies would be useful to investors and why.

30. Would the gathering of data and preparation of expanded interim period disclosure be burdensome to smaller reporting companies? Could the proposed requirement be structured a different way for smaller reporting entities so as to enable interim period reporting without imposing a significant cost? If so, please provide details of such an alternative.

31. Are the nature of the short-term borrowings and the related risks different for smaller reporting companies such that additional or alternate disclosure would be appropriate? In particular, would the proposed annual requirement for disclosing short-term borrowings information cause a smaller reporting company to collect the same data it would need to collect for interim reporting, such that the expanded level of interim period disclosure proposed for registrants that are not smaller reporting companies would not be unduly burdensome?

C. Leverage Ratio Disclosure Issues

Many observers believe that high leverage at financial institutions, in the U.S. and globally, was a contributing factor to the financial crisis.[74] As a result, investors and market participants are

[74] See, e.g., Financial Stability Board, Report of the Financial Stability Forum on Addressing Pro-cyclicality in the Financial System (2009) available at http://www.financialstabilityboard.org/publications/r_0904a.pdf; S. Deng, SIVs, Bank Leverage and Subprime Mortgage Crisis, (Dec. 2009), available at http://ssrn.com/abstract=1319431.

increasingly focused on leverage ratio disclosures, particularly for banks and for non-bank financial institutions.[75] Similarly, we believe that investors may benefit from additional transparency about the capitalization and leverage profile of non-financial companies, particularly for those companies that rely heavily on external financing and credit markets to fund their businesses and future growth.

Under U.S. GAAP, bank holding companies are currently required to disclose certain capital and leverage ratios (calculated in accordance with the requirements of their primary banking regulator) in the financial statements that are included in filings with the Commission.[76] The Commission's staff has observed that some bank holding companies also include disclosure of these ratios in their MD&A presented in annual and quarterly reports. The financial statement disclosure by bank holding companies of their capital and leverage ratios provides to investors some of the same information that banking regulators use to assess a bank's capital adequacy and leverage levels.[77] For U.S. banks and thrifts, the standards applied by the various banking agencies

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75 See, e.g., K. D'Hulster, The Leverage Ratio, WORLD BANK PUB. POL'Y J. (2009); J. Gabilondo, Financial Moral Panic! Sarbanes-Oxley, Financier Folk Devils, and Off-Balance Sheet Arrangements, 36 SETON HALL L. REV. 781 (2006) (proposing that a financial transparency ratio would reduce the public information gap arising from off-balance sheet arrangements); P. M. Hildebrand, Vice-Chairman of the Governing Board of the Swiss National Bank, Is Basel II Enough? The Benefits of a Leverage Ratio, London School of Economics Financial Markets Group Lecture, Dec. 15, 2008, available at http://www.bis.org/review/r081216d.pdf; Standard & Poor's, The Basel III Leverage Ratio is a Raw Measure but Could Supplement Risk Based Capital Measures, April 15, 2010, available at http://www.bis.org/publ/bcbs165/splr.pdf.

76 See FASB ASC 942-505-50, Regulatory Capital Disclosures. Specifically, bank holding companies must present their required and actual ratios and amounts of Tier 1 leverage, Tier 1 risk based capital, and total risk based capital, (for savings institutions) tangible capital, and (for certain banks and bank holding companies) Tier 3 capital for market risk. Under U.S. GAAP, bank holding companies are required to include this information in the footnotes to their financial statements.

77 See Regulation Y, Appendices A (Risk-Based Capital), B (Leverage Measure) and D (Tier I Leverage Measure) [12 CFR 225].

are substantially uniform,[78] which means that the ratios that bank holding companies are required to include in their financial statements filed with the Commission should be calculated using consistent methodology. Consistent with existing disclosure rules, where disclosed ratios are likely to be materially impacted by known events such as short-term borrowings, contractual obligations or off-balance sheet arrangements, or are not otherwise indicative of the registrant's leverage profile, additional disclosure would be required in order to provide an understanding of the registrant's financial condition and prospects.[79]

We are considering whether to extend a leverage ratio disclosure requirement to companies that are not bank holding companies. We understand that, outside the banking industry, a variety of metrics are used to evaluate a company's debt levels and capital adequacy. There does not appear to be a "one-size-fits all" leverage ratio that is used by companies or investors. For example, we understand that financial analysts, credit analysts and other sophisticated users of financial statements tend to apply their own models and calculate their own ratios for use in their analyses of a registrant's financial health, using their own proprietary calculation methods.[80] We also understand that there is not a consensus on how to measure and treat "off-balance sheet" leverage for purposes of calculating leverage or capital ratios. We are requesting comment today as to the scope of a potential disclosure requirement, and importantly, how such a requirement would take into account the differences among metrics and industries while still providing comparability.

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78 See The Federal Reserve Board et al., Joint Report: Differences in Capital and Accounting Standards among the Federal Banking and Thrift Agencies (Feb. 5, 2003) [68 FR 5976].

79 See, e.g., Item 303(a)(1) of Regulation S-K, and Instructions 1, 2 and 3 to Paragraph 303(a).

80 See, e.g., P. Kraft, Rating Agency Adjustment to GAAP Financial Statements and Their Effect on Ratings and Bond Yields (Nov. 1, 2009) at http://ssrn.com/abstract=1266381.

Request for Comment

32. Should all types of registrants be required to provide leverage ratio disclosure and discussion? Are there differences among industries or types of businesses that would need to be addressed in such a requirement so that it is meaningful to investors? If so, how should "leverage ratio" be defined in this context? Is comparability across companies and industries important, or is the disclosure more meaningful if it is presented in the context of the particular registrant's business?

33. Rather than extending the leverage ratio disclosure requirement to include all registrants, should we extend it only to other financial institutions or financial services companies? If so, how should the scope of included companies be defined? Would the proposed definition of "financial company" used in proposed Item 303(a)(6) work for this purpose? How should "leverage ratio" be defined in this context? Is there a different metric that would be more useful to investors? Should the ratio include "off-balance sheet" leverage or off-balance sheet equity adjustments? If so, describe how such a ratio would be calculated. What are the costs and benefits of defining a leverage ratio that would be applicable to all registrants? Where relevant, discuss the usefulness of a standardized ratio requirement given that many users of financial statements make their own calculations.

34. Should bank holding companies be required to include the same level of disclosure of leverage and capital ratios for quarterly financial statements as they do for annual financial statements, rather than quarterly reporting of material changes? Should

additional disclosures be required to accompany existing ratio disclosure that would make it more meaningful?

D. Technical Amendments Reflecting FASB Codification

On June 30, 2009, the FASB issued FASB Statement of Financial Accounting Standards No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles – a replacement of FASB Statement No. 162, to establish the FASB Codification as the source of authoritative non-Commission accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with U.S. GAAP. In August 2009, we issued guidance regarding the interpretation of references in the Commission's rules and staff guidance to specific standards under U.S. GAAP in light of the FASB Codification.[81] As noted in that interpretive release, the Commission and its staff intend to embark on a longer term rulemaking and updating initiative to revise comprehensively specific references to specific standards under U.S. GAAP in the Commission's rules and staff guidance. Although we plan to make those comprehensive changes at a later date, we believe it is appropriate, at the same time that we propose to make other amendments to Item 303 of Regulation S-K and Item 5 of Form 20-F, to propose technical amendments to these provisions to reflect the FASB Codification. These proposed technical amendments include:

- updating the U.S. GAAP references in the definition of "off-balance sheet arrangement" in Item 303(a)(4)(ii) of Regulation S-K and Item 5.E.2 of Form 20-F;

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81 See Commission Guidance Regarding the Financial Accounting Standards Board's Accounting Standards Codification, Release No. 33-9062A (Aug. 19, 2009)[74 FR 42772] (stating that, concurrent with the effective date of the FASB Codification, references in the Commission's rules and staff guidance to specific standards under U.S. GAAP should be understood to mean the corresponding reference in the FASB Codification).

- updating U.S. GAAP references in the existing definitions of "Long-Term Debt Obligation," "Capital Lease Obligation" and "Operating Lease Obligation" in Item 303(a)(5)(ii) of Regulation S-K;[82] and
- updating U.S. GAAP references in instructions 8 and 9 of the Instructions to Paragraph 303(a) of Regulation S-K.

As part of our continuing initiative to update the references in the Commission's rules and staff guidance, we believe that these proposed technical amendments would assist registrants in applying the relevant definitions and instructions, without needing to spend time and resources to identify the corresponding FASB provision as contemplated by the interpretive guidance.

Request for Comment

35. Are there any additional revisions to the provisions of Regulation S-K or Form 20-F affected by the proposal that would be necessary or appropriate to reflect the release by the FASB of its FASB codification?

E. Conforming Amendments to Definition of "Direct Financial Obligation" in Form 8-K

We are proposing revisions to the definition of "direct financial obligation" used in Items 2.03 and 2.04 of Form 8-K to conform to the definition of short-term borrowings used in proposed Item 303(a)(6). Specifically, the proposed amendment would revise paragraph (4) of the definition of "direct financial obligation" contained in Item 2.03(c) of Form 8-K.[83]

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[82] The instructions to Item 5.F (Tabular Disclosure of Contractual Obligations) of Form 20-F direct registrants to provide disclosure of contractual obligations (other than purchase obligations, for which a definition is provided) based on the classifications used in the generally accepted accounting principles under which the registrant prepares its primary financial statements. Accordingly, no update for FASB codification is necessary for Item 5.F of Form 20-F.

[83] Item 2.03(c) defines a "direct financial obligation" as any of the following: (1) a long-term debt obligation, as defined in Item 303(a)(5)(ii)(A) of Regulation S-K [17 CFR 229.303(a)(5)(ii)(A)]; (2) a capital lease obligation, as defined in Item 303(a)(5)(ii)(B) of Regulation S-K [17 CFR 229.303(a)(5)(ii)(B)];(3) an operating lease obligation, as defined in Item 303(a)(5)(ii)(C) of Regulation S-K [17 CFR

The current definition of "direct financial obligation" was adopted as part of the 2004 adoption of Items 2.03 and 2.04 of Form 8-K, in connection with updates to Form 8-K to require real-time disclosure of material information regarding changes in a company's financial condition or operations as mandated by Section 409 of the Sarbanes-Oxley Act of 2002.[84] Items 2.03 and 2.04 of Form 8-K are intended to provide real-time disclosure when a company becomes obligated under a direct financial obligation or off-balance sheet arrangement that is material to the company, and upon the triggering of an increase or acceleration of any of those types of transactions where the impact would be material to the company. This real-time disclosure was intended to supplement and align with the requirements for annual and quarterly disclosure of off-balance sheet arrangements and contractual obligations under Items 303(a)(4) and (a)(5) of Regulation S-K. Acknowledging the importance of short-term financing disclosure to an understanding of a company's financial condition and risk profile, we included certain short-term debt obligations in the definition of "direct financial obligations," along with the long-term debt, leases and purchase obligations identified by reference to Item 303(a)(5) of Regulation S-K.

We believe it is appropriate to align the existing reporting requirements for short-term debt obligations under Items 2.03 and 2.04 of Form 8-K with the new proposed definition of short-term borrowings in Item 303(a)(6), in order to continue to provide consistency of disclosure. Accordingly, we are proposing to amend clause (4) of the definition of direct financial obligation to refer to "a short-term borrowing, as defined in Item 303(a)(6)(iii) of Regulation S-K (17 CFR

229.303(a)(5)(ii)(C)]; or (4) a short-term debt obligation that arises other than in the ordinary course of business. The item defines "short-term debt obligation" as a payment obligation under a borrowing arrangement that is scheduled to mature within one year, or, for those companies that use the operating cycle concept of working capital, within a company's operating cycle that is longer than one year.

84 Pub. L. No. 107-204, 116 Stat. 745 (2002). See Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release No. 33-8400 (Mar. 16, 2004) [69 FR 15594].

229.303(a)(6)(iii) that arises other than in the ordinary course of business."[85] In doing so, however, we propose to retain the existing carve-out in the definition of direct financial obligation for obligations that arise in the ordinary course of business, in order to maintain the focus of Items 2.03 and 2.04 on real-time disclosure of individual transactions that are not routine or "ordinary course" financing transactions. If we were to eliminate the ordinary course of business carve-out in the definition, we do not believe that the level of material information provided would justify the burden on registrants to prepare, and the burden on investors to review and understand, potentially voluminous disclosure about routine transactions. In addition, we believe that the proposed short-term borrowings disclosures in MD&A would provide investors with timely information about fluctuations in short-term borrowings levels and about short-term borrowings practices, such that current reporting on Form 8-K of particular instances of significant fluctuations that arise due to ordinary course transactions would not necessarily provide additional insight to investors. Moreover, a registrant that experiences a material increase in short-term borrowings during a reporting period that is not consistent with past practices would likely need to consider carefully whether the underlying transactions causing the fluctuations fall within the meaning of "ordinary course of business" for purposes of Items 2.03 and 2.04.

Request for Comment

36. Instead of amending the definition of "direct financial obligation" to refer to proposed Item 303(a)(6), should the category of short-term financings included in the definition of "direct financial obligation" for purposes of Items 2.03 and 2.04 of Form 8-K differ from the standard used in proposed Item 303(a)(6)? Describe how

[85] See proposed revisions to Item 2.03(c)(4) of Form 8-K.

the standards should differ and explain why. For example, should we retain the existing reference to "short-term debt obligation" instead?

37. Is the proposed definition of short-term borrowings sufficiently tailored so as to exclude borrowing obligations that arise in the ordinary course of business, so that the carve-out in the definition of direct financial obligation is unnecessary? Should the carve-out for obligations that arise in the ordinary course of business be retained, as proposed? Describe the costs and burdens for companies if the carve-out were eliminated, particularly the burden on management to make an assessment of materiality of each short-term borrowing transaction within the filing timeframe. Is current reporting of routine short-term borrowing transactions that are material to the registrant sufficient? Would the new reporting requirements regarding short-term borrowing practices and average borrowings sufficiently improve reporting on this topic, so that Form 8-K reporting of ordinary course short-term borrowings would be unnecessary? Explain why or why not.

F. Transition

In connection with the proposed short-term borrowings disclosure, we are proposing a transition accommodation for registrants that are not bank holding companies or subject to Guide 3 that would, for purposes of the annual reporting requirement, permit those companies to phase in compliance with the comparable annual period disclosure under proposed Item 303(a)(6). In the initial year of the transition period, these companies would be required to include short-term borrowings information for the most recent fiscal year and permitted to omit information for the two preceding fiscal years. In the second year of the transition period, these companies would be required to include the two most recent fiscal years, and permitted to omit the third preceding fiscal year. In the third year of the transition period, and thereafter, these companies would be required to include disclosure for the each of the three most recent fiscal years as prescribed in proposed Item 303(a)(6)(v). This transition accommodation would not apply to bank holding companies or other companies subject to Guide 3, since those companies already provide this disclosure for the three most recent fiscal years (or two fiscal years for certain smaller bank holding companies).[86]

Request for Comment

38. Is the proposed transition accommodation appropriate? Should we require all companies to present all required periods at the outset?

39. Would the proposed transition accommodation be useful for registrants? Is it sufficiently clear? Should we extend it to cover bank holding companies? If so, why?

40. Are any other transition accommodations necessary for any aspects of the proposed requirements? Would any of the proposed requirements present any particular difficulty or expense that should be addressed by a transition accommodation? If so, please explain what would be needed and why. For example, should we provide a transition period to allow smaller reporting companies and/or non-bank companies time to set up systems to gather the data for the proposed disclosure? If so, what should that period be?

III. GENERAL REQUEST FOR COMMENT

We request and encourage any interested person to submit comments on any aspect of our proposals, other matters that might have an impact on the amendments, and any suggestions for

[86] See General Instruction 3 of Guide 3.

additional changes. With respect to any comments, we note that they are of greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments and by alternatives to our proposals where appropriate.

IV. PAPERWORK REDUCTION ACT

A. Background

Certain provisions of the proposed amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 (PRA).[87] We are submitting the proposed amendments to the Office of Management and Budget (OMB) for review in accordance with the PRA.[88] The titles for the collection of information are:

(A) "Regulation S-K" (OMB Control No. 3235-0071);[89]

(B) "Form 10-K" (OMB Control No. 3235-0063);

(C) "Form 10-Q" (OMB Control No. 3235-0070);

(D) "Form 8-K" (OMB Control No. 3235-0060);

(E) "Form 20-F" (OMB Control No. 3235-0288);

(F) "Form 10" (OMB Control No. 3235-0064);

(G) "Form S-1" (OMB Control No. 3235-0065);

(H) "Form F-1" (OMB Control No. 3235-0258);

(I) "Form S-4" (OMB Control No. 3235-0324);

(J) "Form F-4" (OMB Control No. 3235-0325);

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87 44 U.S.C. 3501 et seq.

88 44 U.S.C. 3507(d) and 5 CFR 1320.11.

89 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.

(K) "Proxy Statements – Regulation 14A (Commission Rules 14a-1 through 14a-15) and Schedule 14A" (OMB Control No. 3235-0059);

(L) "Information Statements – Regulation 14C (Commission Rules 14c-1 through 14c-7) and Schedule 14C" (OMB Control No. 3235-0057); and

(M) "Form N-2" (OMB Control No. 3235-0026).

These regulations, schedules and forms were adopted under the Securities Act and the Exchange Act, and in the case of Form N-2, the Investment Company Act of 1940.[90] They set forth the disclosure requirements for periodic and current reports, registration statements, and proxy and information statements filed by companies to help investors make informed investment and voting decisions. The hours and costs associated with preparing, filing and sending each form or schedule constitute reporting and cost burdens imposed by each 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.

We anticipate that the proposed amendments to Item 303 of Regulation S-K and to Item 5 of Form 20-F would increase existing disclosure burdens for annual reports on Form 10-K and Form 20-F, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy and information statements, and registration statements on Forms 10, S-1, F-1, S-4, F-4 and N-2 by requiring new disclosure and discussion of short-term borrowings to be provided on an annual and interim basis.

At the same time, the proposed technical amendments to Item 303 of Regulation S-K and Item 5.E of Form 20-F that update references to U.S. GAAP to reflect the FASB Codification would not increase existing disclosure burdens for annual reports on Form 10-K and Form 20-F,

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90 15 U.S.C. 80a-1 et seq.

quarterly reports on Form 10-Q, current reports on Form 8-K, proxy and information statements, and registration statements on Forms 10, S-1, F-1, S-4, F-4 and N-2.

We also estimate that the amendments to the definition of "direct financial obligation" for purposes of disclosure requirements in Items 2.03 and 2.04 of Form 8-K would not increase existing disclosure burdens for filings of Form 8-K. Although we propose to amend the existing definition to conform to the terminology used in the proposed MD&A requirements, we propose to retain the existing carve-out for ordinary course obligations. Thus, we assume that the proposed change in the definition would not substantially change the existing scope of the disclosure requirement, and, therefore, the proposed amendments would not increase the number of Form 8-K filings nor add incremental costs and burdens to the existing disclosure burden under Form 8-K. We solicit comment on whether our assumption is correct, and if not, how to estimate the additional number of Forms 8-K that would be filed pursuant to the proposed amendments to the definition of "direct financial obligation." We note that, based on the number of filings made under Items 2.03 and 2.04 of Form 8-K in 2009, only approximately 4% of all Form 8-K filings would be made in connection with those Items.

Compliance with the proposed amendments would be mandatory. Responses to the information collections would not be kept confidential, and there would be no mandatory retention period for the information disclosed.

B. Burden and Cost Estimates Related to the Proposed Amendments

As discussed below, we have estimated the average number of hours a company would spend preparing and reviewing the proposed disclosure requirements and the average hourly rate for outside professionals. In deriving our estimates, we recognize that some companies would experience costs in excess of those averages in the first year of compliance with the proposed amendments, and some companies may experience less than the average costs. The estimates of reporting and cost burdens provided in this PRA analysis address the time, effort and financial resources necessary to provide the proposed collections of information and are not intended to represent the full economic cost of complying with the proposal.

For purposes of the PRA, we estimate that over a three year period, the average annual incremental paperwork burden for all companies to prepare the disclosure that would be required under the proposals to be approximately 872,458 hours of company personnel time and a cost of approximately $144,061,000 for the services of outside professionals.[91] These estimates include the time and the cost of implementing data gathering systems and disclosure controls and procedures, the time and cost of in-house preparers, review by executive officers, in-house counsel, outside counsel, in-house accounting staff, independent auditors and members of the audit committee, and the time and cost of filing documents and retaining records.

Our methodologies for deriving the burden hour and cost estimates presented in the tables below represent the average burdens for all registrants who are required to provide the disclosure, both large and small. As discussed elsewhere in this release, the time required to prepare the proposed disclosures could vary significantly depending on, among other factors, the nature of the registrant's business, its capital structure, its internal controls and disclosure controls systems, its risk management systems and other applicable regulatory requirements. In addition, the estimates do not distinguish between registrants that are bank holding companies and other registrants. Although bank holding companies and other companies that currently provide Guide 3 disclosure

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91 We calculated an annual average over a three-year period because OMB approval of PRA submissions covers a three-year period. For administrative convenience, the presentation of totals related to the paperwork burden hours have been rounded to the nearest whole number. The estimates reflect the burden of collecting and disclosing information under the PRA. Other costs associated with the proposed amendments are discussed in below under "Cost-Benefit Analysis."

would already collect and disclose on an annual basis some of the information covered by the new requirements, the new requirements are not identical to the provisions of Guide 3. Accordingly, for purposes of these estimates, we assume that bank holding companies would have the same burden as other registrants, although they might not actually incur additional expenses for those portions of the new requirements that are the same as the existing provisions of Guide 3.

Because our estimates assume that 100% of public companies engage in short-term borrowings from time to time, we estimate that the same percentage of companies would be impacted by the proposed disclosure requirements for short-term borrowings.[92] Therefore, for those companies that do not engage in short-term borrowing activities during a reporting period, the incremental burdens and costs may be lower than our estimate. However, because these companies may still need to implement systems and controls to capture short-term borrowings data that is not currently collected, we have assumed that they would share the same average burden and cost estimate. In addition, we assume that the burden hours of the proposed amendments would be comparable to the burden hours related to similar disclosure requirements, such as off-balance sheet arrangements disclosure requirements,[93] contractual obligations disclosure requirements,[94] and requirements for the qualitative and quantitative disclosure of market risk,[95] which call for quantitative and/or qualitative discussion and analysis of financial data.

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92 We further assume that the proposed amendments would not affect the number of filings.

93 OBS Adopting Release, supra note 6, at 5994 (which we estimated to be 14.5 hours for annual reports and proxy statements, 16 hours for registration statements and 10 hours for quarterly reports).

94 OBS Adopting Release, supra note 6, at 5994 (which we estimated to be 7.5 hours for annual reports and proxy statements, 8.5 hours for registration statements and 3 hours for quarterly reports).

95 Disclosure of Accounting Policies for Derivative Financial Instruments and Derivative Commodity Instruments and Disclosure of Qualitative and Quantitative Information About Market Risk Inherent in Derivative Financial Instruments, Other Financial Instruments and Derivative Commodity Instruments, Release No. 33-7386 (Jan. 31, 1997) [62 FR 6044] (which we estimated to be 80 hours total per registrant).

We derived the estimates by estimating the total amount of time it would take a company to implement systems to capture the data, implement related disclosure controls and procedures, prepare and review the disclosure pursuant to the proposed short-term borrowings requirements. We first estimated the total amount of time it would take a company to prepare and review the proposed disclosure for each form, using the estimates for the comparable disclosure requirements identified above as a starting point. Because we believe that the proposed rules would impose an increased burden on companies in connection with the implementation of data gathering systems and the implementation of related disclosure controls and procedures as compared to those comparable disclosure requirements, we added hours to those estimates, to reflect our best estimate of the additional time needed to implement the new systems.

The tables below illustrate the total incremental annual compliance burden of the collection of information in hours and in cost under the proposed amendments for annual reports, proxy and information statements, quarterly reports and current reports on Form 8-K under the Exchange Act (Table 1) and for registration statements under the Securities Act and Exchange Act (Table 2). There is no change to the estimated burden of the collection of information under Regulation S-K because the burdens that Regulation S-K imposes are reflected in our revised estimates for the forms. The burden estimates were calculated by multiplying the estimated number of annual responses by the estimated average number of hours it would take a company to prepare and review the proposed disclosure requirements. We recognize that some registrants may need to include MD&A disclosure in more than one filing covering the same period, accordingly actual numbers may be lower than our estimates.

We have based our estimated number of annual responses on the actual number of filings during the 2009 fiscal year, with three exceptions. First, we reduced the number of annual responses for Schedules 14A and 14C, based on our belief that only a minimal number of companies that file these schedules would need to prepare MD&A disclosure for the filing, rather than incorporating by reference from a periodic report. Second, we reduced the number of annual responses for Form N-2, based on our estimate of the number of Form N-2 filings made by business development companies in 2009 because only business development companies are required to include MD&A disclosure in a Form N-2.[96] In addition, we recognize that smaller reporting companies would be exempted from "full" interim period reporting in their quarterly reports rather than only reporting material changes on a quarterly basis. To reflect this, we reduced the number of annual responses of Forms 10-Q by our estimate of the number of Forms 10-Q filed by smaller reporting companies.[97]

For Exchange Act reports and proxy and information statements, we estimate that 75% of the burden of preparation is carried by the company internally and that 25% of the burden of preparation is carried by outside professionals retained by the company at an average cost of $400 per hour.[98] For registration statements, we estimate that 25% of the burden of preparation is carried by the company internally and that 75% of the burden of preparation 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 is reflected in hours.

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96 The current estimate of annual responses for Form N-2 is 205. Our best estimate of the total number of Forms N-2 filed in 2009 by business development companies is 29. Accordingly, for purposes of Table 2, we reduced the current estimate of annual responses for Form N-2 (205 Form N-2 filings) to 29 Form N-2 filings.

97 This adjustment is based on our best estimate of the number of Forms 10-Q filed by smaller reporting companies in 2009.

98 For Form 20-F, we estimate that 25% of the burden is carried by the company and 75% by outside professionals because we assume that foreign private issuers rely more heavily on outside counsel for preparation of the Form.

Table 1. Incremental Paperwork Burden under the proposed amendments for annual reports, quarterly reports, Forms 8-K and proxy and information statements:

	Annual Responses[99]	Incremental Burden Hours/Form	Total Incremental Burden Hours	75% Company	25% Professional	Professional Costs
	(A)	(B)	(C)=(A)*(B)	(D)=(C)*0.75	(E)=(C)*0.25	(F)=(E)*$400
10-K	13,545	40	541,800	406,350	135,450	$54,180,000
20-F	942	30	28,260	7,065	21,195	$8,478,000
10-Q	28,841	20	574,840	431,130	143,710	$57,484,000
8-K	115,795	0	0	0	0	0
SCH 14A	365	30	10,950	8,212.5	2,737.5	$1,095,000
SCH 14C	34	30	1,020	765	255	$102,000
Total	159,522	150	1,156,860	853,522.5	303,347.5	$121,339,000

Table 2. Incremental Paperwork Burden under the proposed amendments for registration statements:

	Annual Responses[100]	Incremental Burden Hours/Form	Total Incremental Burden Hours	25% Company	75% Professional	Professional Costs
	(A)	(B)	(C)=(A)*(B)	(D)=(C)*0.25	(E)=(C)*0.75	(F)=(E)*$400
S-1	1,168	35	40,880	10,220	30,660	$12,264,000
F-1	42	35	1,470	367.5	1,102.5	$441,000
S-4	619	35	21,665	5416.25	16,248.75	$6,499,500
F-4	68	35	2,380	595	1,785	$714,000
10	238	35	8,330	2,082.5	6,247.5	$2,499,000
N-2	29	35	1,015	253.75	761.25	$304,500
Total	2,164	210	75,740	18,935	56,805	$22,722,000

99 Except as described above, the number of responses reflected in the table equals the actual number of forms and schedules filed with the Commission during the 2009 fiscal year.

100 Except as described above, the number of responses reflected in the table equals the actual number of forms filed with the Commission during the 2009 fiscal year.

1. Annual Reports and Proxy/Information Statements

We estimate that the preparation of annual reports currently results in a total annual compliance burden of 21,986,455 hours and an annual cost of outside professionals of $3,591,562,980. We estimate that the preparation of proxy and information statements currently result in a total annual compliance burden of 735,122 hours and an annual cost of outside professionals of $86,608,526.

As set forth in Table 1 above, if the proposals were adopted, we estimate that the incremental cost of outside professionals for annual reports would be approximately $62,658,000 per year and the incremental company burden would be approximately 413,415 hours per year; and, for proxy and information statements, the total incremental cost of outside professionals would be approximately $1,197,000 per year and the incremental company burden would be approximately 8,978 hours per year. For purposes of our submission to the OMB under the PRA, if the proposals were adopted, the total cost of outside professionals for annual reports would be approximately $3,654,220,980 per year and the total company burden would be approximately 22,399,870 hours per year; and the total cost of outside professionals for proxy and information statements would be approximately $87,805,526 per year and the total company burden would be approximately 744,100 hours per year.

2. Quarterly Reports

We estimate that Form 10-Q preparation currently results in a total annual compliance burden of 4,559,793 hours and an annual cost of outside professionals of $607,972,400. As set forth in Table 1 above, if the proposals were adopted, we estimate that the incremental cost of outside professionals for quarterly reports would be approximately $57,484,000 per year and the incremental company burden would be approximately 431,130 hours per year. For purposes of our submission to the OMB under the PRA, if the proposals were adopted, the total cost of outside professionals for quarterly reports would be approximately $665,456,400 per year and the total annual company burden for quarterly reports would be approximately 4,990,923 hours per year.

3. Current Reports on Form 8-K

Form 8-K prescribes information about significant events that a registrant must disclose on a current basis. We are proposing amendments to the definitions used in Items 2.03 and 2.04 of Form 8-K that revise the terminology used, but which we assume would not significantly impact the scope of information required to be disclosed under those items. Accordingly, we estimate that the proposed amendments would not increase the number of current reports filed on Form 8-K nor add incremental costs and burdens to the existing disclosure burden under Form 8-K. If the proposed revisions to Items 2.03 and 2.04 of Form 8-K were adopted, we estimate that, on average, completing and filing a Form 8-K would require the same amount of time currently spent by entities completing the form — approximately 4 hours.

We estimate that Form 8-K preparation currently results in a total annual compliance burden of 493,436 hours and an annual cost of outside professionals of $65,791,500.

4. Registration Statements

We estimate that the preparation of registration statements that would be affected by the proposed amendments currently has a total annual compliance burden of 1,023,273 hours and an annual cost of outside professionals of $1,127,687,401. As set forth in Table 2 above, if the proposals were adopted, we estimate that the incremental cost of outside professionals for registration statements would be approximately $22,722,000 per year and the incremental company burden would be approximately 18,935 hours per year. For purposes of our submission to the OMB under the PRA, if the proposals were adopted, the total cost of outside professionals for registration statements would be approximately $1,150,409,401 per year and the total company burden would be approximately 1,042,208 hours per year.

C. Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), we request comment in order to:

- Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information would have practical utility;
- Evaluate the accuracy of our estimates of the burden of the proposed collections of information;
- Determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected;
- Evaluate whether there are ways to minimize the burden of the collections of information on those who respond, including through the use of automated collection techniques or other forms of information technology; and
- Evaluate whether the proposed amendments would have any effects on any other collections of information not previously identified in this section.

Any member of the public may direct to us any comments concerning the accuracy of these burden estimates and any suggestions for reducing the burdens. 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 send a copy of the comments to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-22-10. Requests for materials submitted to the OMB by us with regard to these collections of information should be in writing, refer to File No. S7-22-10 and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street NE, Washington DC 20549-0213. Because the OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, your comments are best assured of having their full effect if the OMB receives them within 30 days of publication.

V. COST-BENEFIT ANALYSIS

A. Introduction and Objectives of Proposals

We are proposing amendments to enhance the disclosure that companies provide about short-term borrowings in order to provide more useful disclosure to investors about liquidity and short-term financings and to enhance investor understanding of issuers' liquidity. The proposed amendments are intended to improve disclosure by expanding and supplementing existing requirements.

First, the proposals would require a registrant to provide a comprehensive explanation of its short-term borrowings, including both quantitative and qualitative information. In addition, we are proposing conforming amendments to Form 8-K so that the Form uses the terminology contained in the proposed short-term borrowings disclosure requirement. Finally, we are making technical amendments to Item 303 of Regulation S-K to revise references to U.S. GAAP to reflect the FASB Codification.

The proposals seek to improve transparency of a company's short-term borrowings in order to provide investors with comprehensive information about a company's liquidity profile and demands on capital resources in each reporting period. The proposals also aim to clarify existing MD&A requirements in these areas to assist registrants in preparing disclosure that is meaningful, useful and clear. Ultimately, the proposals are expected to enhance the ability of investors to make informed investment decisions and to allocate capital on a more efficient basis.

We considered alternative regulatory approaches for achieving these objectives, including providing further interpretive guidance on existing MD&A disclosure requirements and encouraging companies to voluntarily provide quantitative and qualitative information on short-term borrowings where material to their financial condition. Although some public companies are voluntarily providing more detailed information as to short-term financings in their MD&A, we have observed that some companies generally do not provided investors with the desired level of detail in their disclosure absent a specific disclosure requirement or guidance, such as Guide 3. To elicit more detailed and comparable disclosures regarding a company's short-term borrowings activities in each reporting period as part of its overall liquidity profile, we are proposing mandated disclosure of short-term borrowings to complement existing MD&A disclosures.

B. Benefits

The proposed disclosures would benefit investors by informing them about the fluctuations in short-term borrowings during the reporting period. Information about the variability of borrowing levels and variations in types of borrowing activities over the course of the reporting period should enable investors to better understand the ability of a registrant to obtain the financing it needs to conduct its business operations and the costs of that financing, and how those may vary during the reporting period. The transparency of the financial statements should increase because investors would be able to learn more about the amount of financial risk taken by the company, its liquidity and capital resources, and the amount of capital deployed in earning activities by the company on an on-going basis during the year, including at quarter-ends. The proposed narrative discussion of the short-term borrowings arrangements, including the importance of those arrangements to the registrant in terms of its liquidity and capital resources, should provide investors with insight into the magnitude of the registrant's short-term borrowing activities, the specific material impact of the short-term borrowing arrangements on the registrant, and the factors that could affect its ability to continue to use those short-term borrowing arrangements.

The proposed disclosures would inform investors about the amount of financial risk taken by the company.[101] For some businesses, short-term borrowings may decrease or increase at quarter- and year-ends due to innate fluctuations in cash flow obligations. In other cases, management may be deliberately reducing short-term debt at period ends.[102] Regardless of the cause, period-end financial statements could be less informative regarding the financial risks taken by companies <u>during</u> the period. The proposed disclosures should add transparency to the ongoing risks taken by companies. These disclosures should also help facilitate a more accurate understanding of a company's liquidity and capital resources.

The proposed disclosures should also inform investors about the amount of capital deployed in earning activities by a company and thus help evaluate its overall source of profitability. Investors should benefit from knowing whether the period-end balance sheet fully reflects all intra-period activities and assets. The disclosure should also enable more accurate comparisons between companies that engage in a pattern of borrowing and those that do not.

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[101] K. Kelly et al., <u>Big Banks Move to Mask Risk Levels — Quarter-End Loan Figures Sit 42% Below Peak, Then Rise as New Period Progresses</u>, WALL ST. J., Apr. 9, 2010; and M. Rappaport & T. McGinty, <u>supra</u> note 16 (reporting that "the practice, known as end-of-quarter 'window dressing' on Wall Street, suggests that the banks are carrying more risk most of the time than their investors or customers can easily see. This activity has accelerated since 2008…").

[102] M. Griffiths & D. Winters, <u>The Turn of the Year in Money Markets: Tests of the Risk-Shifting Window Dressing and Preferred Habitat Hypotheses</u>, J. BUS, 2005, vol. 78, no. 4.; M. Griffiths & D. Winters, <u>On a Preferred Habitat for Liquidity at the Turn-of-the-Year: Evidence from the Term-Repo Market</u>, 12 J. FIN. SERV. RES. 1, 1997; V. Kotomin & D. Winters, <u>Quarter-End Effects in Banks: Preferred Habitat or Window Dressing?</u>, 29 J. FIN. SERV. RES. 1, 2006.

Thus, the new disclosures should enhance transparency and competition especially in industries where short-term borrowing practices are common. Similar disclosure requirements exist in a more limited fashion for banks and bank holding companies under applicable banking regulations.[103] Therefore, bank regulators find this information to be useful in monitoring the risk of these institutions.[104]

The proposed amendments are likely to increase transparency. Therefore, information asymmetry and information risk would be lower and investors should demand a lower risk premium and rate of return.[105] Thus, the proposed disclosures would help reduce cost of capital and improve capital allocation and formation in the overall economy.

C. Costs

The proposals to require short-term borrowings disclosure on an annual and quarterly basis are new. In connection with the new disclosure requirements, registrants would be required to incur additional direct costs to which they were previously not subject, and could incur indirect costs as well. Because the proposed requirements require additional disclosures that are not currently provided in connection with Guide 3 compliance, bank holding companies would also

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103 Banks and bank holding companies report the quarterly average for federal funds sold and securities purchased under agreements to resell (FFIEC 031 and 041 Schedule RC-K, and FR Y-9C Schedule HC-K).

104 See e.g., Board of Governors of the Federal Reserve System, Announcement of Board Approval Under Delegated Authority and Submission to OMB, (March. 18, 2006) [71 FR 11194]. ("The FR Y-9 family of reports historically has been, and continues to be, the primary source of financial information on [bank holding companies] between on-site inspections. Financial information from these reports is used to detect emerging financial problems, to review performance and conduct pre-inspection analysis, to monitor and evaluate capital adequacy, to evaluate [bank holding company] mergers and acquisitions, and to analyze a [bank holding company's] overall financial condition to ensure safe and sound operations.").

105 See D. Easley & M. O'Hara, Information and the Cost of Capital, 59 J. FIN. 1553 (2004) (arguing that the information composition between public and non-public information affects the cost of capital because investors demand a higher return from their investments when they face asymmetric information); R. Lambert et al., Accounting Information, Disclosure, and the Cost of Capital, 45 J. ACCT. RES. 385 (2007) (deriving conditions under which an increase in information quality leads to an unambiguous decline in the cost of capital).

incur additional direct and indirect costs to which they were previously not subject. Furthermore, as noted in our PRA analysis, we estimate that registrants would incur higher costs in the initial reporting periods than would be incurred in ongoing reporting periods.

We estimate that the proposals would impose new disclosure requirements on approximately 10,380 public companies.[106] We estimate that the collection of information and the preparation of the disclosure would involve multiple parties, including in-house preparers, senior management, in-house accounting staff, in-house counsel, information technology personnel, outside counsel, outside auditors and audit committee members. For purposes of our PRA analysis, we estimated that company personnel would spend approximately 872,204 hours per year (84 hours per company) to prepare, review and file the proposed disclosure. We also estimated that companies would spend approximately $143,756,500 ($13,849 per company) on outside professionals to comply with the proposed requirements.

We believe that the proposed amendments could increase the costs for some companies to collect the information necessary to prepare the disclosure. We also believe that the proposed amendments will impose different costs for companies, depending on whether they are bank-holding companies that currently provide Guide 3 information, financial companies as defined in the proposed rule, non-financial companies, or smaller reporting companies, as described below. Although management must already consider short-term borrowing information as it prepares its financial statements and MD&A under existing requirements, the proposed amendments could impose significant incremental costs for the collection and calculation of data, particularly in connection with the registrant's initial compliance.

106 We estimate that all registrants who filed annual reports in 2009 would be required to provide the proposed disclosures.

In particular, this disclosure requires the production of new data for companies that are not already reporting this type of data voluntarily or to their primary regulators. In some industries, companies may readily have access to this information in their systems while others may not be producing it on a daily basis as would be required for financial companies under the proposals. For example, insurance companies may find it difficult to produce daily balances for each day that is necessary for the average and maximum short-term borrowing disclosures applicable to them. In addition, companies that are not financial companies under the proposed definition, particularly those with multi-national operations, may not currently be producing the data necessary for the monthly average and maximum short-term borrowings disclosures, and they may be faced with complex calculation issues when gathering the data from multiple jurisdictions. For many companies, the costs of data production may be high.

For bank holding companies currently subject to Guide 3, costs will likely arise primarily from the preparation of incremental disclosure in MD&A (i.e., the proposed requirements for maximum daily amounts instead of maximum monthly amounts and the proposed narrative discussion of short-term borrowings arrangements) as well as quarterly reporting of this information (rather than on an annual basis alone). These bank holding companies already report to the Commission average short-term borrowings data computed based on daily averages on an annual basis, pursuant to Item VII of Guide 3. Of the approximately 10,380 public companies, we estimate that approximately 800 are bank holding companies.

For registrants that meet the proposed definition of "financial company" but that are not bank holding companies, such as insurance companies, broker-dealers, business development companies, and financing companies, the costs imposed could be substantial because, as requirements that are newly applicable to these entities, costs would likely include implementing or adjusting data gathering systems to capture daily balance information, implementing new disclosure controls and procedures, time spent by internal accounting staff to compile the data, as well as the preparation of narrative disclosure. As a portion of these costs would arise from data collection, the costs of compliance in the initial reporting period would likely be higher because systems may need to be implemented or adjusted. We estimate that, in addition to the approximately 800 bank holding companies, approximately 700 registrants would meet the proposed definition of "financial company."

Registrants that do not meet the definition of "financial companies" could have lower costs than those registrants that are financial companies, because they would not be required to compile data based on daily balances. Again, the requirements would be newly applicable, and could require these registrants to incur costs to implement or adjust data gathering systems to capture month-end balance information, the implementation of new disclosure controls and procedures, time spent by internal accounting staff to compile the data, as well as preparation of narrative disclosure. For companies that do not currently close their books on a monthly basis, the costs of gather the data would likely be higher than those that do, because monthly balances would not be readily available from existing books and records systems. The implementation or adjustment of data gathering systems would likely cause costs to be higher for these companies in the initial compliance period. We estimate that the number of registrants that are not financial companies and that are not smaller reporting companies, is approximately 7,640.

For smaller reporting companies, the proposed requirements would also be newly applicable, and costs incurred would be similar to those applicable to large reporting companies, except that, as proposed, smaller reporting companies would only be required to provide two years of annual short-term borrowings information, rather than three years, and would not be required to provide quarterly disclosure on the same level of detail as annual disclosure. Accordingly, in addition to the costs to prepare and review the disclosure, smaller reporting companies that do not currently track the data needed to compile the short-term borrowings disclosure or that do not currently close their books on a monthly basis, would incur costs to implement or adjust data collection systems and disclosure controls and procedures. On the other hand, small entities without such systems would be more likely to engage in financing activities that are less complex, where the compilation and calculation of such data would not raise significant burdens. In addition, the cost estimates set forth in our PRA analysis may be lower for a small entity to the extent its costs for personnel and outside professionals are lower than our assumed amounts. As discussed elsewhere in this release, we estimate that there are approximately 1,240 smaller reporting companies.

In addition, registrants that are not smaller reporting companies could incur increased costs in connection with the preparation of their quarterly reports, as the amendments call for disclosure in quarterly reports at the same level of detail as in annual reports. To provide this increased level of detail, registrants may need to alter their existing disclosure controls and procedures for quarterly reporting. For purposes of our PRA analysis, we estimated that company personnel would spend approximately 18 additional hours per year to prepare, review and file the proposed disclosure in Form 10-Q. We estimate that approximately 8,200 registrants (based on our estimated number of annual report filers, less smaller reporting companies and foreign private issuers) would be subject to the requirement to provide quarterly disclosure at the same level of detail as in annual reports.

Companies may also be faced with indirect costs arising from the amendments. For example, companies may need to consider the impact of the amendments on their financing plans, to the extent the gathering of data and preparation of disclosure imposes significant time burdens. Specifically, companies could decide to delay registered offerings or conduct unregistered offerings if they are unable to gather data and prepare the new disclosures without significant time and expense. This indirect cost should decrease over time, as companies implement disclosure controls and procedures to comply with the new disclosures. In other cases, companies may alter their short-term borrowings activities in response to the proposed disclosure, in order to avoid incurring the cost of compliance, and in doing so could incur transaction costs or opportunity costs that they would not face without a mandatory disclosure requirement.

In certain cases, mandatory required disclosure requirements can have adverse effects for companies and their shareholders if the disclosures reveal confidential information and trade secrets of a company. In the case of the proposed short-term borrowings, however, such indirect costs should be minimal due to the non-proprietary nature of short-term borrowings. There is some possibility that a company's competitors could be able to infer proprietary or sensitive information about a company's business operations or strategy from disclosure about short-term borrowings arrangements. If this were the case, it could disproportionately impact companies that meet the proposed definition of "financial company," to the extent that amounts calculated based on daily balance information provide a more accurate basis for such inferences. We preliminarily believe that the likelihood of this impact is low.

D. Request for Comment

We request data to quantify the costs and the value of the benefits described above. We seek estimates of these costs and benefits, as well as any costs and benefits not already defined, that may result from the adoption of these proposed amendments. We also request qualitative feedback on the nature of the benefits and costs described above and any benefits and costs we may have overlooked.

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

Section 23(a)(2) of the Exchange Act requires us,[107] 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.

Section 2(b) of the Securities Act[108] and Section 3(f) of the Exchange Act[109] require us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

The proposed amendments are intended to enhance disclosure in MD&A relating to registrants' liquidity profile in each reporting period by highlighting and expanding disclosure requirements for short-term borrowings. The proposed amendments to Form 8-K, which would conform the disclosure requirements in the Form to the proposed amendments to Regulation S-K, are intended to continue to provide real-time disclosure in connection with these topics.

The proposed amendments may increase the usefulness of MD&A. The ability of users of financial information to understand registrants' financial statements and to determine the existence of trends in borrowing and funding activity is expected to improve as a result of the disclosure of average and maximum short-term borrowings during each reporting period.

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107 15 U.S.C. 78w(a)(2).

108 15 U.S.C. 77b(b).

109 15 U.S.C. 78c(f).

The proposed amendments also should increase the efficiency of U.S. capital markets by providing investors with additional and more timely information about registrants' borrowing and funding activities, including borrowing activities that are not apparent on the face of period-end financial statements and exposures to market and funding liquidity risks. This information could be used by investors in allocating capital across companies, and toward companies where the risk incentives appear better aligned with an investor's appetite for risk. Furthermore, these reductions in the asymmetry of information between registrants and investors could reduce registrants' cost of capital as investors may demand a lower risk premium when they have access to more information.[110]

In certain cases, mandatory required disclosure requirements can have adverse effects for companies and their shareholders if the disclosures reveal confidential information and trade secrets of a company. In the case of the proposed short-term borrowings, however, such indirect costs should be minimal due to the non-proprietary nature of short-term borrowings. There is some possibility that a company's competitors could be able to infer proprietary or sensitive information about a company's business operations or strategy from disclosure about short-term borrowings arrangements. If this were the case, it could disproportionately impact companies that meet the proposed definition of "financial company," to the extent that amounts calculated based on daily balance information provide a more accurate basis for such inferences. We preliminarily believe that the likelihood of this impact is low.

We request comment on whether the proposed amendments would promote efficiency, competition, and capital formation or have an impact or burden on competition. Commentators are requested to provide empirical data and other factual support for their view to the extent possible.

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110 See D. Easley & M. O'Hara, supra note 98, and R. Lambert et al, supra note 98.

VII. SMALL BUSINESS REGULATORY ENFORCEMENT FAIRNESS ACT

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA)[111] we solicit data to determine whether the proposed rule amendments constitute a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment or innovation.

Commentators should provide empirical data on (a) the potential annual effect on the economy; (b) any increase in costs or prices for consumers or individual industries; and (c) any potential effect on competition, investment or innovation.

VIII. INITIAL REGULATORY FLEXIBILITY ACT ANALYSIS

This Initial Regulatory Flexibility Analysis (IRFA) has been prepared in accordance with the Regulatory Flexibility Act.[112] It relates to proposed revisions to the rules and forms under the Securities Act and Exchange Act to enhance disclosure that registrants provide in MD&A regarding short-term borrowings.

A. Reasons for, and Objectives of, the Proposed Action

The proposed amendments are intended to enhance disclosure in MD&A relating to registrants' liquidity profile by highlighting and expanding disclosure requirements for short-term borrowings. The proposed amendments to Form 8-K, which would conform the disclosure requirements in the Form to the proposed amendments to Regulation S-K, are intended to continue

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111 Pub. L. No. 104-121, tit. II, 110 Stat. 857 (1996).

112 5 U.S.C. 603.

to provide real-time disclosure in connection with these topics. These amendments are being proposed to increase transparency in the presentation of registrants' borrowing and funding activities and exposure to liquidity risks in connection with that activity. This increased transparency in areas of increasing importance to investors is intended to maintain investor confidence in the full and fair disclosure required of all registrants.

B. Legal Basis

We are proposing the amendments pursuant to Sections 6, 7, 10, 19(a) and 28 of the Securities Act and Sections 12, 13, 14, 15(d), 23(a) and 36 of the Exchange Act.

C. Small Entities Subject to the Proposed Action

The proposed amendments would affect some companies that are small entities. The Regulatory Flexibility Act defines "small entity" to mean "small business," "small organization," or "small governmental jurisdiction."[113] 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. Securities Act Rule 157[114] and Exchange Act Rule 0-10(a)[115] define a company, 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 1,240 companies that may be considered small entities.[116] The proposed amendments would affect small entities that (i) have a class of securities that are registered under Section 12 of the Exchange Act, or are required to file reports under Section 15(d)

113 5 U.S.C. 601(6).

114 17 CFR 230.157.

115 17 CFR 240.0-10(a).

116 This includes approximately 30 business development companies that are small entities. For purposes of the Regulatory Flexibility Act, an investment company (including a business development 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. 17 CFR 270.0-10(a).

of the Exchange Act and (ii) are required to provide MD&A disclosure under applicable rules and forms or disclosure under Items 2.03 and 2.04 of Form 8-K. In addition, the proposals also would affect small entities that file, or have filed, a registration statement (that is required to include MD&A disclosure under the applicable rules and forms) that has not yet become effective under the Securities Act and that has not been withdrawn.

The data underlying the proposed short-term borrowing disclosures should be available from a company's books and records, although it may not currently be collected on month-end basis or daily basis, as proposed in the rule. As discussed in our PRA analysis, we believe that the collection and calculation of short-term borrowing data in the form proposed may have a cost impact on registrants, including small entities, that do not currently maintain information technology systems for the collection of the required data. On the other hand, small entities without such systems would be more likely to engage in financing activities that are less complex, where the compilation and calculation of such data would not raise significant burdens. In addition, the cost estimates set forth in our PRA analysis may be lower for a small entity to the extent its costs for personnel and outside professionals are lower than our assumed amounts.

We are proposing an accommodation for smaller reporting companies, such that expanded disclosures of short-term borrowings would not be required for interim periods and annual period data would only be required for two years rather than three years.

D. Reporting, Recordkeeping, and other Compliance Requirements

The proposed amendments are intended to enhance disclosure about short-term borrowings. These proposals would require a small entity to:

- provide, in a separately captioned subsection of MD&A, a comprehensive explanation of its short-term borrowings, including both quantitative and qualitative information; and

- use a revised definition of "direct financial obligation" for purposes of disclosure requirements in Items 2.03 and 2.04 of Form 8-K.

These proposed amendments largely would apply to both large and small entities equally, except that smaller reporting companies would benefit from the proposed exclusion from expanded interim reporting of short-term borrowings and would provide two years of annual data rather than three. As noted above, the proposed short-term borrowings disclosure should be available from a company's books and records and tracked with existing internal controls without a significant incremental burden imposed on small entities, except to the extent that it doesn't track the data on a monthly basis.

E. Duplicative, Overlapping, or Conflicting Federal Rules

We believe the proposed amendments would not duplicate, overlap, or conflict with other federal rules. The proposed new requirements for short-term borrowings disclosures provide specific, additional information that would be complementary to existing MD&A requirements.

F. Significant Alternatives

The Regulatory Flexibility Act directs us to consider alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. In connection with the proposed disclosure 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.

Currently, small entities are subject to the same MD&A requirements as larger registrants under Item 303 of Regulation S-K, except that smaller reporting companies are permitted to exclude information as to their contractual obligations.[117] The proposed amendments would not alter the exclusions applicable to smaller reporting companies, except, as discussed above, an additional exclusion would be provided for smaller reporting companies so that they would not need to provide the proposed expanded interim period disclosures of short-term borrowings and would be permitted to provide two years of annual data instead of three years. The remaining proposed disclosure requirements would apply to small entities to the same extent as larger registrants, and would require clear, straightforward disclosure about short-term borrowings.

Except for the exclusions noted above, we are not proposing to change existing alternative reporting requirements under Item 303 of Regulation S-K, or establish additional different compliance requirements or an exemption from coverage of the proposed amendments for small entities. The proposed amendments would provide investors with greater transparency into the liquidity profile of registrants, by highlighting short-term borrowings. With potentially fewer financing options available to small entities, information about critical funding risks and future commitments is important to investors in the context of small entities as it is in the context of larger entities. Therefore, we do not believe it is appropriate to develop separate requirements for small entities that would involve clarification, consolidation, or simplification of the proposed disclosure requirements, other than the proposed exclusions discussed above. We do not believe that these proposed disclosures would create a significant new burden for small entities, and, we

[117] Item 303(d) of Regulation S-K provides an exclusion for smaller reporting companies from the requirements of Item 303(a)(5), and permits smaller reporting companies to provide, if they meet specified conditions, only two fiscal years of information on the impact of inflation and changing prices pursuant to Item 303(a)(3)(iv).

believe that uniform, comparable disclosures across all companies would be beneficial for investors and the markets.

We have used design standards and performance standards in connection with the proposed amendments. We rely on design standards for two reasons. First, based on our past experience, we believe that the proposed requirements would result in disclosure that is more useful to investors than if there were specific, enumerated informational requirements. The proposed requirements are intended to elicit more comprehensive and clear disclosure, while still affording registrants the ability to tailor the disclosure to reflect their specific activities and to provide the information that is most important in the context of their specific business. Second, the proposed amendments would promote consistent disclosure among all companies, providing information that is increasingly important to investors. Our existing MD&A requirements are largely performance standards, designed to elicit disclosure unique to the particular company.

Finally, we believe that requiring additional short-term borrowings information in MD&A is the most effective way to elicit the disclosure both for small entities. MD&A's existing emphasis on liquidity and capital resources, as well as identification of significant uncertainties and events, makes the placement of the disclosure as part of MD&A an appropriate choice. Because the proposed disclosure of short-term borrowings is intended to supplement the discussions of liquidity and capital resources already required to be provided by smaller reporting companies under existing rules, we believe the inclusion of the proposed requirements in MD&A would reduce redundant disclosure requirements and promote investors' understanding of this important and, at times highly complex, information.

We seek comment on whether we should exempt small entities from any of the proposed amendments or scale the proposed disclosure requirements to reflect the characteristics of small entities and the needs of their investors.

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:

- How the proposed amendments can achieve their objective while lowering the burden on small entities;
- 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 discussed in the analysis; and
- How to quantify the impact of the proposed amendments.

Respondents are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rule amendments are adopted, and will be placed in the same public file as comments on the proposed amendments themselves.

IX. STATUTORY AUTHORITY AND TEXT OF THE PROPOSED AMENDMENTS

The amendments contained in this release are being proposed under the authority set forth in Sections 6, 7, 10, 19(a) and 28 of the Securities Act and Sections 12, 13, 14, 15(d), 23(a) and 36 of the Exchange Act.

List of Subjects

17 CFR Parts 229 and 249

Reporting and recordkeeping requirements, Securities.

TEXT OF THE PROPOSED AMENDMENTS

For the reasons set out in the preamble, the Commission proposes to amend Title 17, Chapter II, of the Code of Federal Regulations as follows:

PART 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

1. 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.

* * * * *

2. Amend Section 229.303 by:

a. Removing the phrase "paragraphs (a)(1) through (5) of this Item" and adding in its place "paragraphs (a)(1) through (a)(6) of this Item" in the second sentence of the introductory text of paragraph (a);

b. Revising paragraphs (a)(4)(ii)(A), (a)(4)(ii)(C) and (a)(4)(ii)(D), and (a)(5)(ii)(A), (a)(5)(ii)(B) and (a)(5)(ii)(C);

c. Redesignating the "Instructions to paragraph 303(a) (4)" to directly follow paragraph (a)(4)(ii)(D);

d. Adding a new paragraph (a)(6) directly above the "Instructions to paragraph 303(a)";

e. Revising the fourth sentence of Instruction 8 to paragraph 303(a);

f. Revising Instruction 9 to paragraph 303(a);

g. Adding the phrase ", except as provided in Instruction 8 to paragraph 303(b)" at the end of the first sentence of Instruction 3 of the Instructions to paragraph (b) of Item 303;

h. Adding Instruction 8 to the Instructions to paragraph (b) of Item 303; and

i. Revising paragraph (d).

The revisions and additions read as follows:

§229.303 (Item 303) Management's Discussion and Analysis of Financial Condition and Results of Operations.

* * * * *

(a) * * *

(4) * * *

(ii) * * *

(A) Any obligation under a guarantee contract that has any of the characteristics identified in FASB ASC Topic 460, Guarantees, paragraph 460-10-15-4, as may be modified or supplemented, and that is not excluded from the initial recognition and measurement provisions of FASB ASC paragraphs 460-10-15-7, 460-10-25-1, and 460-10-30-1;

(B) * * *

(C) Any obligation, including a contingent obligation, under a contract that would be accounted for as a derivative instrument, except that it is both indexed to the registrant's own stock and classified in stockholders' equity in the registrant's statement of financial position, and therefore excluded from the scope of FASB ASC Topic 815, Derivatives and Hedging, pursuant to FASB ASC subparagraph 815-15-74(a), as may be modified or supplemented;

(D) Any obligation, including a contingent obligation, arising out of a variable interest (as defined in the FASB ASC Master Glossary, as may be modified or supplemented) in an unconsolidated entity that is held by, and material to, the registrant, where such entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with, the registrant.

(5) * * *

(ii) * * *

(A) Long-Term Debt Obligation means a payment obligation under long-term borrowings referenced in FASB ASC Topic 470, Debt, paragraph 470-10-50-1, as may be modified or supplemented.

(B) Capital Lease Obligation means a payment obligation under a lease classified as a capital lease pursuant to FASB ASC Topic 840, Leases, as may be modified or supplemented.

(C) Operating Lease Obligation means a payment obligation under a lease classified as an operating lease and disclosed pursuant to FASB ASC Topic 840, as may be modified or supplemented.

* * * * *

(6) Short-term Borrowings. (i) In tabular format, provide for each category of short-term borrowings specified in paragraph (a)(6)(iii) of this Item and for the periods specified in paragraph (a)(6)(v) of this Item:

(A) The average amount outstanding during each reported period and the weighted average interest rate thereon;

(B) The amount outstanding at the end of each reported period and the weighted average interest rate thereon;

(C) (1) For registrants that are financial companies, the maximum daily amount outstanding during each reported period or

(2) For registrants that are not financial companies, the maximum month-end amount outstanding during each reported period; and

(D) For any of the amounts referred to in paragraphs (a)(6)(i)(A), (B) or (C) of this Item, disaggregate the amounts in the table by currency, interest rate or other meaningful category, to the extent presentation of separate amounts is necessary to promote understanding or to prevent aggregate amounts from being misleading, and include a footnote to the table indicating the method of disaggregation and any other pertinent data relating to the calculation of the amounts presented, including, without limitation, the timing and exchange rates used for currency translations.

(ii) Discuss the registrant's short-term borrowings, including the items specified in paragraphs (a)(6)(ii)(A) through (D) of this Item to the extent necessary to an understanding of such borrowings and the current or future effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources:

(A) A general description of the short-term borrowings arrangements included in each category (including any key metrics or other factors that could reduce or impair the company's ability to borrow under any of such arrangements and whether there are any collateral posting arrangements) and the business purpose to the registrant of such short-term borrowings;

(B) The importance to the registrant of such short-term borrowings in respect of its liquidity, capital resources, market-risk support, credit-risk support or other benefits;

(C) The reasons for any material differences between average short-term borrowings and period-end borrowings; and

(D) The reasons for the maximum outstanding amounts in each reported period, including any non-recurring transactions or events, use of proceeds or other information that provides context for the maximum amount.

(iii) As used in this paragraph (a)(6), the term "short-term borrowings" includes amounts payable for short-term obligations that are:

(A) Federal funds purchased and securities sold under agreements to repurchase;

(B) Commercial paper;

(C) Borrowings from banks;

(D) Borrowings from factors or other financial institutions; and

(E) Any other short-term borrowings reflected on the registrant's balance sheet.

(iv) As used in this paragraph (a)(6), the term "financial company" means a registrant that, during the reported period, is engaged to a significant extent in the business of lending, deposit-taking, insurance underwriting or providing investment advice, or is a broker or dealer as defined in Section 3 of the Exchange Act (15 U.S.C. 78c), and includes, without limitation, an entity that is, or is the holding company of, a bank, a savings association, an insurance company, a broker, a dealer, a business development company as defined in Section 2(a)(48) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(48)), an investment adviser, a futures commission merchant, a commodity trading advisor, a commodity pool operator, or a mortgage real estate investment trust.

(v) Information required by this paragraph (a)(6) shall be presented for each of the three most recent fiscal years, and, in the case of annual reports filed on Form 10-K (referenced in §249.310), information for the registrant's fourth fiscal quarter presented in accordance with the requirements for interim periods set forth in Instruction 8 to paragraph (b) of this Item 303;

provided that a registrant that is a smaller reporting company may provide the information required for each of the two most recent fiscal years in accordance with paragraph (d) of this Item 303 and, in the case of annual reports filed on Form 10-K (referenced in §249.310), is not required to include information for the fourth fiscal quarter.

Instruction 1 to Paragraph 303(a)(6): Where a registrant meets the definition of financial company, but also has operations that do not involve lending, deposit-taking, insurance underwriting, providing investment advice, or broker or dealer activities, it may present the information specified in Item 303(a)(6)(i) separately for such operations. In doing so, the registrant may disclose averages and maximum amounts for such operations using the rules and instructions applicable to registrants that are not financial companies, provided that it must disclose averages computed on a daily average basis and maximum daily amounts for its operations that fall within the definition of financial company. For purposes of making this segregation, the registrant should make the distinction assuming the business in question were itself a registrant. Additional information should be presented by footnote to enable readers to understand how the registrant's operations have been grouped for purposes of the disclosure.

Instruction 2 to Paragraph 303(a)(6): For registrants that are financial companies, averages called for by paragraph (a)(6) of this Item are averages computed on a daily average basis (which means the amount outstanding at the end of each day, averaged over the reporting period). For all other registrants, the basis used for calculating the averages must be identified, and the averaging period used must not exceed a month.

Instruction 3 to Paragraph 303(a)(6): As used in this Item 303(a)(6), the maximum daily amount outstanding during a reported period means the largest amount outstanding at the end of any day in the reported period, and the maximum month-end amount outstanding during a reported period means the largest amount outstanding at the end of the last day of any month in the reported period.

Instructions to Paragraph 303(a):

* * * * *

8. * * * However, registrants may elect to voluntarily disclose supplemental information on the effects of changing prices as provided for in FASB ASC Topic 255, Changing Prices, or through other supplemental disclosures. * * *

9. Registrants that elect to disclose supplementary information on the effects of changing prices as specified by FASB ASC Topic 255 may combine such explanations with the discussion and analysis required pursuant to this Item or may supply such information separately with appropriate cross-reference.

* * * * *

(b) * * *

Instructions to Paragraph 303(b):

* * * * *

8. Notwithstanding anything to the contrary in this Item 303, a registrant that is not a smaller reporting company must include the disclosure required pursuant to (a)(6) of this Item for each interim period for which financial statements are included or required to be included by Article 3 of Regulation S-X (17 CFR 210.3-01 to 3.18), and for the registrant's fourth fiscal quarter in the case of an annual report filed on Form 10-K (referenced in §249.310), and must provide an updated discussion and analysis of the information presented. The discussion and analysis should also highlight any material changes from prior periods. For purposes of interim period disclosures of short-term borrowings required by paragraph (a)(6) of this Item, the term

"reported period" used in paragraph (a)(6) of this Item means the most recent interim period presented or, in the case of an annual report filed on Form 10-K (referenced in §249.310), the registrant's fourth fiscal quarter.

* * * * *

(d) Smaller reporting companies. A smaller reporting company, as defined in §229.10(f)(1) of this Chapter, may provide the information required in paragraphs (a)(3)(iv) and (a)(6) of this Item for the last two most recent fiscal years of the registrant if it provides financial information on net sales and revenues and on income from continuing operations for only two years. For interim periods, a smaller reporting company is not required to follow Instruction 8 to paragraph 303(b) and, instead, must discuss material changes to the information specified in paragraphs (a)(4) and (a)(6) of this Item from the end of the preceding fiscal year (and, if included, from the corresponding interim balance sheet date of the preceding fiscal year) to the date of the most recent interim balance sheet provided. In the case of an annual report filed on Form 10-K (referenced in §249.310), a smaller reporting company is not required to provide information for the fourth quarter of the most recent fiscal year.

* * * * *

PART 249 — FORMS, SECURITIES EXCHANGE ACT OF 1934

3. The authority citation for part 249 continues to read in part as follows:

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

* * * * *

4. Form 8-K (referenced in §249.308) is amended by:

a. Revising paragraph (c)(4) of Item 2.03; and

b. Removing paragraph (e) of Item 2.03.

The revisions read as follows:

Note: The text of Form 8-K does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 8-K

* * * * *

Item 2.03 Creation of a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement of a Registrant.

* * * * *

(c) * * *

(4) a short-term borrowing, as defined in Item 303(a)(6)(iii) of Regulation S-K (17 CFR 229.303(a)(6)(iii)), that arises other than in the ordinary course of business.

* * * * *

5. Form 20-F (referenced in §249.220f) Item 5 is amended by:

a. Revising paragraphs (a) and (d) of Item 5.E.2;

b. Adding Item 5.H; and

c. Adding Instructions to Item 5.H after the "Instructions to Item 5.F".

The revisions and additions read as follows:

Note: The text of Form 20-F does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 20-F

* * * * *

Item 5. Operating and Financial Review and Prospects

* * * * *

E. Off-balance sheet arrangements.

* * * * *

2. * * *

(a) Any obligation under a guarantee contract that has any of the characteristics identified in FASB ASC Topic 460, Guarantees, paragraph 460-10-15-4, as may be modified or supplemented, excluding the types of guarantee contracts described in FASB ASC paragraphs 460-10-15-7, 460-10-25-1, and 460-10-30-1;

(b) * * *

(c) * * *

(d) Any obligation, including a contingent obligation, arising out of a variable interest (as defined in the FASB ASC Master Glossary, as may be modified or supplemented) in an unconsolidated entity that is held by, and material to, the company, where such entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with, the company.

* * * * *

H. Short-Term Borrowings

1. In tabular format, provide for each category of short-term borrowings specified in Item 5.H.3 of this Form and for the periods specified in Item 5.H.5 of this Form:

(a) The average amount outstanding during each reported period and the weighted average interest rate thereon;

(b) The amount outstanding at the end of each reported period and the weighted average interest rate thereon;

(c)(i) For companies that are financial companies, the maximum daily amount outstanding during each reported period or

(ii) For companies that are not financial companies, the maximum month-end amount outstanding during each reported period; and

(d) For any of the amounts referred to in (a), (b) or (c) of this Item 5.H.1, disaggregate the amounts in the table by currency, interest rate or other meaningful category, to the extent presentation of separate amounts is necessary to promote understanding or to prevent aggregate amounts from being misleading, and include a footnote to the table indicating the method of disaggregation and any other pertinent data relating to the calculation of the amounts presented, including, without limitation, the timing and exchange rates used for currency translations.

2. Provide a discussion of the company's short-term borrowings, including the items specified in paragraphs (a) through (d) of this Item 5.H.2 to the extent necessary to an understanding of such borrowings and the current or future effect on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources:

(a) A general description of the short-term borrowings included in each category (including any key metrics or other factors that could reduce or impair the company's ability to borrow under any of such arrangements and whether there are any collateral posting arrangements) and the business purpose to the company of such short-term borrowings;

(b) The importance to the company of such short-term borrowings in respect of its liquidity, capital resources, market-risk support, credit-risk support or other benefits;

(c) The reasons for any material differences between average short-term borrowings and period-end borrowings; and

(d) The reasons for the maximum outstanding amounts in each reported period, including any non-recurring transactions or events, use of proceeds or other information that provides context for the maximum amount.

3. As used in this Item 5.H, the term "short-term borrowings" means amounts payable for short-term obligations that are:

(a) Federal funds purchased and securities sold under agreements to repurchase;

(b) Commercial paper;

(c) Borrowings from banks;

(d) Borrowings from factors or other financial institutions; and

(e) Any other short-term borrowings reflected in the company's balance sheet.

4. As used in this Item 5.H, the term "financial company" means a company that, during the reported period, is engaged to a significant extent in the business of lending, deposit-taking, insurance underwriting or providing investment advice, or is a broker or dealer as defined in Section 3 of the Exchange Act (15 U.S.C. 78c), and includes, without limitation, an entity that is or is the holding company of, a bank, a savings association, an insurance company, a broker, a dealer, a business development company as defined in Section 2(a)(48) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(48)), an investment adviser, a futures commission merchant, a commodity trading advisor, a commodity pool operator, or a mortgage real estate investment trust.

5. Information required by this Item 5.H shall be presented for each of the three most recent fiscal years.

* * * * *

Instructions to Item 5.H:

1. Notwithstanding Item 5.H.3, the categories of short-term borrowings disclosed pursuant to Item 5.H of this Form may be based on the classifications for such types of short-term borrowings used under the comprehensive set of accounting principles that the company uses to prepare its primary financial statements, so long as the disclosure is provided at a level of detail that satisfies the objective of this Item 5.H disclosure requirement.

2. Where a company meets the definition of financial company, but also has operations that do not involve lending, deposit-taking, insurance underwriting, providing investment advice, or broker or dealer activities, it may present the information specified in Item 5.H.1 of this Form separately for such operations. In doing so, the company may disclose averages and maximum amounts for such operations using the rules and instructions applicable to companies that are not financial companies, provided that it must disclose averages computed on a daily average basis and maximum daily amounts for its operations that fall within the definition of financial company. For purposes of making this segregation, the company should make the distinction assuming the business in question were itself a registrant. Additional information should be presented by footnote to enable readers to understand how the company's operations have been grouped for purposes of the disclosure.

3. For companies that are financial companies, averages called for by this Item 5.H are averages computed on a daily average basis (which means the amount outstanding at the end of each day, averaged over the reporting period). For all other companies, the basis used for calculating the averages must be identified, and the averaging period used must not exceed a month.

4. As used in this Item 5.H, the maximum daily amount outstanding during a reported period means the largest amount outstanding at the end of any day in the reported period, and the maximum month-end amount outstanding during a reported period means the largest amount outstanding at the end of the last day of any month in the reported period.

* * * * *

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

September 17, 2010

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 211, 231 and 241

Release Nos. 33-9144; 34-62934; FR-83

Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis

AGENCY: Securities and Exchange Commission.

ACTION: Interpretation.

SUMMARY: We are providing interpretive guidance that is intended to improve discussion of liquidity and capital resources in Management's Discussion and Analysis of Financial Condition and Results of Operations in order to facilitate understanding by investors of the liquidity and funding risks facing the registrant.

EFFECTIVE DATE: [insert date of publication in the Federal Register]

FOR FURTHER INFORMATION CONTACT: Questions about specific filings should be directed to staff members responsible for reviewing the documents the registrant files with the Commission. For general questions about this release, contact Christina L. Padden, Attorney Fellow in the Office of Rulemaking, at (202) 551-3430 or Stephanie L. Hunsaker, Associate Chief Accountant, at (202) 551-3400, in the Division of Corporation Finance; or Wesley R. Bricker, Professional Accounting Fellow, Office of the Chief Accountant at (202) 551-5300; U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

I. BACKGROUND

Over the past several years, we have provided guidance and have engaged in rulemaking initiatives to improve the presentation of information about funding and liquidity risk.[1] In a companion release, we are proposing amendments to enhance the disclosure that registrants present about short-term borrowings.[2] The proposals in that release would require a registrant to provide, in a separately captioned subsection of Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"), a comprehensive explanation of its short-term borrowings, including both quantitative and qualitative information. The proposed amendments to MD&A would be applicable to annual and quarterly reports, proxy or information statements that include financial statements, registration statements under the Securities Exchange Act of 1934, and registration statements under the Securities Act of 1933. We are also proposing conforming amendments to Form 8-K so that the Form would use the terminology contained in the proposed short-term borrowings disclosure requirement. To further improve the discussion of liquidity and

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1 See, e.g., Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8056 (Jan. 22, 2002) [67 FR 3746]; Disclosure in Management's Discussion and Analysis About Off Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments, Release No. 33-8144 (Nov. 4, 2002) [67 FR 68054]; Disclosure in Management's Discussion and Analysis About Off Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments, Release No. 33-8182 (Jan. 28, 2003) [68 FR 5982] (adopting rules for disclosure in MD&A of off-balance sheet arrangements and aggregate contractual obligations); and Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8350 (Dec. 19, 2003) [68 FR 75056] (providing interpretive guidance on disclosure in MD&A, including liquidity and capital resources).

2 See Short-Term Borrowings Disclosure, Release No. 33-9143 (the "Proposing Release").

capital resources in MD&A in order to facilitate understanding by investors of the liquidity and funding risks facing the registrant, we are also providing the following guidance with respect to existing MD&A requirements.

II. GUIDANCE ON PRESENTATION OF LIQUIDITY AND CAPITAL RESOURCES DISCLOSURES IN MANAGEMENT'S DISCUSSION AND ANALYSIS

A. Liquidity Disclosure

As discussed in the Proposing Release, companies have expanded the types of funding methods and cash management tools they use. We remind registrants that Item 303(a)(1) of Regulation S-K requires them to "identify and separately describe internal and external sources of liquidity, and briefly discuss any material unused sources of liquidity." Accordingly, as the financing activities undertaken by registrants become more diverse and complex, it is increasingly important that the discussion and analysis of liquidity and capital resources provided by registrants meet the objectives of MD&A disclosure.

In 2003, the Commission issued interpretive guidance relating to MD&A disclosures of liquidity and capital resources, as well as MD&A generally.[3] We encourage registrants to review that guidance when preparing their MD&A, as it covers topics relating to the discussion of cash requirements, cash management, sources and uses of cash, as well as a registrant's debt instruments, guarantees and related covenants, that continue to be relevant to investors.

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[3] See Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8350 (Dec. 19, 2003) [68 FR 75056] (the "2003 Interpretive Release").

As we have stated in the past, MD&A requires companies to provide investors with disclosure that facilitates an appreciation of the known trends and uncertainties that have impacted historical results or are reasonably likely to shape future periods.[4] This disclosure should both discuss and analyze the company's business from the perspective of management.[5] In the context of liquidity, Item 303(a)(1) of Regulation S-K requires disclosure of known trends or any known demands, commitments, events or uncertainties that will result in, or that are reasonably likely to result in, the registrant's liquidity increasing or decreasing in any material way.[6] In past guidance, the Commission has highlighted a number of issues for management to consider when identifying trends, demands, commitments, events and uncertainties that require disclosure in MD&A.[7] Some additional important trends and uncertainties relating to liquidity might include, for example, difficulties accessing the debt markets, reliance on commercial paper or other short-term

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4 See Disclosure in Management's Discussion and Analysis About Off Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments, Release No. 33-8182 (Jan. 28, 2003) [68 FR 5982] (the "OBS Adopting Release"), at 5982 ("MD&A also provides a unique opportunity for management to provide investors with an understanding of its view of the financial performance and condition of the company, an appreciation of what the financial statements show and do not show, as well as important trends and risks that have shaped the past and are reasonably likely to shape the future.").

5 "MD&A should be a discussion and analysis of a company's business as seen through the eyes of those who manage that business. Management has a unique perspective on its business that only it can present. As such, MD&A should not be a recitation of financial statements in narrative form, or an otherwise uninformative series of technical responses to MD&A requirements, neither of which provides this important management perspective." See 2003 Interpretive Release, supra note 3, at 75056.

6 "The scope of the discussion should thus address liquidity in the broadest sense, encompassing internal as well as external sources, current conditions as well as future commitments and known trends, changes in circumstances and uncertainties." See Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8056 (Jan. 22, 2002) [67 FR 3746] (the "2002 Interpretive Release"), at 3748 n.11.

7 See 2002 Interpretive Release, supra note 5, at 3748.

financing arrangements, maturity mismatches between borrowing sources and the assets funded by those sources, changes in terms requested by counterparties, changes in the valuation of collateral, and counterparty risk.

In addition, in the context of liquidity and capital resources, if the registrant's financial statements do not adequately convey the registrant's financing arrangements during the period, or the impact of those arrangements on liquidity, because of a known trend, demand, commitment, event or uncertainty, additional narrative disclosure should be considered and may be required to enable an understanding of the amounts depicted in the financial statements. For example, depending on the registrant's circumstances, if borrowings during the reporting period are materially different than the period-end amounts recorded in the financial statements, disclosure about the intra-period variations is required under current rules to facilitate investor understanding of the registrant's liquidity position.

Moreover, the Commission's staff has noted that there may be confusion on the part of registrants about how to address disclosure of certain repurchase agreements that are accounted for as sales, as well as other types of short-term financings that are not otherwise fully captured in period-end balance sheets.[8] Again, disclosure is required in MD&A where

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8 In its 2005 OBS Report, the Commission's staff identified transfers of assets with continuing involvement as one of the principal areas in need of improvement in disclosure of off-balance sheet arrangements. See Staff of the U.S. Securities and Exchange Commission, Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities and Transparency of Filings by Issuers (June 2005), available at http://www.sec.gov/news/studies/soxoffbalancerpt.pdf. See also, the Division of Corporation Finance, Sample Letter Sent to Public Companies Asking for Information Related to Repurchase Agreements, Securities Lending Transactions, or Other Transactions Involving the Transfer of Financial Assets (Mar. 2010), available at http://www.sec.gov/divisions/corpfin/guidance/cforepurchase0310.htm., and the Division of Corporation Finance, Sample Letter Sent to Public Companies That Have Identified Investments in

a known commitment, event or uncertainty will result in (or is reasonably likely to result in) the registrant's liquidity increasing or decreasing in a material way.[9] The absence of specific references in existing disclosure requirements for off-balance sheet arrangements or contractual obligations to repurchase transactions that are accounted for as sales, or to any other transfers of financial assets that are accounted for as sales, does not relieve registrants from the disclosure requirements of Item 303(a)(1).[10] Further, as stated in the 2002 Interpretive Release, legal opinions regarding "true sale" issues do not obviate the need for registrants to consider whether disclosure is required.[11] In evaluating whether disclosure in MD&A may be required in connection with a repurchase transaction, securities lending transaction, or any other transaction involving the transfer of financial assets with an obligation to repurchase financial assets, that has been accounted for as a sale under applicable accounting standards, the registrant should consider whether the transaction is reasonably likely to result in the use of a material amount of cash or other liquid assets. Disclosure may be required in the discussion of liquidity and capital resources, particularly

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Structured Investment Vehicles, Conduits or Collateralized Debt Obligations (Off-balance Sheet Entities) (Dec. 2007) available at http://www.sec.gov/divisions/corpfin/guidance/cfoffbalanceltr1207.htm.

9 See Item 303(a)(1) [17 CFR 229.303(a)(1)].

10 We also note that, in 1986, the Commission adopted changes to Rule 4-08 of Regulation S-X to require financial statement footnote disclosure of the nature and extent of a registrant's repurchase and reverse repurchase transactions and the degree of risk involved. See Disclosure Amendments to Regulation S-X Regarding Repurchase and Reverse Repurchase Agreements, Release No. 33-6621 (Jan. 22, 1986) [51 FR 3765]. These requirements focus on disclosure of risk of loss due to counter-party default. See Rule 4-08(m) of Regulation S-X [17 CFR §210.4-08m]. However, the adopting release indicates that the requirements do not affect obligations under MD&A requirements to discuss "any material impact on liquidity or operations and risk resulting from involvement with repurchase and reverse repurchase agreements."

11 See 2002 Interpretive Release, supra note 5, at 3749.

where the registrant does not otherwise include such information in its off-balance sheet arrangements or its contractual obligations table. A registrant may determine where in its MD&A this information would be most informative based on the type of obligation and potential exposure involved, with an emphasis on providing disclosure that is clear and not misleading.

To provide context for the exposures identified in MD&A, companies should also consider describing cash management and risk management policies that are relevant to an assessment of their financial condition. Banks, in particular, should consider discussing their policies and practices in meeting applicable banking agency guidance on funding and liquidity risk management, or any policies and practices that differ from applicable agency guidance. In addition, a company that maintains or has access to a portfolio of cash and other investments that is a material source of liquidity should consider providing information about the nature and composition of that portfolio, including a description of the assets held and any related market risk, settlement risk or other risk exposure. This could include information about the nature of any limits or restrictions and their effect on the company's ability to use or to access those assets to fund its business operations.

Transparent financial reporting that conveys a complete and understandable picture of a company's financial position reduces uncertainty in our markets. Surprises to investors can be reduced or avoided when a company provides clear and understandable information about known trends, events, demands, commitments and uncertainties, particularly where they are reasonably likely to have a current or future material impact on that company. The economic environment is not static. Circumstances and risks change and, as a result, disclosure about those circumstances and risks must also evolve. As we stated in the 2003 Interpretive Release, if prior disclosure "does not adequately foreshadow subsequent events, or if new information that impacts known trends and uncertainties becomes apparent...additional disclosure should be considered and may be required."[12] This principle is equally applicable in the context of liquidity and capital resources disclosure.

B. Leverage Ratio Disclosures

Where a registrant includes capital or leverage ratio disclosure in its filings with the Commission, and there are no regulatory requirements prescribing the calculation of that ratio, or where a registrant includes capital or leverage ratios that are calculated using a methodology that is modified from its prescribed form, we remind registrants of our long-standing approach to disclosure of financial measures and non-financial measures in MD&A. First, the registrant should determine whether the measure is a financial measure. If the measure is not a financial measure, registrants should refer to the guidance we provided in 2003 for disclosures relating to non-financial measures, such as industry metrics or value metrics.[13] If the measure is a financial measure, the registrant should next determine whether the measure falls within the scope of our requirements for non-GAAP financial measures,

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12 <u>See</u> 2003 Interpretive Release, <u>supra</u> note 3, at 75061, and Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Release No. 33-6835 (May 18, 1989) [54 FR 22427] (the "1989 Interpretive Release"). The 1989 Interpretive Release clarifies that material changes to items disclosed in MD&A in annual reports should be discussed in the quarter in which they occur. The 2003 Interpretive Release states that "there may also be circumstances where an item may not be material in the context of a discussion of annual results of operations but is material in the context of interim results."

13 <u>See</u> 2003 Interpretive Release, <u>supra</u> note 3, at 75060.

and if it is, the registrant would need to follow our rules and guidance governing the inclusion of non-GAAP financial measures in filings with the Commission.[14]

In any event, any ratio or measure included in a filing should be accompanied by a clear explanation of the calculation methodology. The explanation would need to clearly articulate the treatment of any inputs that are unusual, infrequent or non-recurring, or that are otherwise adjusted so that the ratio is calculated differently from directly comparable measures. Similar to our guidance for the disclosure of non-financial measures, if the financial measure presented differs from other measures commonly used in the registrant's industry, the registrant would need to consider whether a discussion of those differences or presentation of those measures would be necessary to make the disclosures not misleading. Finally, a registrant would need to consider its reasons for presenting the particular financial measure, and should include disclosure clearly stating why the measure is useful to understanding its financial condition. Where the ratio is being presented in connection with disclosure on debt instruments and related covenants, registrants should also consult our past guidance on disclosure of debt instruments, guarantees and related covenants.[15]

C. Contractual Obligations Table Disclosures

As an aid to understanding other liquidity and capital resources disclosures in MD&A, the contractual obligations tabular disclosure should be prepared with the goal of

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14 See Conditions for Use of Non-GAAP Financial Measures, Release No. 33-8176 (Jan. 22, 2003) [68 FR 4820] and Item 10(e) of Regulation S-K [17 CFR 229.10(e)(5)]. We note that existing rules and guidance governing the inclusion of non-GAAP financial measures in filings with the Commission do not apply to financial measures that are "required to be disclosed by GAAP, Commission rules, or a system of regulation of a government or governmental authority or self-regulatory organization that is applicable to the registrant.

15 See 2003 Interpretive Release, supra note 3, at 75064.

presenting a meaningful snapshot of cash requirements arising from contractual payment obligations. The Commission's staff has observed that divergent practices have developed in connection with the contractual obligations table disclosure, with registrants drawing different conclusions about the information to be included and the manner of presentation. The requirement itself permits flexibility so that the presentation can reflect company-specific information in a way that is suitable to a registrant's business. Accordingly, registrants are encouraged to develop a presentation method that is clear, understandable and appropriately reflects the categories of obligations that are meaningful in light of its capital structure and business. Registrants should highlight any changes in presentation that are made, so that investors are able to use the information to make comparisons from period to period.

Since the adoption of Item 303(a)(5), registrants and industry groups have raised questions to our staff about how to treat a number of items under the contractual obligations requirement, including: interest payments, repurchase agreements, tax liabilities, synthetic leases, and obligations that arise under off-balance sheet arrangements. In addition, a variety of questions has been raised with our staff in the context of purchase obligations. Because the questions that arise tend to be fact-specific and closely related to a registrant's particular business and circumstances, we have not issued general guidance as to how to treat these items or other questions regarding the presentation of the contractual obligations table. The purpose of the contractual obligations table is to provide aggregated information about contractual obligations and contingent liabilities and commitments in a single location so as to improve transparency of a registrant's short-term and long-term liquidity and capital resources needs and to provide context for investors to assess the relative role of off-balance sheet arrangements;[16] registrants should prepare the disclosure consistent with that objective. Uncertainties about what to include or how to allocate amounts over the periods required in the table should be resolved consistent with the purpose of the disclosure. To that end, footnotes should be used to provide information necessary for an understanding of the timing and amount of the specified contractual obligations, as indicated in the instructions contained in Item 303(a)(5)(i), or, where necessary to promote understanding of the tabular data, additional narrative discussion outside of the table should be considered. Registrants should determine how best to present the information that is relevant to their own business in a manner that is clear, consistent with the purpose of the disclosure and not misleading, and should provide additional disclosure where necessary to explain what the tabular data includes and does not include.[17]

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16 See OBS Adopting Release, supra note 4, at 5990.

17 As an example, if useful to a clear understanding of the information presented, a registrant might consider separating amounts in the table into those that are reflected on the balance sheet and those arising from off-balance sheet arrangements, particularly where such a distinction helps to tie the information to financial statement disclosure and other MD&A discussion.

III. Codification Update

The "Codification of Financial Reporting Policies" announced in Financial Reporting Release 1 (April 15, 1982) [47 FR 21028] is updated by adding new Section 501.03.a.i, captioned "Additional Guidance on Presentation of Liquidity and Capital Resources Disclosures" to the Financial Reporting Codification and under that caption including the text in Section II of this release.

The Codification is a separate publication of the Commission. It will not be published in the Federal Register/Code of Federal Regulations.

List of Subjects

17 CFR Part 211, 231 and 241

Securities.

Amendments to the Code of Federal Regulations.

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

PART 211 — INTERPRETATIONS RELATING TO FINANCIAL REPORTING MATTERS

1. Part 211, Subpart A, is amended by adding Release No. FR-83 and the release date of September 17, 2010 to the list of interpretive releases.

PART 231 — INTERPRETATIVE RELEASES RELATING TO THE SECURITIES ACT OF 1933 AND GENERAL RULES AND REGULATIONS THEREUNDER

2. Part 231 is amended by adding Release No. 33-9144 and the release date of September 17, 2010 to the list of interpretive releases.

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

3. Part 241 is amended by adding Release No. 34-62934 and the release date of September 17, 2010 to the list of interpretive releases.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: September 17, 2010

Commissioner Aguilar not participating

SECURITIES AND EXCHANGE COMMISSION
Washington D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 62937 / September 20, 2010

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 3085 / September 20, 2010

Admin. Proc. File No. 3-13481

In the Matter of

DAVID G. GHYSELS
and
KENNETH E. MAHAFFY, Jr.

OPINION OF THE COMMISSION

BROKER-DEALER PROCEEDING

INVESTMENT ADVISER PROCEEDING

Grounds for Remedial Action

Criminal Conviction

Former associated persons of registered broker-dealers and investment advisers were criminally convicted for participating in a conspiracy to commit securities fraud. *Held*, it is in the public interest to bar Respondents from association with any broker, dealer, or investment adviser.

APPEARANCES:

Susan C. Wolfe of Hoffman & Pollok LLP, for David G. Ghysels and *Andrew J. Frisch* for Kenneth E. Mahaffy, Jr.

Jack Kaufman and *William Finkel* for the Division of Enforcement.

Appeal filed: January 2, 2010
Last brief received: August 3, 2010

I.

David G. Ghysels and Kenneth E. Mahaffy, Jr. (together, "Respondents") appeal from the decision of an administrative law judge barring them from association with any broker, dealer, or investment adviser[1] based on their convictions for participating in a conspiracy to commit securities fraud. We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal.

II.

A. During the period at issue, Respondents were associated with broker-dealers and investment advisers registered with the Commission (the "Firms").[2] On October 16, 2008, Respondents were indicted for participating in a scheme to provide "day traders"[3] with access to confidential and proprietary business information transmitted over the Firms' internal speaker systems, i.e., "squawk boxes," between January 2002 and February 2004. The Firms used the squawk boxes to broadcast large customer orders to their registered representatives on an ongoing basis throughout the day so that the representatives could contact potential counterparties to fill these orders at the best available price. The indictment charged that the Respondents allowed day traders to listen in on these internal Firm communications and, in exchange, received "bribes in the form of cash, commissions and other things of value."

On April 22, 2009, a jury found Respondents guilty of participating in a conspiracy to commit securities fraud under 18 U.S.C. Sections 1348 and 1349.[4] By special verdict, the jury

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1 *David G. Ghysels*, Initial Decision Rel. No. 391 (Dec. 11, 2009), 97 SEC Docket 23911.

2 Ghysels was a registered representative of Lehman Brothers, Inc. from approximately March 2001 through March 2003 and a registered representative of Citigroup Global Markets, Inc. from approximately April 2003 through May 2005. Mahaffy was a registered representative of Merrill Lynch, Pierce, Fenner & Smith, Inc. from approximately December 1997 through January 2003 and a registered representative of Citigroup Global Markets, Inc. from approximately February 2003 through 2005.

3 The indictment defined "day trading" as a "strategy whereby stock traders, through a high volume of trading activity, attempt to profit from slight changes in the prices of securities by buying and selling securities within a very short period of time."

4 18 U.S.C. § 1348 (making it a crime to "knowingly execute, or attempt to execute, a scheme or artifice – (1) to defraud any person in connection" with any registered security; or (2) "to obtain, by . . . fraudulent pretenses . . . any money or property in connection with the purchase or sale" of any registered security); 18 U.S.C. § 1349 (criminalizing any "attempt or

(continued...)

found that Respondents had, "knowingly and with intent to defraud," obtained money or property for their participation in a scheme to misappropriate confidential business information and to deprive the Firms of the honest services of their employees. Before rendering its verdict, the jury was instructed that good faith was a "complete defense" to the charges, and that:

> if a defendant had an honestly held belief none of the information being transmitted to the [day trading] defendants was confidential, you must acquit that defendant of conspiring to defraud the brokerage houses of their property. Similarly, if the defendant had an honestly held belief the transmission of squawk box communications to [the day traders] didn't deprive the brokerage houses of the honest services of their employees, you must acquit that defendant of conspiring to deprive the brokerage firms of the honest services of those employees.

On December 29, 2009, Mahaffy was sentenced in the United States District Court for the Eastern District of New York to two years of incarceration, forfeiture of $98,328, and ordered to "notify any potential future employers who would be entrusting [him] to access and/or manage financial accounts of the instant conviction." Ghysels was sentenced to three years of probation, including six months of home detention, and forfeiture of $36,680. Respondents have appealed the convictions, and the judgment was stayed by the United States Court of Appeals for the Second Circuit on May 24, 2010 pending disposition of the appeal.[5]

B. Based on these criminal convictions, we authorized administrative proceedings against Respondents on May 21, 2009 pursuant to Section 15(b) of the Securities Exchange Act of 1934

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[4] (...continued)
conspiracy" to commit an offense); *see also* 18 U.S.C. § 1346 (defining "scheme or artifice to defraud" to "include a scheme or artifice to deprive another of the intangible right of honest services").

[5] Respondents also moved for dismissal of the indictment or for a new trial (the "Motion for Dismissal"), which was denied by the district court judge in a memorandum and order dated July 21, 2010 (the "July 21 Order"). On August 3, 2010, the Division of Enforcement (the "Division") filed a motion requesting that the Commission take notice of the July 21 Order, and noting that Respondents have filed a notice of appeal for the July 21 Order. We take official notice of the July 21 Order pursuant to Rule of Practice 323, 17 C.F.R. § 201.323.

Mahaffy's reply brief also includes exhibits that were not introduced during the proceedings below – including excerpts of investigative testimony and e-mails from a Division attorney – that Respondents apparently submitted to the district court in connection with their Motion for Dismissal. We admit these exhibits pursuant to Rule of Practice 452, 17 C.F.R. § 201.452.

and Section 203(f) of the Investment Advisers Act of 1940.[6] On December 11, 2009, a law judge issued an initial decision by summary disposition.[7] The law judge found the convictions collaterally estopped relitigation of the underlying facts. Concluding that there were no extraordinary mitigating circumstances, the law judge barred Respondents from associating with any broker, dealer, or investment adviser.

III.

Exchange Act Section 15(b) and Advisers Act Section 203(f) authorize administrative proceedings based on a conviction for certain enumerated offenses, including any felony or misdemeanor "aris[ing] out of the conduct of the business of a broker [or] dealer" or that "involves the purchase or sale of any security."[8] Upon such a conviction, the Exchange Act and the Advisers Act authorize discipline if such person was associated with a broker-dealer or an investment adviser, in each case, "at the time of the alleged misconduct."[9]

Respondents do not dispute the law judge's findings, supported by the record, that their convictions met these statutory benchmarks, and that each Respondent was associated with a firm that was both a broker-dealer and an investment adviser during the alleged misconduct. Mahaffy's answer to the order instituting proceedings (the "OIP") "admit[ted] that he was associated with a broker-dealer and investment advisor registered with the Commission, but object[ed] to the relevance of his employers' registrations as investment advisors." Ghysels' answer did not address or contest this OIP allegation.[10] Accordingly, the requirements for discipline under Exchange Act Section 15(b) and Advisers Act Section 203(f) have been met.[11]

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6 15 U.S.C. § 78*o*(b); 15 U.S.C. § 80b-3.

7 A hearing officer "may grant . . . summary disposition if there is no genuine issue with regard to any material fact and the party making the motion is entitled to a summary disposition as a matter of law." 17 C.F.R. § 201.250(b).

8 15 U.S.C. § 78*o*(b)(4)(B) and (6)(A); 15 U.S.C. § 80b-3(e)(2)(B) and (f); *see also Kornman v. SEC*, 592 F.3d 173, 184 (D.C. Cir. 2010) ("Congress has authorized the Commission to discipline persons who have been convicted of crimes that suggest a lack of fitness to remain in the securities industry.").

9 15 U.S.C. § 78*o*(6)(A); 15 U.S.C. § 80b-3(f).

10 *See* Rule of Practice 220(c), 17 C.F.R. § 201.220(c) ("Any allegation [in the OIP] not denied shall be deemed admitted.").

11 *See* 15 U.S.C. § 80b-2(a)(17) (defining "person associated with an investment adviser"); 15 U.S.C. § 78c(a)(18) (defining "person associated with a broker or dealer");

(continued...)

A. The Exchange Act and the Advisers Act authorize us to censure, place limitations on, suspend, or bar an associated person based on these findings if we find that such sanction is in the public interest.[12] In analyzing the public interest we consider, among other things: the egregiousness of the respondent's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the likelihood that the respondent's occupation will present opportunities for future violations.[13] Our "inquiry into . . . the public interest is a flexible one, and no one factor is dispositive."[14]

Based on our consideration of these factors, we believe that the bars imposed by the law judge were amply warranted.[15] Respondents were criminally convicted for conduct that was egregious. Mahaffy asserts that his actions were "not done clandestinely and did not implicate any other part of his work as a registered representative." However, Respondents exchanged

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[11] (...continued)
Kornman, 592 F.3d at 183 (citing "Congress['s] . . . original intent that misconduct during a past association . . . subjects a person to administrative proceedings and sanctions under the Exchange and Advisers Acts"); *Ira William Scott*, 53 S.E.C. 862, 866 (1998) (finding that respondent who "registered as an investment adviser . . . submitted himself to our jurisdiction pursuant to the Advisers Act"). Moreover, the Advisers Act is triggered by Respondents' association with investment advisers during the criminal scheme – not the scope of the scheme itself. We have rejected claims that Section 203 is limited "to only those persons who commit the specified felonies in their capacity as an investment adviser." *Scott*, 53 S.E.C. at 867.

[12] 15 U.S.C. § 78*o*(b)(6)(A); 15 U.S.C. § 80b-3(f).

[13] *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981).

[14] *David Henry Disraeli*, Securities Exchange Act Rel. No. 57027 (Dec. 21, 2007), 92 SEC Docket 852, 875, *petition denied*, 33 Fed. Appx. 334 (D.C. Cir. 2008) (per curiam).

[15] The indictment and jury instructions establish the factual framework for our analysis of the convictions. *See United States v. Fabric Garment Co.*, 366 F.2d 530, 534 (2d Cir. 1966) ("[A] prior criminal conviction will work an estoppel in favor of the Government in a subsequent civil proceeding with respect to questions distinctly put in issue and directly determined in the criminal prosecution . . . . In the case of a criminal conviction based on a jury verdict of guilty, issues which were essential to the verdict must be regarded as having been determined by the judgment." (internal punctuation omitted) (citing *Emich Motors Corp. v. General Motors Corp.*, 340 U.S. 558, 569 (1951))); *see also Alexander V. Stein*, 52 S.E.C. 296, 301 (1995); *William F. Lincoln*, 53 S.E.C. 452, 453 & n.3 (1998); *Robert Berkson*, 47 S.E.C. 280, 281-82 & n.6 (1980).

bribes for confidential trading information, conduct that "was an egregious abuse of . . . the trust placed in [them as] securities professional[s]."[16]

Their conduct was not limited to a brief, isolated incident, but rather reflected extended participation in an ongoing scheme. During the criminal proceedings, Ghysels himself characterized his conduct as "last[ing] a total of forty days," and covering squawk box transmissions daily from "9:30 to 4." Mahaffy acknowledged before the law judge that his "relationship with the relevant clients" occurred "over about eighteen months."

The convictions were based on an elevated level of scienter. The jury found that Respondents acted "knowingly and with intent to defraud," i.e., with "knowledge of at least some of the purposes of objectives of the conspiracy and with the intention of aiding in the accomplishment of its unlawful goals."[17]

Moreover, Respondents have consistently failed to recognize the wrongfulness of their actions, raising serious concerns about the likelihood that they will commit future violations.[18] Mahaffy argues here, as he has argued in the federal court proceedings, that the squawk transmissions were not confidential and that he acted in the good faith belief that it was "acceptable for a broker to provide a client with squawk broadcasts." He also argues that the

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16 *John S. Brownson*, 55 S.E.C. 1021, 1029 (2002), *petition denied*, 66 Fed. Appx. 687 (9th Cir. 2003) (unpublished).

17 In *Skilling v. United States*, 130 S.Ct. 2896 (June 24, 2010), the Supreme Court held that honest services prosecutions under 18 U.S.C. § 1346 are properly limited to cases involving bribes and kickbacks. Skilling's conduct, the Court found, was not violative based on a proper construction of the statute because he had not been charged with "solicit[ing] or accept[ing] side payments from a third party." *Id.* at 2934. Here, by contrast, the special jury verdict found that Respondents committed both "money or property" fraud and "honest services fraud," and each of these findings are independent bases for the convictions. If both bases for the convictions are vacated on appeal, Respondents may pursue relief from the sanctions imposed in these proceedings. *See infra* text accompanying note 33.

18 Like the law judge, we treat a refusal to concede wrongdoing as an aggravating factor, a practice that Mahaffy challenges as "unconstitutional and simply wrong." However, the courts have repeatedly recognized the propriety of this analysis in formulating sanctions. *See Seghers v. SEC*, 548 F.3d 129, 137 (D.C. Cir. 2008) (finding that this analysis does not constitute an "unconstitutional[] burden" in federal district court or "deny [respondent] due process before the SEC"); *see also Steadman*, 603 F.2d at 1140; *Scott B. Gann*, Exchange Act Rel. No 59729 (Apr. 8, 2009), 95 SEC Docket 15818, *aff'd*, 361 Fed. Appx. 556, 560 (5th Cir. 2010) (unpublished) (finding that the "Commission could certainly weigh this myopia about his own behavior as a factor against Gann – if he doesn't know right from wrong in this industry, how can he avoid wrongdoing in the future?").

evidence at the trial was not sufficient to establish a finding that the transmissions were confidential.[19]

These claims, which go to the heart of Respondents' convictions, have been considered and rejected in the district court proceedings.[20] Accordingly, Respondents are precluded from relitigating these issues before us. We have long declined to "revisit the factual basis for" or legal

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[19] Mahaffy claims that the non-confidential nature of the squawks is established in excerpts from Division depositions of Firm employees. He received transcripts of these depositions from the Division in connection with these follow-on proceedings under Rule of Practice 230 ("Rule 230 Testimony"). Rule 230 generally requires the Division to allow "inspection and copying [of] documents . . . in connection with the investigation leading to the Division's recommendation to institute proceedings" and to commence making documents available "no later than seven days after service of the order instituting proceedings." It also states that, if "a document required to be made available to a respondent . . . is not made available by the Division . . . , no rehearing or redecision . . . shall be required, unless the respondent shall establish that the failure to make the document available was not harmless error." 17 C.F.R. § 201.230(a), (d) and (h).

Mahaffy points out that summary judgment was issued before Mahaffy finished reviewing the Rule 230 Testimony and that he was not notified of the existence of these depositions in connection with the criminal trials. The law judge found, "While not all documents had been made available at the time of the [i]nitial [d]ecision, Mahaffy has failed to establish that the failure to do so was not harmless error in the instant proceeding, as required by Commission Rule of Practice 230(h)." Mahaffy argues that "Rule 230 would be rendered meaningless if [the Commission] were permitted to sanction a respondent based on disclosure of voluminous files without giving the respondent adequate time for review." However, we believe this was harmless error since collateral estoppel principles preclude consideration of Mahaffy's challenges to the findings of his criminal conviction. In any case, the district court has evaluated the Rule 230 Testimony and concluded that it does not support his claims. *See infra* note 20 and accompanying text.

[20] For instance, consistent with its heightened scienter finding and the jury instructions, the jury declined to find that Respondents had an "honestly held belief" that none of the transmitted information was confidential. In addition, Respondents' Motion for Dismissal in district court, like the present appeal, argued that the Rule 230 Testimony supported their claim that the squawk box transmissions were not confidential. After examining all of the Rule 230 Testimony, however, the district court judge rejected this argument. His July 21 Order concluded, "Though there are snippets of testimony here and there that, viewed in isolation, support the proposition that the squawk box communications were not confidential, each witness's testimony, viewed as a whole, actually supports the government's theory of the case."

defenses to a conviction in follow-on proceedings.[21] While "[w]e recognize that a respondent in a 'follow-on proceeding' may introduce evidence regarding the 'circumstances surrounding' the conduct that forms the basis of the underlying proceeding," our analysis does not extend to assertions that cannot be reconciled with the convictions.[22]

B. Respondents challenge the sanctions as unwarranted.[23] Characterizing the conduct at issue as isolated and "far removed from" his rendering of investment advice, Mahaffy asserts that the adviser bar "has no bearing on the underlying conduct" and that a broker-dealer bar "amply addresses the public interest."[24] He further contends that his conduct "was not sufficiently venal to equate him with others for whom a total bar from the industry would be appropriate."[25] He

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21 *Jose P. Zollino*, Exchange Act Rel. No. 55107 (Jan. 16, 2007), 89 SEC Docket 2598, 2605; *see also supra* note 15 and *Joseph P. Galluzzi*, 55 S.E.C. 1110, 1116 nn.20-22 (2002) (collecting cases); *Westerfield*, 54 S.E.C. 25, 32 at n.22 (1999) (citing *Parklane Hosiery Co., Inc. v. Shore*, 439 U.S. 322, 326 & n.5 (1979)); *Elliott v. SEC*, 36 F.3d 86, 87 (11th Cir. 1994) (per curiam).

22 *Schield Mgmt. Co.*, 58 S.E.C. 1197, 1213 (2006) (declining to consider denial of misconduct expressly alleged in an injunctive complaint).

23 Ghysels did not file a separate brief but asked that we consider Mahaffy's arguments to the extent that they applied to him. He adds, "The only additional fact the Commission should consider is that, in the underlying criminal case which is pending on appeal and in the district court on a motion for a new trial, [he] was sentenced to probation and six months home detention."

24 While not challenging the broker-dealer bar, Mahaffy does not concede that it is appropriate. He explains that, because he does not intend "to seek employment or associate with a broker-dealer . . .[,] it would elevate form over substance to contest [the broker-dealer] bar here." Ghysels challenges both bars.

25 Mahaffy cites two cases addressing permanent bars from service as an officer or director of any public company under Exchange Act Section 21(d)(2), *SEC v. Patel*, 61 F.3d 137, 142 (2d Cir. 1995) (remanding to consider whether defendant "demonstrate[d] substantial unfitness to serve as an officer or director" of any public company) and *SEC v. Robinson*, 2002 WL 1552049 at *13 (S.D.N.Y. 2002) (imposing permanent Section 21 bar). As the *Patel* court noted, however, bars covering service as an officer or director of any public company are distinguishable from the securities industry bars at issue here. Securities industry bars call for a more limited analysis focused on the Commission's interest in protecting the public from wrongdoing in the securities industry. Thus, while the conduct in *Robinson* was egregious, the *Robinson* court's analysis of the appropriateness of an officer and director bar is not relevant to

(continued...)

adds that the criminal proceedings adversely affected his family and finances, suggesting that additional administrative sanctions are unnecessary.

We find these challenges unpersuasive. As we have previously held, "[a]bsent extraordinary mitigating circumstances," a person convicted of conspiracy to commit securities fraud "cannot be permitted to remain in the securities industry."[26] Respondents have not presented extraordinary circumstances that would warrant mitigation under these circumstances. We particularly disagree with Mahaffy's claim that the investment adviser bar is not warranted because his conduct has no bearing on his "role in dispensing investment advice." As noted above, Section 203 of the Advisers Act expressly authorizes investment adviser disciplinary sanctions based on a conviction arising out of the business of a broker-dealer if the underlying misconduct took place while the respondent was associated with an investment adviser.[27] Here, Respondents were convicted for participating in a securities fraud conspiracy that took place while they were associated with investment advisers. This conduct demonstrates a troubling lack

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[25] (...continued)
whether Respondents' convictions for conspiracy to commit securities fraud merit broker-dealer or adviser bars.

In any case, our analysis "depends on the facts and circumstances of each particular case and cannot be precisely determined by comparison with the action taken in other proceedings." *Paz Sec., Inc.*, Exchange Act Rel. No. 57656 (Apr. 11, 2008), 93 SEC Docket 5122, 5134 (citing *Butz v. Glover Livestock Comm'n Co.*, 411 U.S. 182, 187 (1973)), *petition denied*, 566 F.3d 1172 (D.C. Cir. 2009); *see also Geiger v. SEC*, 363 F.3d 481, 488 (D.C. Cir. 2004) (declining to "compare this sanction to those imposed in previous cases."); *Hiller v. SEC*, 429 F.2d 856, 858 (2d Cir. 1970) ("[W]e cannot disturb the sanctions ordered in one case because they were different from those imposed in an entirely different proceeding.").

[26] *Brownson*, 55 S.E.C. at 1027. As we have previously explained, a "criminal conviction of a securities offense, rather than being a reason for withholding administrative action, is an express ground for remedial action" in an administrative proceeding. *Richard N. Cea*, 44 S.E.C. 8, 25 (1969) (noting the "several parallel and compatible procedures for the achievement of [the Exchange Act's] objectives"); *see also Hudson v. United States*, 522 U.S. 93, 104 (1997) (noting that "'revocation of a privilege voluntarily granted,' such as a debarment, 'is characteristically free of the punitive criminal element'"); *Frederick W. Wall*, 58 S.E.C. 758, 764 & n.12 (2005) (citing *Lincoln*, 53 S.E.C. at 459).

[27] 15 U.S.C. § 80b-3(e)(2)(B); *see supra* Section III. Contrary to Mahaffy's claim, the statute covers "crimes that suggest a lack of fitness to remain in the securities industry," *Kornman*, 592 F.3d at 184, and is not limited to crimes directly connected to investment advisory services. *See* 15 U.S.C. § 80-b(e)(2) & (3) (covering, for example, convictions for "any crime punishable by imprisonment for 1 or more years," for false oaths, bribery, perjury, burglary, larceny, theft robbery, forgery, and counterfeiting).

of integrity and a fundamental misunderstanding of any securities professional's responsibility to safeguard confidential information – regardless of whether they had access to such confidential information pursuant to an association with a broker-dealer or an investment adviser.[28] Respondents' dissemination of confidential information for personal gain demonstrates their unfitness to act as securities professionals, and particularly their unfitness to meet the fiduciary standards that investment advisers owe to their clients.[29] The convictions based on this misconduct are more than sufficient to establish the public interest in preventing their future participation in the securities industry through either broker-dealers or investment advisers.

Mahaffy also argues that, since he will not seek future association with a broker-dealer, his conviction would prevent "access to a firm's confidential information." This claim does not offer meaningful protection for investors. Respondents' experience in the securities industry suggests a likelihood that they would, if permitted, again seek work in the securities industry, presenting further opportunities for misconduct. Nor does Mahaffy offer any reason to credit his claim that his conviction would automatically preclude access to confidential information if he were successful in securing such future association.[30] Securities professionals, particularly investment advisers, routinely have access to confidential information including, among other things, account information, investment strategies, and trading information.

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28 Mahaffy cites his "unblemished record in the industry beginning in 1981" to argue that "there is no basis to infer the likelihood of future violations." This claim is not mitigating in light of the recurrent nature of the violative conduct. Moreover, we have long held that "securities professionals should not be rewarded for" past compliance with the securities laws. *Guy P. Riordan*, Exchange Act Rel. No. 61153 (Dec. 11, 2009), 97 SEC Docket 23445, 23477 n.104 (citing *Mitchell M. Maynard*, Advisers Act Rel No. 2875 (May 15, 2009), 95 SEC Docket 16844, 16860 & n.39), *appeal filed*, No. 10-1024 (D.C. Cir. Feb. 12, 2010).

29 As is well recognized, investment advisers owe fiduciary duties to their clients. *SEC v. Capital Gains Research Bureau Inc.*, 375 U.S. 180, 191 (1963) ("The Investment Advisers Act of 1940 thus reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship.'" (internal citation omitted)); *see also Conrad P. Seghers*, Advisers Act Rel. No. 2656 (Sept. 26, 2007), 91 SEC Docket 2293, 2304 n.44 (noting that persons associated with investment advisers owe "affirmative dut[ies] of 'utmost good faith, and full and fair disclosure of all material facts,' as well as [the] affirmative obligation to employ reasonable care to avoid misleading clients" (internal citations omitted)), *petition denied*, 548 F.3d 129 (D.C. Cir. 2008); *Ahmed Mohamed Soliman*, 52 S.E.C. 227, 231 (1995) (noting that the investment advisory business "can cause havoc unless engaged in by those with appropriate background and standards").

30 *Cf. Gann*, 361 Fed. Appx. at 560 n.5 (declining to disturb Commission's finding that "numerous assurances that he [would] not violate the law in the future" were "unpersuasive because of Gann's continuing refusal to admit that he did anything wrong").

C. Mahaffy also challenges the sanctions by pointing to what he claims was prosecutorial misconduct in the criminal proceedings. He argues that the prosecution improperly failed to turn over exculpatory evidence during the criminal trial and suggests that e-mails from a Division attorney to the prosecutors in connection with the criminal case illustrate impropriety in the prosecution's production decisions.

However, as discussed, Respondents are foreclosed from using this proceeding to challenge their criminal convictions, and these collateral estoppel principles extend to Mahaffy's procedural and constitutional claims.[31] Any such challenges are appropriately reserved for the federal courts.[32] If their appeal is successful, Respondents may seek modification of the sanctions imposed here.[33]

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[31] In his petition for review, Mahaffy requested a stay pending resolution of Respondents' Motion for Dismissal in federal court or, alternatively, a "fact-finding hearing on the SEC's role in denying Mr. Mahaffy his constitutional rights to due process and fundamental fairness." As previously noted, the Motion for Dismissal was denied by the district court on July 21, 2010. *See supra* notes 5 and 19-20. Although we originally extended the briefing deadlines, *see Ghysels*, Order Granting Extension of Time (Mar. 10, 2010), we decline to extend further relief premised on challenges to the convictions or claims of "SEC[] complicity in obtaining [the] criminal conviction." *See Wall*, 58 S.E.C. at 764-65 (declining to consider, in follow-on proceeding, claims of "evidence obstruction and witness tampering" in the criminal proceedings); *see also James E. Franklin*, Exchange Act Rel. No. 56649 (Oct. 12, 2007), 92 SEC Docket 2708, 2714 (stating that "this is not the appropriate forum for challenging the propriety of the Division's conduct"), *petition denied*, 285 Fed. Appx. 761 (D.C. Cir. 2008) (unpublished); *Lincoln*, 53 S.E.C. at 455-56 (finding that collateral estoppel "extends to issues relating to the validity of the conviction, including the credibility of the evidence presented at trial and any defenses to the criminal charge" and "the exercise of prosecutorial discretion").

[32] The federal court challenges in the criminal case do not bear on these proceedings. *See Elliott v. SEC*, 36 F.3d at 87 ("Nothing in the statute's language prevents a bar [from being] entered if a criminal conviction is on appeal."); *Hunt v. Liberty Lobby, Inc.*, 707 F.2d 1493, 1497 (D.C. Cir. 1983) ("Under well-settled federal law, the pendency of an appeal does not diminish the *res judicata* effect of a judgment rendered by a federal court."); *see also* Restatement (Second) of Judgments § 13, cmt. g (1982) (stating that "for purposes of issue preclusion . . . 'final judgment' includes any prior adjudication of an issue in another action that is determined to be sufficiently firm to be accorded conclusive effect" and "a judgment otherwise final [for purposes of res judicata] remains so despite the taking of an appeal unless what is called an appeal actually consists of a trial de novo; finality is not affected by . . . the fact that the appellant has actually obtained a stay or supersedeas pending appeal").

[33] *See Jimmy Dale Swink Jr.*, 52 S.E.C. 379 (1995).

* * * *

As we have noted, the "securities industry presents continual opportunities for dishonesty and abuse, and depends heavily on the integrity of its participants and on investors' confidence."[34] By participating in a criminal conspiracy to profit from confidential information, Respondents took advantage of such an opportunity for dishonesty and abuse and demonstrated their unfitness to participate in the industry.

The imposition of a bar reflects the importance of "deterrence, both specific and general, as a component in analyzing the remedial efficacy of sanctions."[35] By barring Respondents from associating with broker-dealers and investment advisers, these sanctions address the risks of allowing Respondents to remain in the securities industry, serving as a "legitimate prophylactic remedy consistent with [our] statutory obligations"[36] to "protect[] investors and the integrity of the markets by preventing those convicted of crimes from acting in the capacity of a securities professional."[37] The sanctions also promote general deterrence by discouraging others associated

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[34] *Seghers*, 91 SEC Docket at 2308; *see also Charles Phillip Elliott*, 50 S.E.C. 1273, 1276 (1992) (stating that the securities industry is "a business that presents many opportunities for abuse and overreaching"), *aff'd*, 36 F.3d 86 (11th Cir. 1994) (per curiam).

[35] *McCarthy v. SEC*, 406 F.3d 179, 189 (2d Cir. 2005); *see also Schield Mgmt. Co.*, 58 S.E.C. at 1217-18 & n.46 (citing cases).

[36] *Kornman*, 592 F.3d at 189.

[37] *Lincoln*, 53 S.E.C. at 461 (citing cases noting remedial purpose of bars by FDIC, FDA, CFTC, and HUD); *see also SEC v. Palmisano*, 135 F.3d 860, 866 (2d Cir. 1998) (finding that "deterrence of securities fraud serves other important nonpunitive goals, such as encouraging investor confidence, increasing the efficiency of financial markets, and promoting the stability of the securities industry."); *LaCrosse v. CFTC*, 137 F.3d 925, 932 (7th Cir. 1998) (finding that a CFTC trading ban was "intended to ensure market integrity and enhance public confidence").

with broker-dealers and investment advisers from compromising sensitive market, customer, or client information.

Accordingly, we hold that it is in the public interest to bar Respondents from association with any broker, dealer, or investment adviser. An appropriate order will issue.[38]

By the Commission (Chairman SCHAPIRO, and Commissioners CASEY, WALTER, and PAREDES); Commissioner AGUILAR not participating.

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

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[38] We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 62937 / September 20, 2010

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 3085 / September 20, 2010

Admin. Proc. File No. 3-13481

In the Matter of

DAVID G. GHYSELS

and

KENNETH E. MAHAFFY, Jr.

ORDER IMPOSING REMEDIAL SANCTIONS

On the basis of the Commission's opinion issued this day, it is

ORDERED that David G. Ghysels be barred from association with any broker, dealer, or investment adviser; and it is further

ORDERED that Kenneth E. Mahaffy be barred from association with any broker, dealer, or investment adviser.

By the Commission.

Elizabeth M. Murphy
Secretary

Florence E Harmon

By: Florence E. Harmon
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62943 / September 20, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14058

In the Matter of **Millennia Automated Products, Inc.,** **Millennium Software, Inc.,** **Momentum Software Corp.,** **Moonlight International Corp.,** **Moviefone, Inc.,** **MSI Electronics, Inc., and** **Multimedia Concepts International, Inc.,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Millennia Automated Products, Inc., Millennium Software, Inc., Momentum Software Corp., Moonlight International Corp., Moviefone, Inc., MSI Electronics, Inc., and Multimedia Concepts International, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Millennia Automated Products, Inc. (CIK No. 1076049) is a permanently revoked Nevada corporation located in Las Vegas, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Millennia Automated Products is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2002.

2. Millennium Software, Inc. (CIK No. 1100730) is a defaulted Nevada corporation located in Las Vegas, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Millennium Software is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB/A for the period ended June 30, 2000.

3. Momentum Software Corp. (CIK No. 887530) is an inactive New York corporation located in Hasbrouck Heights, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Momentum Software is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 1997, which reported a net loss of $54,908 for the prior nine months.

4. Moonlight International Corp. (CIK No. 945390) is a forfeited Delaware corporation located in Norwalk, Connecticut with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Moonlight International is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 1997, which reported a net loss of $1,456,517 for the prior nine months.

5. Moviefone, Inc. (CIK No. 919867) is an inactive Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Moviefone is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended March 31, 1999, which reported a net loss of $2,826,381 for the prior three months.

6. MSI Electronics, Inc. (CIK No. 354807) is a void Delaware corporation located in Long Island City, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). MSI Electronics 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 30, 2000, which reported a net loss of $332,711 for the prior twelve months.

7. Multimedia Concepts International, Inc. (CIK No. 948070) is a void Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Multimedia Concepts is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the period ended March 31, 2002, which reported a net loss of $545,327 for the prior twelve months.

B. DELINQUENT PERIODIC FILINGS

8. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic

filing obligations or, through their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

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

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

III.

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

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

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62944 / September 20, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14059

In the Matter of **United Education & Software, Inc.,** **United Film Partners, Inc.** **(n/k/a Seoul Movie USA, Inc.),** **United Leisure Corp., and** **United Rayore Gas, Ltd.,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents United Education & Software, Inc., United Film Partners, Inc. (n/k/a Seoul Movie USA, Inc.), United Leisure Corp., and United Rayore Gas, Ltd.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. United Education & Software, Inc. (CIK No. 814069) is a void Delaware corporation located in Los Angeles, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). United Education & Software is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended October 31, 1992, which reported a net loss of $2,027,000 for the prior nine months.

2. United Film Partners, Inc. (n/k/a Seoul Movie USA, Inc.) (CIK No. 1138655) is a forfeited Texas corporation located in Westlake Village, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). United Film Partners 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 $2,991 for the prior nine months.

3. United Leisure Corp. (CIK No. 59684) is a void Delaware corporation located in Los Angeles, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). United Leisure Corp. 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 27, 2004. As of September 15, 2010, the company's stock (symbol "UTDL") was traded on the over-the-counter markets.

4. United Rayore Gas, Ltd. (CIK No. 913884) is a British Columbia corporation located in Calgary, Alberta, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). United Rayore Gas is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-FR registration statement on October 20, 1993, which reported a deficit of $358,000 for the year ended March 31, 1993.

B. DELINQUENT PERIODIC FILINGS

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

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

7. 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 hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Walter and Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62939 / September 20, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14057

In the Matter of

David A. Swoish,

Respondent.

ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

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

II.

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

III.

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

1. In 2005 and 2006, Swoish was employed as divisional controller of a manufacturing facility of CTS Corporation, a manufacturer and supplier of electronic components and sensors headquartered in Elkhart, Indiana. Swoish (1) was employed as a financial and operations principal ("FINOP") for Fenwick Securities, Inc., a registered broker

dealer and (2) was a registered representative. Swoish held his series 7, 24, 27 and 63 licenses. Swoish, 43 years old, currently resides in a state prison facility in California.

2. On August 5, 2009, in California v. Swoish, Court No. 200800483 before the Superior Court of California – Ventura County, Swoish pled guilty to several counts of corporate embezzlement, grand theft, filing a false tax return and taking more than $150,000 in violation of California Penal Code §§ 487,186.11(a)(1),12022.6(a)(2) and 12022.6(B), California Financial Code §3531, and California Revenue and Taxation §19795(a)(1). On October 28, 2009, the court sentenced Swoish to 4 years, 8 months in prison and ordered to pay $369,389.23 in restitution.

3. The criminal complaint to which Swoish pled guilty alleged, inter alia, that Swoish embezzled money from CTS Corporation by causing CTS Corporation to make payments to a company owned and controlled by Swoish, Brokerage Development Corporation ("BDC").

IV.

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

Accordingly, it is hereby ORDERED:

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

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62962 / September 21, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14060

In the Matter of e-DOCS.MD, Inc., Electrical Generation Technology Corp., Electrosource, Inc., eLinear, Inc., Elite Logistics, Inc., Elite Technologies, Inc., Emerald Capital Holdings, Inc., Enviropact, Inc., and eTravelserve.com, Inc., Respondents.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents e-DOCS.MD, Inc., Electrical Generation Technology Corp., Electrosource, Inc., eLinear, Inc., Elite Logistics, Inc., Elite Technologies, Inc., Emerald Capital Holdings, Inc., Enviropact, Inc., and eTravelserve.com, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. e-DOCS.MD, Inc. (CIK No. 780882) is a void Delaware corporation located in Houston, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). e-DOCS.MD 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 $2,291,139 for the prior nine months. On April 30, 2001, the company filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Southern District of Texas and the case was terminated on August 12, 2009. As of September 15, 2010, the company's stock (symbol "EDMD") was traded on the over-the-counter markets.

2. Electrical Generation Technology Corp. (CIK No. 1089814) is an expired Utah corporation located in San Antonio, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Electrical Generation Technology is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 2001, which reported a net loss of $85,070 for the prior six months.

3. Electrosource, Inc. (CIK No. 823927) is a delinquent Delaware corporation located in San Marcos, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Electrosource 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 $2,095,507 for the prior nine months. On November 27, 2001, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Western District of Texas, and the case was terminated on October 3, 2003.

4. eLinear, Inc. (CIK No. 1001903) is a void Delaware corporation located in Houston, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). eLinear is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2006, which reported a net loss of $1,108,375 for the prior three months. On September 15, 2006, the company filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Southern District of Texas, and the case was still pending as of September 15, 2010. As of September 15, 2010, the company's stock (symbol "ELURQ") was traded on the over-the-counter markets.

5. Elite Logistics, Inc. (CIK No. 95284) is an Idaho corporation located in Freeport, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Elite Logistics 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 November 30, 2002, which reported a net loss of $426,856. As of September 15, 2010, the company's stock (symbol "ELOG") was traded on the over-the-counter markets.

6. Elite Technologies, Inc. (CIK No. 835909) is a forfeited Texas corporation located in Birmingham, Michigan with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Elite Technologies 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. As of September 15, 2010, the company's stock (symbol "ETCH") was traded on the over-the-counter markets.

7. Emerald Capital Holdings, Inc. (CIK No. 868667) is a void Delaware corporation located in Venice, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Emerald Capital Holdings 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.

8. Enviropact, Inc. (CIK No. 797989) is an administratively dissolved Florida corporation located in Dania, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Enviropact 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, 1992, which reported a net loss of $944,000 for the prior three months. On January 6, 1993, the company filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Southern District of Florida, and the case was terminated on December 29, 2008.

9. eTravelserve.com, Inc. (CIK No. 1059899) is a permanently revoked Nevada corporation located in Boca Raton, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). eTravelserve.com 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 30, 2000, which reported a net loss of $2,905,493 for the prior six months. As of September 15, 2010, eTravelserve.com's stock (symbol "TSER") was traded on the over-the-counter markets.

B. DELINQUENT PERIODIC FILINGS

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

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

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

III.

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

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

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 62968 / September 22, 2010

Admin. Proc. File No. 3-13860

In the Matter of the Application of DAGONG GLOBAL CREDIT RATING CO., LTD. c/o Philip Nelson Lee Fulbright & Jaworski LLP 555 South Flower Street, Forty-First Floor Los Angeles, CA 90071 For Review of Application for Registration as NRSRO	ORDER DENYING APPLICATION FOR REGISTRATION AS A NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION

I.

Section 15E of the Securities Exchange Act of 1934 and related rules prescribe the process by which credit rating agencies may apply to the Commission for registration as Nationally Recognized Statistical Rating Organizations ("NRSROs") and the requirements to which NRSROs must adhere if they become so registered.[1] On December 24, 2009, Dagong Global Credit Rating Co., Ltd. ("Dagong"), a credit rating agency located in the People's Republic of China ("China"), submitted an application for registration as an NRSRO. Exchange Act Section 15E(a)(2)(A) requires the Commission, not later than ninety days after a rating agency furnishes its application for NRSRO registration, to either grant that application or institute proceedings to determine whether the request should be denied.[2]

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[1] *See* 15 U.S.C. § 78*o*-7; 17 C.F.R. §§ 240.17g-1 *et seq*. Registration as an NRSRO is voluntary and confers upon the registrant certain regulatory benefits. For example, the credit ratings of an NRSRO are used to assess the creditworthiness of obligors and debt instruments under the securities laws, U.S. banking regulations, state insurance regulations, and U.S. student loan legislation.

[2] Dagong consented to two short extensions of time, totaling twenty-one days, to assist Commission staff in considering whether to grant Dagong's application or institute proceedings to determine whether the application should be denied.

On April 14, 2010, we issued an order instituting proceedings to determine whether Dagong's application should be denied.[3] In that order, we directed the parties to submit briefs addressing issues of law or fact in dispute and noted that the possible grounds for denial included: (1) whether Dagong has sufficient connection with U.S. interstate commerce to register as an NRSRO and invoke our regulatory and oversight authority; and (2) whether Dagong, if registered as an NRSRO, would be unable to comply with those provisions of the federal securities laws and rules that require registrants to create and maintain certain records that are subject at any time to Commission examination and that must be furnished to the Commission upon request. Dagong and the Commission's Division of Trading and Markets (the "Division") have submitted briefs in response to that order, and each attached several documents in support of its position.[4] Neither party objected to any documents submitted by the other. Having considered all these submissions, we find that we must deny Dagong's application because, irrespective of the jurisdictional question, it does not appear possible at this time for Dagong to comply with the recordkeeping, production, and examination requirements of the federal securities laws.

II.

A. Dagong's application for NRSRO status

Dagong was formed in 1994 and is the largest credit rating agency in China. Dagong is headquartered in Beijing and has more than two dozen branch offices throughout China, but it currently has no office in the United States.[5] Dagong is licensed to operate as a credit rating institution by the China Securities Regulatory Commission ("CSRC") and is subject to its oversight, rules, and regulations. Dagong represents that it rates the credit of several Chinese companies that are listed on stock exchanges in the United States and that several American companies have used Dagong's Web site to consult its ratings.

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[3] *See* Order Instituting Administrative Proceedings Pursuant to Section 15E(a)(2)(A)(ii) of the Securities Exchange Act of 1934 and Notice of Hearing, Securities Exchange Act Rel. No. 61906 (Apr. 14, 2010), 98 SEC Docket 27376.

[4] In the course of that briefing, Dagong requested two extensions of time totaling forty-two days and, to facilitate those requests, consented to extend by a reasonable amount of time the deadline by which the Commission must conclude these proceedings. As a result, the deadline for conclusion of these proceedings was established as September 23, 2010.

[5] Dagong represents that it intends to open an office in New York once it obtains NRSRO status.

B. OIA's efforts to clarify the CSRC's position with respect to the Commission's ability to inspect Dagong's records

At the request of the Division, the Commission's Office of International Affairs ("OIA") exchanged several letters with the CSRC from March to May 2010, inquiring about Dagong's ability to comply with the federal securities laws and regulations applicable to NRSROs.[6] First, on March 10, 2010, OIA wrote a letter to the CSRC explaining that NRSROs are required by applicable laws and regulations to (1) allow Commission staff to conduct on-site reviews of the firm's books and records; (2) produce to Commission staff copies of the firm's books and records; and (3) furnish such reports as Commission staff deems necessary. The letter asked the CSRC to confirm that, under domestic Chinese law, Dagong would be able to comply with these requirements.

By letter dated March 26, 2010, the CSRC responded that the issue of on-site visits for examination of an NRSRO would require an arrangement between the Commission and the CSRC after the CSRC resolved an issue regarding the inspection of Chinese accounting firms by the Public Company Accounting Oversight Board ("PCAOB").[7] The CSRC's response did not address OIA's questions about the production of documents and reports.

On April 14, 2010, OIA responded to the CSRC, pointing out that the CSRC's March 26 letter was silent on the issue of whether Dagong would be able to provide documents to the Commission in response to requests. OIA also noted that it had informed the Division that the CSRC had been unable to confirm that Dagong would, under Chinese law, be able to produce directly to the Commission information it required as part of its ongoing supervision and regulation of an NRSRO. The CSRC responded by letter on May 10, 2010, stating that, because Dagong did not conduct any significant business in the United States, the CSRC "[did] not see any short-term necessity" for the Commission to conduct on-site inspections or review Dagong's "working papers." The CSRC reiterated its position that the resolution of issues arising from

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[6] The description of the correspondence between OIA and the CSRC derives from a memorandum prepared by the Director of OIA on May 14, 2010, which was attached to the Division's opening brief. The original letters were not included in the record before us due to the confidential nature of correspondence with foreign regulators. Dagong has not taken any exception to the OIA memorandum or its description of events.

[7] In December 2008, the PCAOB sought public comment on how sovereignty concerns should influence its disciplinary process if a non-U.S. accounting firm is prevented by local law from complying with its inspection requests. The CSRC took the position that, "under the current Chinese laws and regulations, PCAOB is not allowed to perform any form of independent or joint on-site inspection in the Chinese territory," while expressing the desire to continue working together to "safeguard our cross-border financial activities." *See* Comment Letter from Dr. Daochi Tong, Director-General, Department of International Affairs, and Zhonghui Zhou, Chief Accountant, China Securities Regulatory Commission (Jan. 22, 2009) *available at* http://pcaobus.org/Rules/Rulemaking/Docket%20027/024_Csrc.pdf.

Dagong's NRSRO application were contingent upon resolving its concerns with the PCAOB about the inspection of Chinese accounting firms.

C. Dagong's view of its ability to comply with applicable law

At the request of Division staff during its consideration of Dagong's application, Dagong submitted a letter on March 10, 2010, expressing its intention to comply with the rules and regulations applicable to an NRSRO if it were to be so designated. In that letter, Dagong's president acknowledged that Dagong, as an NRSRO, would be subject to the document production provisions of Exchange Act Section 17(b) and related rules. The letter explained that Dagong would make a "good-faith effort" to comply with those rules, subject to the requirements of Chinese law:

> Dagong intends to make a good-faith effort to comply with such rules and to produce such documents for examination and inspections as may be requested by the Commission, subject, however, to Dagong's compliance with the laws, rules and regulations of the People's Republic of China and the [CSRC] or such other appropriate Chinese regulatory authority.

In its opening brief, Dagong explained how the Commission would have access to Dagong's records in practice: "The Commission shall send the required document list first to the CSRC, and then the CSRC will collect the documents on behalf of the Commission." The documents would then be translated, Dagong noted. Dagong further explained that the document production would be subject to provisions in Chinese law that prohibit the disclosure of documents containing "state secrets or [information of] vital interest to relevant securities companies" without approval from the CSRC, China's State Archives Administration, the Administration for the Protection of State Secrets, or "other relevant authorities."

III.

A. Applicable law

Exchange Act Sections 15E(a)(2)(C)(ii)(II), 15E(d), and 15(b)(4)(D) provide that we must deny a credit rating agency's application for NRSRO status if the applicant would be subject to having its registration suspended or revoked because it is "unable to comply" with any provision of the securities laws and related rules.[8] Among other things, Dagong must be able to comply with provisions in the Exchange Act and related rules that pertain to the Commission's examination of Dagong's records and Dagong's obligation to produce information to the Commission.

Exchange Act Section 17(b)(1) provides, in relevant part, that "all records" of NRSROs (as well as national securities exchanges, broker-dealers, and certain other regulated entities)

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[8] 15 U.S.C. §§ 78*o*-7(a)(2)(C)(ii)(II); 78*o*-7(d); 78*o*(b)(4)(D).

> are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the Commission . . . as the Commission . . . deems necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of [the Exchange Act].[9]

In addition, Exchange Act Rule 17g-2 requires NRSROs to create and retain certain records, including, for example, records regarding the identities of credit analysts who participate in ratings; the identities of persons paying for the ratings; compliance reports; internal audit plans and reports and supporting documentation; credit analysis reports ("including non-public information and work papers, used to form the basis for the opinions expressed in these reports"); and external and internal communications relating to the NRSRO's initiation, determination, maintenance, change, or withdrawal of a credit rating.[10] The rule also provides that NRSROs "must promptly furnish the Commission or its representatives with legible, complete, and current copies, and, if specifically requested, English translations" of those records required by rule to be created and maintained.

B. Dagong's proposal for inspection and production of documents and reports is too restrictive to comply with securities laws and rules

Dagong's management represented that it "intends to make a good-faith effort" to comply with the recordkeeping and production requirements applicable to NRSROs but acknowledged that the extent of its compliance would be potentially limited by its concurrent obligation to comply with domestic laws and regulations. We credit Dagong's statement that it intends to make a sincere effort to comply with our oversight requirements.[11] However, on the record before us, it appears that Dagong would not control what information would be produced to Commission staff. As an initial matter, we are unable to conclude that Dagong can comply with the recordkeeping, production, and inspection requirements of the Exchange Act because the CSRC has taken the position that it does not see "any short-term necessity" for the Commission to review Dagong's "working papers."

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9 15 U.S.C. § 78q(b)(1).

10 17 C.F.R. § 240.17g-2(a), (b).

11 In its brief, Dagong states that the "good-faith letter" "was not an attempt to express reservations or highlight inconsistency between Chinese and U.S. laws and rules." We acknowledge that Dagong provided the letter in an attempt to demonstrate that it wished to comply with applicable U.S. law and also that Dagong was not required by law to provide such assurances during the application process. Regardless, as noted above, the letter is useful evidence of Dagong's understanding of the competing regulatory frameworks within which it conducts business.

Moreover, we find that the process Dagong proposes for document production and inspection does not meet the requirements of Exchange Act Section 17(b) and related rules. As Dagong explained in its brief, Commission staff must submit its document requests not to Dagong but to the CSRC, which would interpret the request, collect from Dagong those documents it deems responsive to the request, and remove any information that contains "state secrets" before sending them to the staff. However, under the Exchange Act and Rule 17g-2, the NRSRO must promptly provide complete documents to the Commission and permit our access to them. The nature of the review we must conduct – *e.g.*, determining whether an NRSRO is following its disclosed policies for preventing misuse of material non-public information or for managing conflicts of interest – requires broad access to documents. The Exchange Act further requires the Commission to examine NRSRO records it deems necessary or appropriate in the public interest and in furtherance of the purposes of the Act.[12]

The CSRC has stated that the Commission should "entrust" the CSRC to "implement" the Commission's oversight of Dagong, and Dagong notes that the two regulators have a common interest in overseeing Dagong's rating activities and share grounds for cooperation in that regard. It urges the Commission to permit the CSRC to administer its document production in accordance with the provisions of existing international arrangements.[13] We recognize the critical importance of cooperation with non-U.S. financial regulators to achieve effective cross-

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[12] *See* Exchange Act Section 15E(c)(1), 15 U.S.C. § 78*o*-7(c)(1) ("The Commission shall have exclusive authority to enforce the provisions of this section in accordance with this title . . . ."); *cf. Citizens Council of Del. Cty. v. Brinegar*, 619 F. Supp. 52 (E.D. Pa. 1985) (noting that, even where a statute permits an agency to delegate functions, some limitation on the ability to delegate is still necessary to prevent "those charged with responsibility by Congress [from] wholly abdicat[ing] that responsibility and frustrat[ing] the intent of Congress and the policy of the Act in question") (citing *Nat'l Small Shipments Traffic Conference, Inc. v. Interstate Commerce Comm'n.*, 725 F.2d 1442, 1450-51 (D.C. Cir. 1984)).

[13] There are three international arrangements between the Commission and the CSRC, none of which is designed to cover cooperation in the supervision and oversight of cross-border regulated entities: (1) the Memorandum of Understanding Concerning Cooperation, Consultation and the Provision of Technical Assistance, which is aimed at facilitating the provision of technical assistance and training by Commission staff to the CSRC and includes a general statement of intent by the Commission and the CSRC to assist one another in cross-border matters involving suspected violations of law; (2) the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, a global information-sharing arrangement among securities regulators in securities enforcement matters, under which the provision of assistance is predicated on a suspected violation of securities laws in the requesting regulator's jurisdiction and is limited to providing bank, brokerage, and beneficial ownership records as well as information in a regulator's files; and (3) the Terms of Reference for Cooperation and Collaboration, which establishes the parameters for a high-level bilateral regulatory dialogue between the two agencies and provides for periodic meetings at the staff and Chairs' level to discuss issues of common interest.

border oversight and enforcement of securities laws. However, none of these arrangements is designed to cover cooperation in the supervision and oversight of cross-border regulated entities. In particular, the existing arrangements do not contemplate access to non-public supervisory information located abroad or cooperation in on-site inspections of regulated entities located abroad, instead focusing on training and technical assistance, information sharing in the context of a suspected violation of law, and the discussion of approaches to common regulatory issues. In any event, the existing arrangements do not authorize the delegation of oversight responsibilities from one regulator to another.

Dagong maintains that the CSRC's role "is not an impediment to the Commission's oversight obligations" because that oversight is focused generally on whether the NRSRO has accurately disclosed information regarding its procedures and methodologies in issuing credit ratings – topics that Dagong believes would not implicate those "issu[es] of national security, confidential[ity,] and state secrets" that would trigger the CSRC to withhold information. However, Dagong does not define "state secrets" in its briefs and suggests that domestic law permits withholding information of "vital interest" to "relevant securities companies." And Dagong does not explain what, if any, mechanism would exist to inform the Commission as to what information was withheld and the basis for withholding it. That potential information vacuum undermines the purposes of the NRSRO examination requirement.[14]

Complicating matters further is the CSRC's position that it will permit no on-site inspections of Dagong until the CSRC resolves its disagreement with the PCAOB over an analogous issue. Dagong argues that Rule 17g-2 "is intended to provide for oversight without Commission staff going to do physical plant inspections." In support of its argument, Dagong

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[14] As the Commission explained in the release accompanying the adoption of Exchange Act Rule 17g-2:

> The Commission believes [Rule 17g-2] is necessary or appropriate in the public interest or for the protection of investors and narrowly tailored to achieve its purpose. The Commission designed the rule based on its experience with recordkeeping rules for other regulated entities. The other books and records rules have proved integral to the Commission's investor protection function because the preserved records are the primary means of monitoring compliance with applicable securities laws. Rule 17g-2 is designed to ensure that an NRSRO makes and retains records that will assist the Commission in monitoring, through its examination authority, whether an NRSRO is following its disclosed procedures and methodologies for determining credit ratings, its disclosed policies and procedures for preventing the misuse of material nonpublic information, and managing conflicts of interest, and whether it is complying with Rules 17g-4, 17g-5, and 17g-6 . . . .

Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations (final rule), 72 Fed. Reg. 33,564, 33,582-83 (June 18, 2007).

cites to the final rule release for Rule 17g-2 in which we noted that the requirement for NRSROs to produce documents to the Commission "was designed to provide a mechanism for the Commission to inspect records maintained overseas without having to travel to the location."[15] However, although document production by NRSROs is one tool with which we fulfill our oversight obligations, nothing in Exchange Act Rule 15E or Rule 17g-2 defines document production as the exclusive means of oversight. To the contrary, as noted previously, Exchange Act Section 17(b)(1) provides that records of NRSROs are subject to such "other examinations . . . as the Commission . . . deems necessary" and does not distinguish between foreign or domestic NRSROs.[16]

C. Dagong's further arguments

Dagong objects to what it perceives as the inappropriate conflation of its application for NRSRO registration with the PCAOB's ability to conduct on-site inspections of registered public accounting firms that are located in China. We recognize that the regulatory frameworks for NRSROs and PCAOB member firms are distinct. The discussions between the CSRC and PCAOB, however, raised concerns for Commission staff about whether the CSRC would take a similar position with respect to examinations of NRSROs. When the staff followed up on those concerns, the position of the CSRC with respect to Dagong – *i.e.*, that the CSRC will not currently permit Commission staff to conduct on-site inspections of Dagong and sees no immediate need for the staff to examine its records – indicated that Dagong is unable to comply with the recordkeeping, examination, and production requirements applicable to NRSROs, as we discussed above.

Dagong argues that "many Chinese companies are registered with the Commission and that they in fact provide information to the Commission on a regular basis. There is no reason to believe that an NRSRO cannot do the same." However, the ability of Chinese companies registered under other provisions of the securities laws to discharge their disclosure and reporting obligations does not bear on Dagong's ability to comply with oversight requirements applicable to NRSROs.

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15 *Id.* at 33,590.

16 *See supra* note 9 and accompanying text. We note that Commission staff currently makes extensive use of on-site data collection in its examinations of resident NRSROs. *See* "Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies," p. 3 (July 8, 2008), *available at* http://www.sec.gov/news/studies/2008/craexamination070808.pdf ("The examinations included extensive on-site interviews with the rating agencies' staff, including senior and mid-level managers, initial ratings analysts and surveillance analysts, internal compliance personnel and auditors, personnel responsible for building, maintaining and upgrading the ratings models and methodologies used in the ratings and other relevant rating agency staff" in addition to reviewing "a large quantity" of the agencies' records).

Dagong also argues that the Commission "must assume" that Dagong, if granted NRSRO status, "will continue to comply with requests for information" in the same way that it has supplied information in support of its NRSRO application. However, the documents required to conduct an examination are not necessarily similar in kind or content to the documents Dagong has so far submitted in support of its application and, as noted above, under the proposed framework, Dagong's supervisory authority, and not Dagong, would manage the process of identifying, collecting, and producing documents for inspection. Therefore, Dagong's prior document submissions in this matter do not establish that it could comply with the inspection and production requirements of the Exchange Act and related rules.

Dagong also suggests that the Commission should grant its application because, in the event Dagong eventually fails to comply with the securities laws, "the Commission has the power and the authority to deregister [Dagong]" at a later time. However, Section 15E does not contemplate this kind of approach. To the contrary, Section 15E *requires* the Commission to reject a credit rating agency's application if the agency cannot comply with the federal securities laws at the time when the Commission considers its application for registration as an NRSRO.[17]

We must, therefore, deny Dagong's application for NRSRO status. At this time, we cannot conclude that Dagong is able to comply with the Exchange Act's recordkeeping, production, and examination requirements. Because we find that Dagong is currently unable to

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17 *See* Exchange Act Section 15E(a)(2)(C)(ii), 15 U.S.C. § 78*o*-7(a)(2)(C)(ii) (providing that the Commission shall grant an NRSRO application unless it finds that, if the applicant were registered as an NRSRO, its registration would be subject to suspension or revocation – "in which case the Commission *shall deny* such registration" (emphasis added)).

comply with these requirements, we do not reach the issue of whether Dagong at this time has sufficient connection with U.S. interstate commerce to register as an NRSRO and invoke our regulatory and oversight authority.[18]

Accordingly, IT IS ORDERED that the application for registration as a Nationally Recognized Statistical Rating Organization filed by Dagong Global Credit Rating Co., Ltd., on December 24, 2009 be, and it hereby is, DENIED.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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[18] On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 ("Dodd-Frank Act"). In Subtitle C of this law, Congress explained that, "[b]ecause credit rating agencies perform evaluative and analytical services on behalf of clients, much as other financial 'gatekeepers' do, the activities of credit rating agencies are fundamentally commercial in character and should be subject to the same standards of liability and oversight as apply to auditors, securities analysts, and investment bankers." To address this need, the law establishes an Office of Credit Ratings within the Commission and requires us to annually examine each NRSRO. The law also imposes new requirements on NRSROs, such as the establishment of effective internal control structures, independent board members, and policies to manage and disclose conflicts of interest. Because we find that Dagong is unable to meet the basic NRSRO examination requirements as they existed before the Dodd-Frank Act was passed, we need not reach the issue of whether Dagong could meet the new, heightened requirements.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62972 / September 22, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14061

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

I.

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

II.

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

III.

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

1. From December 2008 through October 2009, Dyer was a telemarketing sales agent for Commonwealth Capital Management, Inc. ("Commonwealth") and offered and sold the stock of Amante Corporation ("Amante"). During this period, Dyer solicited investors to purchase Amante stock and received transaction-based compensation in connection with sales of Amante securities. When he solicited investors to purchase Amante stock, Dyer was neither registered as a broker or dealer nor associated with a registered broker or dealer. Dyer, 53 years old, is a resident of Pompano Beach, Florida.

2. On August 11, 2010, a final judgment was entered by consent against Dyer, permanently enjoining him from future violations of Section 15(a) of the Exchange Act in the civil action entitled Securities and Exchange Commission v. Amante Corporation, et al., Civil Action Number 09-CIV-61716-JIC, in the United States District Court for the Southern District of Florida.

3. The Commission's complaint alleged that Dyer acted as an unregistered broker or dealer by offering and selling Amante's stock to investors without being associated with a broker or dealer registered with the Commission.

IV.

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

Accordingly, it is hereby ORDERED:

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

Elizabeth M. Murphy
Secretary

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

Commissioner Casey and Commissioner Walter not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62973 / September 22, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14062

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

I.

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

II.

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

III.

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

1. Dies, age 51, a resident of Corona, California, is the investor relations associate of United American Ventures, LLC ("UAV"), a Delaware limited liability company with its principal place of business in Irvine, California. UAV purports to be a venture capital fund that invests in companies with "late-stage" pharmaceutical or medical device technologies and then sells or takes those companies public. Dies has never been registered with the Commission and has never been associated with a registered broker-dealer.

2. On August 13, 2010, a judgment was entered by consent against Dies, permanently enjoining him from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933 and Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder, in the civil action entitled Securities and Exchange Commission v. United American Ventures, LLC, et al., Civil Action Number CV 10-0568 JCH/LFG, in the United States District Court for the District of New Mexico.

3. The Commission's complaint alleged that, from approximately February 2009 through November 2009, Dies engaged in a scheme whereby UAV raised millions of dollars from investors in various states through the fraudulent and unregistered offer and sale of convertible bonds. UAV's offering materials claimed it would pay 25 percent interest on its bonds and that UAV could reliably earn returns in excess of 300 percent on its pharmaceutical and medical ventures. The Commission's complaint alleged that in obtaining money from investors, UAV misrepresented and/or concealed numerous material facts relating to the use of investor funds; the status and value of the pharmaceutical and medical ventures; the size of UAV's investment in the ventures; the source of funds used to pay monthly interest payments to investors; the commissions and fees paid to UAV's referral sources; UAV's financial condition; UAV's track record; and the safety of UAV's bonds. The Commission's complaint alleged that UAV never earned a return from any investment in any venture at any time, and in Ponzi-like fashion used money contributed by new investors to pay monthly interest payments to existing bondholders, to pay for UAV's extravagant operating expenses and salaries, and to pay commissions to third-party referrers to find new investors.

IV.

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

Accordingly, it is hereby ORDERED:

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

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Casey and Commissioner Walter not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62974 / September 22, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14063

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

I.

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

II.

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

III.

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

1. Hollowell, age 37, a resident of Irvine, California, is the president and portfolio manager of United American Ventures, LLC ("UAV"), a Delaware limited liability company with its principal place of business in Irvine, California. UAV purports to be a venture capital fund that invests in companies with "late-stage" pharmaceutical or medical device technologies and then sells or takes those companies public. Hollowell held Series 7 and 63 securities registrations, which lapsed in 2005.

2. On August 13, 2010, a judgment was entered by consent against Hollowell, permanently enjoining him from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933 and Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder, in the civil action entitled Securities and Exchange Commission v. United American Ventures, LLC, et al., Civil Action Number CV 10-0568 JCH/LFG, in the United States District Court for the District of New Mexico.

3. The Commission's complaint alleged that, from approximately July 2007 through November 2009, Hollowell engaged in a scheme whereby UAV raised at least $10 million from approximately 100 investors in various states through the fraudulent and unregistered offer and sale of convertible bonds. UAV's offering materials claimed it would pay 25 percent interest on its bonds and that UAV could reliably earn returns in excess of 300 percent on its pharmaceutical and medical ventures. The Commission's complaint alleged that in obtaining money from investors, UAV misrepresented and/or concealed numerous material facts relating to the use of investor funds; the status and value of the pharmaceutical and medical ventures; the size of UAV's investment in the ventures; the source of funds used to pay monthly interest payments to investors; the commissions and fees paid to UAV's referral sources; UAV's financial condition; UAV's track record; and the safety of UAV's bonds. The Commission's complaint alleged that UAV never earned a return from any investment in any venture at any time, and in Ponzi-like fashion used money contributed by new investors to pay monthly interest payments to existing bondholders, to pay for UAV's extravagant operating expenses and salaries, and to pay commissions to third-party referrers to find new investors.

IV.

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

Accordingly, it is hereby ORDERED:

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

Elizabeth M. Murphy
Secretary

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

Commissioner Casey and Commissioner Walter not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62975 / September 22, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14064

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

I.

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

II.

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

III.

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

1. Oliva, age 54, a resident of Placitas, New Mexico, is the sole officer and owner of Integra Investment Group, LLC ("Integra"), a New Mexico limited liability company doing business out of Oliva's home.

2. On August 13, 2010, a judgment was entered by consent against Oliva, permanently enjoining him from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933 and Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder, in the civil action entitled Securities and Exchange Commission v. United American Ventures, LLC, et al., Civil Action Number CV 10-0568 JCH/LFG, in the United States District Court for the District of New Mexico.

3. The Commission's complaint alleged, among other things, that from approximately July 2007 through November 2009, United American Ventures, LLC ("UAV"), a Delaware limited liability company with its principal place of business in Irvine, California, engaged in a scheme whereby UAV raised at least $10 million from approximately 100 investors in various states through the fraudulent and unregistered sale of convertible bonds. The Commission's complaint further alleged that from approximately April 2009 through November 2009, Oliva, operating through Integra, received commissions from UAV for bringing approximately 50 investors to UAV. Additionally, the complaint alleged that Oliva made misrepresentations and omissions of material fact relating to the offer and sale of approximately $3.5 million of UAV's convertible bonds.

IV.

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

Accordingly, it is hereby ORDERED:

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

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Casey and Commissioner Walter not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62976 / September 22, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14065

In the Matter of PHILIP LEE DAVID JACK THOMAS, Respondent.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Philip Lee David Jack Thomas ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.3 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Thomas, age 74, is a resident of Newport Beach, California. At various times, Thomas has used different iterations of his name, including "P. David Thomas," "David J. Thomas," and "Dave Thomas." Thomas has never been registered with the Commission and has never been associated with a registered broker-dealer. On September 12, 2001, in connection with an action by the California Corporations Commissioner, the Superior Court of the State of California for the County of Los Angeles (Case No. BS 05739) entered an order of final judgment permanently enjoining Thomas from participating, directly or indirectly, in the offer or sale of securities.

2. In 2006, Thomas founded United American Ventures, LLC ("UAV"), a Delaware limited liability company with its principal place of business in Irvine, California. UAV purports to be a venture capital fund that invests in companies with "late-stage" pharmaceutical or medical device technologies and then sells or takes those companies public. Thomas served as president of UAV until approximately May 25, 2009. Since that time he has served as a consultant to UAV.

3. On August 13, 2010, a judgment was entered by consent against Thomas, permanently enjoining him from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933 and Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder, in the civil action entitled Securities and Exchange Commission v. United American Ventures, LLC, et al., Civil Action Number CV 10-0568 JCH/LFG, in the United States District Court for the District of New Mexico.

4. The Commission's complaint alleged that, from approximately July 2007 through November 2009, Thomas engaged in a scheme whereby UAV raised at least $10 million from approximately 100 investors in various states through the fraudulent and unregistered offer and sale of convertible bonds. UAV's offering materials claimed it would pay 25 percent interest on its bonds and that UAV could reliably earn returns in excess of 300 percent on its pharmaceutical and medical ventures. The Commission's complaint alleged that in obtaining money from investors, UAV misrepresented and/or concealed numerous material facts relating to: the use of investor funds; the status and value of the pharmaceutical and medical ventures; the size of UAV's investment in the ventures; the source of funds used to pay monthly interest payments to investors; the commissions and fees paid to UAV's referral sources; UAV's financial condition; Thomas' background; UAV's track record; and the safety of UAV's bonds. The Commission's complaint alleged that UAV never earned a return from any investment in any venture at any time, and in Ponzi-like fashion used money contributed by new investors to pay monthly interest payments to existing bondholders, to pay for UAV's extravagant operating expenses and salaries, and to pay commissions to third-party referrers to find new investors.

IV.

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

Accordingly, it is hereby ORDERED:

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

Elizabeth M. Murphy
Secretary

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

Commissioner Walter and
Commissioner Aguilar

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62982 / September 23, 2010

INVESTMENT ADVISERS ACT OF 1940
Release No. 3086 / September 23, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14066

In the Matter of **Carlson Capital, L.P.** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 203(e) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(e) of the Investment Advisers Act of 1940 ("Advisers Act"), against Carlson Capital, L.P. ("CCLP" or "Respondent").

II.

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

Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934 and Section 203(e) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

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

Summary

These proceedings arise out of violations of Rule 105 of Regulation M of the Exchange Act by CCLP, a registered investment adviser and manager of hedge funds based in Dallas, Texas. Rule 105 prohibits buying an equity security made available through a public offering from an underwriter or broker or dealer participating in the offering after having sold short the same security during a restricted period (generally defined as five business days before the pricing of the offering). The rule provides an exception for the purchase of an offered security in an account that is "separate" from the account through which the same security was sold short.

CCLP makes investment decisions through various strategies, each with dedicated portfolio managers. On four occasions in 2008, CCLP bought offered shares from an underwriter or broker or dealer participating in a public offering after having sold short the same security during the restricted period. In three of these instances, the same CCLP portfolio manager or analyst who directed the short sales also directed the purchase of the offered shares. In the fourth instance, a CCLP portfolio manager from one firm strategy directed the purchase of offered shares after a portfolio manager from another strategy sold short the same security during the restricted period. Because of the firm's structure, the firm's trades do not qualify for the separate accounts exception under Rule 105. CCLP's violative conduct with respect to all four offerings collectively resulted in unlawful profits or loss avoidance of more than $2.25 million.

Respondent

1. Carlson Capital, L.P. is a Delaware limited partnership with its principal office in Dallas, Texas. It manages several funds and private accounts, and trading described in this Order refers to trading by the firm on behalf of those funds or private accounts. The firm has been registered voluntarily with the Commission as an investment adviser since 2001 and currently manages approximately $5.1 billion in investor assets.

Legal Framework

2. As amended in 2007, Rule 105 of Regulation M provides in pertinent part:

> In connection with an offering of equity securities for cash pursuant to a registration statement or a notification on Form 1-A . . . or Form 1-E . . . filed under the Securities Act of 1933 ("offered securities"), it shall be

> unlawful for any person to sell short . . . the security that is the subject of the offering and purchase the offered securities from an underwriter or broker or dealer participating in the offering if such short sale was effected during the period ("Rule 105 restricted period") . . . [b]eginning five business days before the pricing of the offered securities and ending with such pricing . . .
>
> .

17 C.F.R. § 242.105(a); Short Selling in Connection with a Public Offering, Exchange Act Release No. 56,206, 72 Fed. Reg. 45,094, 45,107 (Aug. 10, 2007) ("Adopting Release on Rule 105").

3. Subsection (b)(2) of Rule 105 provides that the rule does "not prohibit the purchase of the offered security in an account of a person where such person sold short during the Rule 105 restricted period in a separate account, if decisions regarding securities transactions for each account are made separately and without coordination of trading or cooperation among or between the accounts." 17 C.F.R. §242.105(b)(2). The Commission's adopting release on Rule 105 states that it uses "account" as a "general term" that can include diverse types of "separate accounts" such as "portions of a fund," a "unit," "departments," and "identifiable divisions." Adopting Release on Rule 105, 72 Fed. Reg. at 45,098 n. 64.

4. Rule 105 applies irrespective of the short seller's intent in effectuating the short sale. "The prohibition on purchasing offered securities . . . provides a bright line demarcation of prohibited conduct consistent with the prophylactic nature of Regulation M." Id. at 45,096. The Commission adopted Rule 105 in an effort to prevent manipulative short selling prior to a public offering and, therefore, "to foster secondary and follow-on offering prices that are determined by independent market dynamics." Id. at 45,094.

CCLP's Structure and Operations

5. CCLP makes investment decisions through strategies that are run by one or more portfolio managers supported by analysts and traders. During the relevant period, the firm's strategies included Relative Value Arbitrage ("Relative Value") and Risk Arbitrage, among others. Each strategy's investment positions were allocated across the firm's funds and accounts according to ratios established by the firm, depending on whether the fund or account subscribed to the particular strategy.

Respondent's Violations of Rule 105 of Regulation M

6. From May to November 2008, CCLP violated Rule 105 with respect to four follow-on or secondary offerings collectively resulting in unlawful profits or loss avoidance of more than $2.25 million.

A. Violations Resulting From Purchases of Offering Shares by the Same Portfolio Managers Who Sold Short During the Restricted Period

7. On April 30 and May 1, 2008, CCLP sold short a total of 100,000 shares of Equitable Corporation ("EQT"). The firm portfolio manager who sold short these shares then directed the purchase of 100,000 shares of EQT in a follow-on offering that was announced on May 5, 2008, and priced on May 6, 2008 at $67.75 per share. The offering price exceeded the prices at which the firm had sold short. By purchasing the offered shares despite having shorted the stock during the restricted period, CCLP improperly obtained a discount from the stock's market price and avoided losses of $31,600.

8. On June 10 and June 11, 2008, CCLP sold short 202,500 shares of Rockwood Holdings, Inc. ("ROC"). After markets closed on June 11, 2008, ROC announced the overnight sale of shares of stock by existing ROC shareholders in an underwritten offering. The same CCLP analyst who had sold short the ROC shares directed the firm to buy offered shares from the underwriter. Before the market opened on the morning of June 12, 2008, the firm confirmed an allocation from the underwriter of 150,000 shares at a price of $38.90 per share. Because the firm sold short shares of ROC during the five-day restricted period that preceded the offering, the firm's purchase of offered shares violated Rule 105. The difference between CCLP's proceeds from the first 150,000 shares it sold short and the price for the offered shares was $500,200.

9. On September 18 and 19, 2008, CCLP sold short over 500,000 shares of Capital One Corp. ("COF"). The portfolio manager responsible for most of these short sales then directed the purchase of 325,000 shares of COF in a follow-on offering that was announced on September 23, 2008, and priced after the close of trading on September 24, 2008 at $49 per share. The offering price generally exceeded the prices at which the firm had sold short. By purchasing the offered shares despite having shorted the stock during the restricted period, CCLP improperly obtained a discount from the stock's market price and avoided losses of $665,503.

10. The investment personnel at CCLP who directed the firm's participation in the above-described offerings either misunderstood or were unaware of Rule 105's requirements during the relevant time period. CCLP's compliance manual did not address Rule 105, and the firm conducted no formal firm-wide training addressing Rule 105 during this period. To comply with Rule 105, CCLP relied on the efforts of one firm trader to coordinate the review of the firm's prior short sales ("Rule 105 reviews") before it participated in offerings. The firm, however, did not have policies and procedures sufficient to prevent the firm from participating in the offerings discussed in this Order. Subsequently, during the Commission staff's investigation, CCLP conducted firm-wide training addressing Rule 105, amended its compliance manual to include the rule, and implemented an automated system to facilitate Rule 105 reviews.

B. Violation Resulting From Purchase of Offering Shares After A Different Portfolio Manager Sold Short

11. CCLP bought 600,000 shares of Wells Fargo & Co. ("WFC") stock in a follow-on offering that was announced on November 5, 2008 and priced after the close of trading on

November 6, 2008 at $27 per share. The firm's Relative Value strategy directed this purchase. Before the market opened on the morning of November 6, 2008, the head Risk Arbitrage portfolio manager received an instant message stating that the Relative Value strategy intended to participate in the offering.

12. Approximately a month before the transactions at issue, the Risk Arbitrage strategy established a short position in WFC as a hedge to its purchases of the stock of Wachovia Bank ("Wachovia"), in connection with the two banks' intended merger. On November 6, 2008, the day of the offering, the Risk Arbitrage strategy sold short 398,225 shares of WFC at prices that exceeded the offering price. The strategy also bought additional Wachovia shares at a total dollar value roughly equivalent to the WFC shares it sold short that day. At the time, the Risk Arbitrage portfolio manager who made these decisions was unfamiliar with Rule 105. Meanwhile, when the Relative Value portfolio manager directed the purchase of the offered WFC shares, she was familiar with Rule 105, but it was not her practice to check the firm's prior short sales outside of her own portfolio before participating in an offering.

13. Although the CCLP strategy that participated in the WFC offering was different than the strategy that sold short during the restricted period, the two strategies are not "separate accounts" under Rule 105. Because the above-described WFC transactions do not qualify for the separate accounts exception set forth in Rule 105(b)(2), CCLP's purchase of the offered WFC shares after having made restricted period short sales violated the rule.

14. In its adopting release, the Commission stated that in order for the separate accounts exception to apply, "there can be no communication of securities positions, investment decisions or other trading matters between accounts." Adopting Release on Rule 105, 72 Fed. Reg. at 45,099.[1] Here, even assuming CCLP's Risk Arbitrage and Relative Value strategies may be considered "accounts," they were not "separate" under Rule 105(b)(2) and the guidance set forth in the adopting release. First, information about securities positions and investment decisions was available to all of the firm's employees and sometimes communicated between strategies. All portfolio managers received or could access detailed reports of each others' positions and trades on a daily basis. They routinely consulted with each other about companies in which they had overlapping positions or interest. In addition, CCLP's Investment Committee had members from each of the strategies who discussed some the firm's more important positions at its weekly

[1] In the adopting release, the Commission listed the following non-exclusive indicia of separateness: (1) The accounts have separate and distinct investment and trading strategies and objectives; (2) Personnel for each account do not coordinate trading among or between the accounts; (3) Information barriers separate the accounts, and information about securities positions or investment decisions is not shared between accounts; (4) Each account maintains a separate profit and loss statement; (5) There is no allocation of securities between or among accounts; and (6) Personnel with oversight or managerial responsibility over multiple accounts in a single entity or affiliated entities, and account owners of multiple accounts, do not have authority to execute trades in individual securities in the accounts and in fact, do not execute trades in the accounts, and do not have the authority to pre-approve trading decisions for the accounts and in fact, do not pre-approve trading decisions for the accounts." Adopting Release on Rule 105, 72 Fed. Reg. at 45,098-99.

meetings. Portfolio managers also sometimes learned of other strategies' investment decisions – including decisions to participate in offerings – from the firm's trading desk. The firm's traders worked in a centralized location, routinely exchanged information amongst themselves, and in some cases traded on behalf of multiple strategies. Thus, a portfolio manager considering participation in an offering might already know or easily could find out whether another portfolio manager recently had sold short the same stock, and vice versa.

15. Second, CCLP's Chief Investment Officer supervised the strategies and had ultimate authority over the firm's positions. He played an active managerial role, regularly reviewing these positions and consulting with subordinate portfolio managers about investment ideas. Moreover, he maintained authority to require any portfolio manager to seek his pre-approval for trades if he so desired. In short, CCLP's Chief Investment Officer exercised oversight over the firm's multiple strategies and did not refrain from influencing trading decisions within the strategies.

16. Finally, the Commission stated in the adopting release that separate accounts have "personnel that are prohibited from coordinating trading between or among accounts." Id. CCLP did not prohibit its personnel from coordinating trading between or among strategies. Id.

17. CCLP's structure allowed information to be shared across strategies regarding the WFC transactions at issue. Risk Arbitrage received an electronic communication reflecting Relative Value's intention to participate in the offering on November 6, 2008, before it sold short WFC stock that same day. In addition, on November 6, 2008, the firm's Chief Investment Officer knew that Risk Arbitrage had sold short WFC during the prior weeks and could be expected to sell additional shares, and he (like Risk Arbitrage) received information reflecting Relative Value's plan to participate in the offering. Accordingly, the firm's strategies did not make their WFC trading decisions separately. Rather, the timely shared information presented the portfolio managers with opportunities – whether or not deliberately realized – to coordinate their trades and to gain profit for certain funds they jointly managed and for CCLP as a whole. The circumstances of the trades also contravened the prophylactic purpose of Rule 105. See Adopting Release on Rule 105, 72 Fed. Reg. at 45,099 (cautioning that "[i]nformation leakage" caused by insufficient barriers or training "can give rise to either deliberate or inadvertent coordination of shorting into an offering").

18. Certain of CCLP's strategies – including Risk Arbitrage and Relative Value – were run by portfolio managers who followed different investment approaches and generally made their own trading decisions. These portfolio managers also were compensated through bonuses largely based on the performances of their own portfolios. These factors alone, however, did not make the strategies separate under Rule 105(b)(2) given the nature of CCLP's structure and operations described above.

19. The difference between CCLP's proceeds from the November 6, 2008 restricted short sales of WFC by the Risk Arbitrage strategy and the price for 398,225 offering shares purchased by the Relative Value strategy was $739,350. CCLP also improperly obtained a benefit

of $319,733 by purchasing the remaining 201,775 of the 600,000 offering shares at a discount from WFC stock's market price.

* * *

20. With respect to each of the offerings of EQT, ROC, COF, and WFC described above, CCLP "purchas[ed] the offered securities from an underwriter or broker or dealer . . . participating in the offering" after having sold short the same security "during the period . . . [b]eginning five business days before the pricing of the offered securities and ending with such pricing." 17 C.F.R. § 242.105(a). As a result of this conduct, CCLP willfully[2] violated Rule 105 of Regulation M under the Exchange Act.

CCLP's Remedial Efforts

21. In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by CCLP.

IV.

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

Accordingly, pursuant to Section 21C of the Exchange Act and Section 203(e) of the Advisers Act, it is hereby ORDERED that:

A. Respondent cease and desist from committing or causing any violations and any future violations of Rule 105 of Regulation M under the Exchange Act.

B. Respondent is censured.

C. Respondent shall, within fourteen (14) days of the entry of this Order, pay a civil penalty of $260,000, disgorgement of $2,256,386, and prejudgment interest of $136,848 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 and 31 U.S.C. § 3717. Payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the 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 CCLP as a Respondent in these proceedings and the file number of these proceedings, a

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[2] A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

copy of which cover letter and money order or check shall be sent to Antonia Chion, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., N.E., Washington, D.C. 20549-5720A.

By the Commission.

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9145 / September 23, 2010

SECURITIES EXCHANGE ACT OF 1934
Release No. 62984 / September 23, 2010

INVESTMENT ADVISERS ACT OF 1940
Release No. 3087 / September 23, 2010

INVESTMENT COMPANY ACT OF 1940
Release No. 29439 / September 23, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14067

In the Matter of SIERRA FINANCIAL ADVISORS, LLC, MICHAEL E. EARL, and MICHAEL L. BREAKEY, Respondents.	ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company

Act of 1940 ("Investment Company Act") against Sierra Financial Advisors, LLC ("SFA"), Michael E. Earl ("Earl") and Michael L. Breakey ("Breakey") (collectively, "Respondents").

II.

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

III.

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

Summary

From 2004 through 2007, SFA, a registered investment adviser, and its principals, Michael E. Earl and Michael L. Breakey, used their discretionary authority to invest client funds in entities Earl and Breakey owned without disclosing their conflicts of interest and in contravention of statements in SFA's Forms ADV. Earl then used the funds invested in these entities for undisclosed purposes, including the financing of other entities in which Earl and Breakey had interests. SFA failed to maintain required records documenting its clients' investments and failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and rules thereunder. As a result of this conduct, SFA, Earl and Breakey violated the antifraud provisions of the Securities Act, the Exchange Act, and the Advisers Act, and violated or aided and abetted violations of other provisions of the Advisers Act.

Respondents

1. Sierra Financial Advisors, LLC, a Kansas limited liability company based in Overland Park, Kansas, was formed by Earl in November 1997. SFA registered with the Commission as an investment adviser on October 11, 2002. According to its Form ADV Part I

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

filing, as of May 4, 2009, SFA managed $25.8 million for 137 clients. Throughout the relevant period, Earl and Breakey controlled SFA and were the only persons responsible for managing SFA client accounts.

2. Michael E. Earl, age 61, is a resident of Lee's Summit, Missouri. Earl has been a fifty percent owner and principal of SFA since it was formed.

3. Michael L. Breakey, age 64, is a resident of Olathe, Kansas. Breakey has been a fifty percent owner and principal of SFA since it was formed. Breakey acted as SFA's compliance officer since at least 2004 and signed SFA's Forms ADV.

Other Relevant Entities

4. PPR Trust, LLC ("PPR Trust"), was a Kansas limited liability company formed by Earl in October 2001 which has been dissolved. Earl controlled PPR Trust, and both Earl and Breakey held membership interests in PPR Trust.

5. Southwinds Development MS, LLC ("Southwinds"), was a Mississippi limited liability company formed by Earl in February 2006 which has been dissolved. Earl controlled Southwinds and was its sole member.

Background

6. According to SFA's Form ADV Part I filings, SFA managed $25.8 million to $93.4 million for 116 to 904 accounts from 2004 through 2009. Under the terms of SFA's investment management agreements, SFA, Earl, and Breakey typically had full discretion to direct transactions in client accounts. SFA was paid a fee based on a percentage of assets under management, and Earl and Breakey received compensation from SFA. SFA, Earl, and Breakey all acted as investment advisers for SFA's clients throughout the relevant period.

Investments in PPR Trust

7. Earl formed PPR Trust in 2001 to make real estate investments and to provide funding and cash flow for other real estate ventures that he and Breakey owned and managed. Earl and Breakey funded PPR Trust by raising approximately $2.2 million from sales of limited liability membership interests to 24 investors, nearly all of whom were SFA clients, between January 2004 and October 2007. Earl and Breakey used SFA's discretionary authority to invest client funds in PPR Trust.

8. Earl transferred a net of approximately $1.74 million of the funds invested in PPR Trust to various other businesses that he and Breakey owned. For years, Earl directed these affiliated companies to pay other obligations but not to repay the purported loans from PPR Trust. Earl loaned the bulk of the remaining PPR Trust investor funds to companies run by friends or acquaintances. These loans also were not repaid. Earl also received $5,000 from PPR Trust and directed transfers totaling $7,500 from PPR Trust to SFA.

9. Earl and Breakey did not disclose to each SFA client whose funds they invested in PPR Trust that they had personal interests in this venture. Earl did not disclose to investors in PPR Trust his use of their funds to finance businesses in which he and Breakey held interests.

10. PPR Trust has been insolvent since approximately February 2008 and has been dissolved. Only three of the PPR Trust investors have received any return of their principal.

Investments in Southwinds

11. Earl formed Southwinds in February 2006 to invest in residential and commercial real estate ventures in the Mississippi gulf region. Beginning in May 2006, Earl funded Southwinds with investments by SFA clients in notes that would purportedly pay 10% to 15% annually in interest, with terms of one or two years. Earl used SFA's discretionary authority to direct the investment of at least $825,000 in Southwinds from at least eight SFA clients.

12. When managing Southwinds, Earl frequently transferred SFA client funds from Southwinds into his personal bank account and to other businesses. In total, Earl received approximately $119,000 in direct payments from Southwinds. He also made net transfers of approximately $439,000 from Southwinds to other businesses and properties in which he had an interest, including $5,000 of net transfers to SFA. Earl used the bulk of the remaining funds to pay Southwinds' business expenses.

13. Earl did not disclose his ownership of Southwinds to each SFA client that he caused to invest in Southwinds notes. Earl also did not disclose to Southwinds investors his use of Southwinds' investor proceeds to fund his unrelated businesses and to pay his compensation.

14. Southwinds does not have any funds or operations and has been dissolved. It has not made a single payment pursuant to any of the notes it issued to SFA clients, and nearly all of the Southwinds notes are in default.

SFA's Compliance Environment

15. Breakey became SFA's chief compliance officer in approximately 2004. His primary activity as SFA's chief compliance officer was to prepare, sign, and file SFA's Form ADV filings through a third party consultant.

16. From 2004 to 2009, SFA repeatedly misrepresented in its responses to Item 8 of its Form ADV Part I filings with the Commission that it and its related persons did not recommend securities to advisory clients in which SFA or a related person had a proprietary interest and did not recommend securities to advisory clients for which SFA or a related person served as a manager. Breakey was responsible for the content of, and signed, SFA's Form ADV Part I filings over the relevant period. Statements in SFA's Form ADV Part II, which SFA provided to its clients, also failed to disclose Earl and Breakey's practices in placing client funds with related entities.

17. SFA did not have policies and procedures in place reasonably designed to prevent violations of the Advisers Act and rule thereunder. SFA's compliance manual recited general legal requirements applicable to investment advisers but did not contain procedures designed to specifically address SFA's business operations and investment practices. For example, it did not address the particular risks created by SFA's investing client assets in affiliated entities that, in turn, invested in businesses in which Earl and Breakey had an interest. SFA and Breakey also failed to effectively implement the policies that are contained in SFA's compliance manual. Breakey did not perform the required annual reviews of SFA's policies and procedures to assess their adequacy or the effectiveness of their implementation.

18. Although SFA's client accounts were maintained by qualified custodians, SFA retained custody of client funds and securities because it had discretionary authority to withdraw and obtain possession of assets held in these accounts. SFA was therefore required to keep various books and records relating to securities held by its clients pursuant to Advisers Act Rule 204-2(b), including records reflecting the ownership of and transactions in PPR Trust and Southwinds securities. However, SFA did not maintain adequate records showing the purchases, sales, receipts, and deliveries of PPR Trust and Southwinds securities; separate ledger accounts for each client showing comparable information and the date and price of each purchase and sale of PPR Trust and Southwinds securities; or records for each PPR Trust and Southwinds security showing the names of clients with interests, the amounts SFA invested on their behalf in PPR Trust and Southwinds, and the location of each security. Earl and Breakey were responsible for maintaining records for the investments in PPR Trust and Southwinds that they directed.

19. Breakey participated in or was aware of SFA clients' investments in PPR Trust and Southwinds. Although Breakey was responsible for overseeing SFA's compliance function, he did not assess SFA's compliance with record keeping requirements, or conduct any other diligence, relating to investments by SFA clients in PPR Trust and Southwinds.

Respondents' Violations

20. As a result of the conduct described above, SFA, Earl and Breakey willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer and sale of securities and in connection with the purchase, offer, or sale of securities.

21. SFA, Earl and Breakey were each investment advisers because they, in return for compensation, engaged in the business of advising others as to the advisability of investing in, purchasing, or selling securities. As a result of the conduct described above, SFA, Earl and Breakey willfully violated Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser.

22. As a result of the conduct described above, SFA willfully violated, and Breakey willfully aided and abetted and caused, SFA's violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and rules

promulgated thereunder, and to review no less frequently than annually the adequacy of such policies and procedures and the effectiveness of their implementation.

23. As a result of the conduct described above, SFA willfully violated, and Earl and Breakey willfully aided and abetted and caused, SFA's violations of Section 204 of the Advisers Act and Rules 204-2(b)(1), 204-2(b)(2) and 204-2(b)(4) thereunder, which require investment advisers to make and keep certain books and records relating to clients' securities transactions.

24. As a result of the conduct described above, SFA and Breakey willfully violated Section 207 of the Advisers Act, which makes it "unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission . . . or willfully to omit to state in any such application or report any material fact which is required to be stated therein."

Disgorgement and Civil Penalties

25. SFA has submitted a sworn Statement of Financial Condition dated January 30, 2010 and other evidence and has asserted its inability to pay disgorgement plus prejudgment interest or a civil penalty.

26. Earl has submitted a sworn Statement of Financial Condition dated January 30, 2010 and other evidence and has asserted his inability to pay disgorgement plus prejudgment interest or a civil penalty.

27. Breakey has submitted a sworn Statement of Financial Condition dated March 1, 2010 and other evidence and has asserted his inability to pay a civil penalty.

IV.

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

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

A. Respondent SFA cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 204, 206(1), 206(2), 206(4) and 207 of the Advisers Act and Rules 204-2(b)(1), 204-2(b)(2), 204-2(b)(4) and 206(4)-7 promulgated thereunder.

B. Respondent Earl cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Sections 204, 206(1) and 206(2) of the Advisers Act and Rule 204-2(b)(1), 204-2(b)(2) and 204-2(b)(4) promulgated thereunder.

C. Respondent Breakey cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Sections 204, 206(1), 206(2), 206(4) and 207 of the Advisers Act and Rule 204-2(b)(1), 204-2(b)(2), 204-2(b)(4) and 206(4)-7 promulgated thereunder.

D. Respondent SFA's registration as an investment adviser be, and hereby is, revoked.

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

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

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

H. Respondent SFA shall pay disgorgement of $12,500 and prejudgment interest of $2,099.29, but that payment of such amount is waived and the Commission is not imposing a civil penalty against SFA based upon SFA's sworn representations in its Statement of Financial Condition dated January 30, 2010 and other documents submitted to the Commission.

I. Respondent Earl shall pay disgorgement of $124,000 and prejudgment interest of $20,756.35, but that payment of such amount is waived and the Commission is not imposing a civil penalty against Earl based upon his sworn representations in his Statement of Financial Condition dated January 30, 2010 and other documents submitted to the Commission.

J. Based upon Respondent Breakey's sworn representations in his Statement of Financial Condition dated March 1, 2010 and other documents submitted to the Commission, the Commission is not imposing a penalty against Breakey.

K. The Division of Enforcement ("Division") may, at any time following the entry of this Order, petition the Commission to: (1) reopen this matter to consider whether Respondents SFA or Earl provided accurate and complete financial information at the time such representations were made; and (2) seek an order directing payment of disgorgement, pre-judgment interest and the maximum civil penalty allowable under the law. No other issue shall be considered in connection with this petition other than whether the financial information provided by Respondents SFA or Earl was fraudulent, misleading, inaccurate, or incomplete in any material respect. Respondents SFA and Earl may not, by way of defense to any such petition: (1) contest the findings in this Order; (2) assert that payment of disgorgement, interest and payment of a penalty should not be ordered; (3) contest the amount of disgorgement and interest to be ordered or the imposition of the maximum civil penalty available under the law; or (4) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

L. The Division may, at any time following the entry of this Order, petition the Commission to: (1) reopen this matter to consider whether Respondent Breakey provided accurate and complete financial information at the time such representations were made; and (2) seek an order directing payment of the maximum civil penalty allowable under the law. No other issue shall be considered in connection with this petition other than whether the financial information provided by Respondent Breakey was fraudulent, misleading, inaccurate, or incomplete in any material respect. Respondent Breakey may not, by way of defense to any such petition: (1) contest the findings in this Order; (2) assert that payment of a penalty should not be ordered; (3) contest the imposition of the maximum penalty allowable under the law; or (4) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62988 / September 24, 2010

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3189 / September 24, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14068

In the Matter of **SUNOPTA, INC.,** **STEVEN R. BROMLEY, CGA, and** **JOHN H. DIETRICH, CA,** **Respondents.**	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") 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 SunOpta, Inc. ("SunOpta"), Steven R. Bromley, ("Bromley"), and John H. Dietrich ("Dietrich") (collectively "Respondents").

II.

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

III.

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

Summary

In 2007, SunOpta, a Canadian health food company, filed inaccurate quarterly financial reports as a result of internal control problems in inventory accounting at its California-based subsidiary, Cleugh's Frozen Foods ("CFF"), after CFF implemented a new accounting software system. SunOpta's chief executive officer ("CEO"), Steven R. Bromley, and chief financial officer ("CFO"), John H. Dietrich became aware of CFF's problems and took steps to address those difficulties and correct its accounts throughout the year. However, these efforts were inadequate to address the scope of CFF's problems. Later restatements show that CFF's errors caused SunOpta to overstate its consolidated earnings for the first three quarters of 2007 by approximately 103%, 42%, and 65%, respectively.[2] In addition, during 2007, SunOpta did not disclose any material changes to its internal controls over financial reporting, as is required under Item 308(c) of Regulation S-K promulgated pursuant to the Sarbanes-Oxley Act.

Respondents

1. SunOpta, Inc., a Canadian corporation headquartered in Ontario, operates throughout North America in the natural and organic food, supplements, and health and beauty markets. SunOpta stock is registered with the Commission under Section 12(b) of the Exchange Act, and it trades on the Nasdaq Global Select Market.

2. Steven R. Bromley, Certified General Accountant ("CGA"), age 51 and a resident of Ontario, Canada, has been SunOpta's president since January 2005, and a board member and CEO since February 2007. He previously served as SunOpta's CFO and chief operating officer. Bromley has been licensed as a CGA in Canada since 1987.

3. John H. Dietrich, Chartered Accountant ("CA"), age 45 and a resident of Ontario, Canada, was SunOpta's CFO and vice president from September 2003 until March 2009. He is now a vice president of corporate development. Dietrich has been licensed as a CA in Canada since 1989.

Facts

4. SunOpta has several business groups and consolidates their financial information for its public filings. SunOpta's "Fruit Group" segment provides fruit and vegetable products to the private label retail and industrial markets. In 2005, SunOpta's Fruit Group acquired CFF.

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

[2] As used in this Order, "consolidated earnings" means SunOpta's reported earnings before taxes, interest expense, other expenses, foreign exchange gain/loss, and minority interest gain/loss.

During 2007, CFF's inventory represented approximately 26% of SunOpta's consolidated inventory balance.

5. At the time of its acquisition, CFF was a family-owned business, and its accounting controls were largely manual and informal. Accordingly, to improve internal control over financial reporting, SunOpta implemented an Oracle accounting system at CFF in early March 2007.

6. Almost immediately, and continuing throughout 2007, information CFF input into Oracle was unreliable and did not accurately depict the value of CFF's inventory. These accounting errors affected virtually every aspect of CFF's inventory accounting. Specifically, CFF improperly accounted for inventory in the following areas:

a. *Costing*. When CFF initially loaded the value of its pre-existing inventory into Oracle, CFF incorrectly increased the recorded costs of that inventory. In addition, the bills of materials CFF input into Oracle throughout the year to document inventory costs frequently incorporated incorrect rates of overhead, materials used, units of measure, and other data.

b. *Quantity*. During 2007, CFF stored the majority of its inventory in warehouses owned by third parties. However, CFF did not reconcile the quantity of inventory recorded in Oracle with the quantity of inventory recorded by the third-party warehouses for the first and second quarters of 2007. CFF's reconciliation for the third quarter was not properly completed.

c. *Unsupported Manual Adjustment*. When CFF received products from growers before growers invoiced CFF, CFF tracked this inventory in an accrual account called "Goods Received Not Invoiced" ("GRNI"). However, CFF often failed to relieve this account when it later received invoices from the growers and completed its accounting for the transaction. When the GRNI account ballooned during the second quarter, CFF made a large adjustment to the account based on incomplete data.

d. *Net Realizable Value*. During the first three quarters of 2007, CFF did not timely input information in Oracle that would show that the cost of much of its inventory exceeded the market price for these products. CFF also failed to otherwise review relevant data and, as a result, it failed to identify necessary downward adjustments to account for such inventory at its net realizable value.

7. Because of CFF's inaccurate inventory accounting, the financial statements CFF generated for each of the first three quarters of 2007 were not fairly stated. These errors in turn caused SunOpta to overstate its consolidated earnings for the first three quarters of 2007 by a total of approximately 103%, 42%, and 65%, respectively, in Forms 10-Q and Forms 8-K that SunOpta filed with the Commission. These errors also caused SunOpta to report misstatements for its Fruit Group segment, changing the segment's previously-reported earnings to a loss for both the first and third quarters, and substantially reducing the previously-reported earnings for the second quarter. Both Bromley and Dietrich participated in the drafting of these filings with the Commission.

8. Bromley and Dietrich knew about, and took steps to remedy, problems with CFF's inventory accounting during 2007. They documented these issues, created plans to address them, and made attempts to correct CFF's accounting at each quarter-end. However, these efforts were insufficient to address the scope of the inventory accounting problems at CFF and produce fairly stated financial statements.

9. In the Forms 10-Q it originally filed for the first three quarters of 2007, SunOpta stated that there had been "no change in the company's internal control over financial reporting" that has "materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting." Both Bromley and Dietrich signed certifications with each Form 10-Q filing attesting that any such changes had been disclosed. When SunOpta filed its restated financial statements for each quarter, its amended Forms 10-Q included the revised disclosure that there had been material changes to its internal controls relating to the "manual procedures and adjustments" that had "supplanted certain system control processes relating to the purchasing, payables, sales, receivables, and inventory accounting cycles."

10. Both Bromley and Dietrich sold SunOpta stock during the time period covered by the restatements. When those sales occurred, SunOpta's stock price was inflated due, in part, to its incorrectly reported financial results that were attributable to internal control issues at CFF. At the time of their sales, Bromley and Dietrich were aware of certain of CFF's internal control issues.

Violations

11. SunOpta violated Section 13(a) of the Exchange Act and Rules 12b-20, 13a-11, and 13a-13 thereunder by filing Forms 10-Q and Forms 8-K for the first three quarters of 2007 that materially misstated SunOpta's financial statements, and by filing Forms 10-Q for these periods that did not disclose material changes to SunOpta's internal control over financial reporting as required by Item 308(c) of Regulation S-K. As described above, Bromley and Dietrich were a cause of SunOpta's violations of these provisions.

12. SunOpta violated Section 13(b)(2)(A) of the Exchange Act by keeping books and records with inaccurate entries related to SunOpta's inventory balances during the first three quarters of 2007. The company violated Section 13(b)(2)(B) by failing to devise and maintain an effective system of internal controls when accounting for CFF's inventory after conversion to the Oracle accounting system. As described above, Bromley and Dietrich were a cause of SunOpta's violations of these provisions.

13. Exchange Act Rule 13a-14 requires an issuer's CEO and CFO to certify that they have disclosed in the issuer's quarterly report any change in the issuer's internal control over financial reporting that occurred during the most recent fiscal quarter that has materially affected, or is likely to materially affect, the issuer's internal control over financial reporting. Because SunOpta's quarterly reports for the first three quarters of 2007 did not disclose material changes to its internal control over financial reporting, Bromley and Dietrich violated Rule 13a-14.

IV.

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

Accordingly, pursuant to Section 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent SunOpta cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-11, and 13a-13 thereunder;

B. Respondent Bromley cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-11, 13a-13, and 13a-14 thereunder;

C. In connection with his sale of SunOpta stock as referenced above, Respondent Bromley shall, within 21 days of the entry of this Order, pay disgorgement of $40,905 and prejudgment interest of $5,294.77 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the 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 Bromley 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 Noel M. Franklin, Division of Enforcement, Securities and Exchange Commission, 1801 California Street, Suite 1500, Denver, CO 80202;

D. Respondent Dietrich cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-11, 13a-13, and 13a-14 thereunder; and

E. In connection with his sale of SunOpta stock as referenced above, Respondent Dietrich shall, within 21 days of the entry of this Order, pay disgorgement of $5,780 and prejudgment interest of $1,011.90 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the 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 Dietrich 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 Noel M. Franklin, Division of Enforcement, Securities and Exchange Commission, 1801 California Street, Suite 1500, Denver, CO 80202.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 241

[Release No. 34-62991]

Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers

AGENCY: Securities and Exchange Commission.

ACTION: Interpretation.

SUMMARY: The Securities and Exchange Commission is publishing interpretive guidance to clarify the application of certain Commission rules, regulations, releases, and staff bulletins in light of the authority granted to the Public Company Accounting Oversight Board in the Dodd-Frank Wall Street Reform and Consumer Protection Act to establish auditing, attestation, and related professional practice standards governing the preparation and issuance of audit reports to be included in broker and dealer filings with the Commission.

EFFECTIVE DATE: [Insert date of publication in the Federal Register]

FOR FURTHER INFORMATION CONTACT: Questions should be referred to Rebekah Goshorn (Attorney), Division of Trading and Markets, at (202) 551-5777, or to John Offenbacher (Senior Associate Chief Accountant) or Jeffrey Cohan (Senior Special Counsel), Office of the Chief Accountant, at (202) 551-5300, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-7561.

SUPPLEMENTARY INFORMATION:

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] ("Dodd-Frank Act") amended the Sarbanes-Oxley Act of 2002[2] (the "Sarbanes-Oxley Act") to authorize the

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] 17 U.S.C. 7202 et seq.

Public Company Accounting Oversight Board ("PCAOB"), among other things, to establish, subject to approval by the Commission, auditing and related attestation, quality control, ethics, and independence standards to be used by registered public accounting firms with respect to the preparation and issuance of audit reports to be included in broker and dealer filings with the Commission pursuant to Rule 17a-5[3] under the Exchange Act of 1934[4] ("Exchange Act"). The amendments directly impact certain Commission rules, regulations, releases, and staff bulletins related to brokers and dealers (collectively referred to in this release as "Commission rules and staff guidance") and certain provisions in the federal securities laws for brokers and dealers, which refer to Generally Accepted Auditing Standards ("GAAS") and to specific standards under GAAS (including related professional practice standards).[5] There may be confusion on the part of brokers, dealers, auditors, and investors with regard to the professional standards auditors should follow for reports filed and furnished by brokers and dealers pursuant to the federal securities laws and the rules of the Commission.

The Commission is considering a rulemaking project to update the audit and related attestation requirements under the federal securities laws for brokers and dealers, particularly in light of the Dodd-Frank Act. In addition, the PCAOB has not yet revised its rules, which currently refer only to issuers, to require registered public accounting firms to comply with PCAOB standards for audits of

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[3] 17 CFR 240.17a-5

[4] 15 U.S.C. 78a et seq.

[5] Many parts of Commission rules and staff guidance related to obligations of brokers and dealers refer to GAAS and contain requirements for audits to be conducted in accordance with GAAS. Rule 17a-5(g)(1) under the Exchange Act, for example, states that the audit of the report required by Rule 17a-5(d) "...shall be made in accordance with generally accepted auditing standards..." (See 17 CFR 240.17a-5) Rule 17a-12 under the Exchange Act requires that the audit of certain over-the-counter derivative dealers "...shall be made in accordance with U.S. Generally Accepted Auditing Standards..." (17 CFR 240.17a-12)

non-issuer brokers and dealers.[6]

As a result, the Commission is providing transitional guidance with respect to its existing rules regarding non-issuer brokers and dealers. Specifically, references in Commission rules and staff guidance and in the federal securities laws to GAAS or to specific standards under GAAS, as they relate to non-issuer brokers or dealers, should continue to be understood to mean auditing standards generally accepted in the United States of America,[7] plus any applicable rules of the Commission. The Commission intends, however, to revisit this interpretation in connection with its rulemaking project referenced above.

List of Subjects

17 CFR Part 241

Brokers, Reporting and recordkeeping reports, Securities.

Amendments to the Code of Federal Regulations

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

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

Part 241 is amended by adding Release No. 34-62991 to the list of interpretive releases as follows:

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[6] See PCAOB Rule 3100. See also, e.g., PCAOB Rules 3200T, 3300T, 3400T, and 3500T.

[7] Audit and attestation standards established by the AICPA.

Subject	Release No.	Date	Fed. Reg. vol. .and page
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Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers	34-62991	September 24, 2010	75 FR [FR PAGE NUMBER]

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: September 24, 2010

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62996 / September 27, 2010

INVESTMENT ADVISERS ACT OF 1940
Release No. 3088 / September 27, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14069

In the Matter of

Timothy M. Gautney, Robert A. Bellia, Jr., and Erik S. Blum,

Respondents.

ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b)(6) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940 AND NOTICE OF HEARING

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b)(6) of the Securities Exchange Act of 1934 ("Exchange Act") against Timothy M. Gautney ("Gautney"), Robert A. Bellia, Jr. ("Bellia"), and Erik S. Blum ("Blum") (collectively, the "Respondents") and pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Gautney.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Timothy M. Gautney, 37, of Birmingham, Alabama, has been the president and principal owner of Aura Financial Services, Inc. ("Aura"), a broker-dealer formerly registered with the Commission from February 1997 until February 2010. He is a former registered representative of Aura as well as an investment adviser representative associated with Aura Asset Management,

Inc., an affiliated investment adviser that he owns which was registered with the Commission from January 2004 through June 2010.

2. Robert A. Bellia, Jr., 40, of Wantagh, New York, was a registered representative with Aura from June 2007 until August 2009. Bellia also owned Aura's branch office in Islandia, New York and served as its branch manager until January 2009. From August 1993 until he became registered with Aura in June 2007, Bellia had been registered with twelve other broker-dealers. During his entire career at Aura, Bellia was under heightened supervision due to FINRA disciplinary history for failing to supervise registered representatives at another broker-dealer and customer complaints.

3. Erik S. Blum, 44, of Boca Raton, Florida, was registered with Aura from August 2006 until August 2009, and served as the manager of its Miami branch office, formerly located in West Palm Beach, Florida. He has worked in the securities business since 1987.

B. OTHER RELEVANT ENTITY

4. Aura is a Birmingham, Alabama-based corporation which was registered with the Commission as a broker-dealer from February 1997 until February 2010. Aura is wholly-owned by Gautney. During the relevant period, it had approximately 90 independent contractor registered representatives, working primarily out of eight registered branch offices in Alabama, Florida, New York and Georgia. On June 11, 2009, the Commission filed a civil injunctive complaint against Aura and six of its then current and former registered representatives ("RRs") based on their violations of the anti-fraud provisions of the federal securities laws. Aura effectively stopped doing business as a broker-dealer shortly after the filing of the Commission's Complaint. On October 8, 2009, a final judgment was entered by consent against Aura, permanently enjoining it from future violations of the antifraud provisions of the federal securities laws. On February 22, 2010, a Commission administrative law judge issued an Order revoking the broker-dealer registration of Aura.

C. FRAUDULENT CHURNING IN AURA'S ISLANDIA, NEW YORK AND MIAMI, FLORIDA BRANCH OFFICES

5. Between at least January 2008 and December 2008 in Aura's former Islandia, New York and Miami, Florida branch offices, three former Aura RRs largely depleted the funds in their customers' accounts through improper churning.[1]

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[1] Churning is the excessive buying and selling of securities in a customer's account by a broker, for the purpose of generating commissions and without regard to the customer's investment objectives or interest or with the intent to defraud. For churning to occur, the broker must exercise control over the investment decisions in the account, either through a formal written discretionary agreement or otherwise, such as through the customer routinely accepting the broker's recommendations without question.

6. Two metrics are commonly used to determine whether an account has been churned: the account's "annualized turnover ratio" and its "cost to equity ratio," which is also known as its "break even percentage." An annualized turnover ratio is the number of times per year a customer's securities are replaced by new securities. It is calculated by determining the aggregate amount of purchases in an account over a given period, calculating the ratio of those aggregate purchases to the account's average net equity during that period, and then annualizing that ratio. A turnover rate that exceeds six is presumptive of churning. A cost to equity ratio or break even analysis determines the rate of return that an account has to earn on an annual basis just to cover transaction costs, and thus "break even." Trading practices that require an account to earn returns in excess of 20% just to break even are indicative of possible churning.

7. The trading by the Aura RRs was extreme. For example, one representative ("RR1"), an RR in the Islandia office, churned the accounts of five Aura customers. These customers had annualized turnover rates, as reflected in quarterly reports sent to Bellia, of 20 to 94 and cost to equity ratios of 87% to 2058%. Another Islandia representative ("RR2") churned the accounts of two Aura customers. These customers had annualized turnover rates, as reflected in quarterly reports sent to Bellia, of 40 and 59 and cost to equity ratios of 144% and 418%, respectively. An RR in the Miami office ("RR3") churned the accounts of two Aura customers. These customers had annualized turnover rates, as reflected in quarterly reports sent to Blum, of 6 to 54 and cost to equity ratios of 14% to 54 %.

8. The nine customers opened and funded their accounts after being cold-called by, or otherwise introduced to, one of the Aura representatives. All had their accounts aggressively traded, though none had indicated to Aura an investment objective or risk tolerance supporting that trading. Nearly every customer was unsophisticated in securities trading and relied on the registered representative to make investments decisions in the account. No customer had an understanding of the total transaction costs they were incurring by trading through Aura. Taken together, the accounts of nine customers generated total gross commissions of approximately $755,000 for the three RRs during 2008—an amount that represented approximately 12% of the total 2008 gross commissions generated by all Aura accounts. While enriching the RRs, Bellia, Blum, Aura, and ultimately Gautney, these customers suffered aggregate losses of almost $2 million.

D. <u>AURA'S SUPERVISORY AND ACTIVE ACCOUNT LETTER PROCEDURES</u>

9. Aura's Written Supervisory Procedures ("WSP"), dated 2007-2008, and in effect during the time of the churning by the four RRs, stated, among other things, that a turnover ratio greater than six:

> warrant[s] immediate attention and further review of a larger sample size, if applicable. The D[esignated] P[rincipal] should take immediate steps to determine that such trading activity is acceptable to the customer (acknowledgment by customer in writing may be sought), and conforms to the customer's objectives. Otherwise, steps may be taken to close the trading activity in the customer's accounts.

10. At least each quarter, Aura's Compliance Department provided each branch manager with excerpts of a report containing annualized turnover ratios, break even ratios, and other account metrics for the largest commission producing accounts from their branch. Aura's active account letter procedure, which was unwritten, required Aura's branch managers to send such letters to all customers whose accounts had turnover ratios greater than six.

11. The active account letters, entitled "Intent to Maintain Active Account," did not explain why Aura was sending the letters to the customers and they were not sent along with cover letters. The body of the form letters did not identify the respective accounts as actively traded or that they had recently shown a certain number of trades or a certain amount of turnover, but stated that "certain clients may wish to engage in more frequent trading in their accounts." The letters included a general disclosure of the risks associated with "frequent" trading and numerous blanks for the customer to complete concerning numbers of trades over the past year, anticipated trades in the future year, investment objective, risk exposure, and other financial information. After the customer filled in the blanks, the firm's procedure contemplated that the customer would sign the letter and return it to the Aura branch where his account was located.

12. Aura did not routinely keep a log or have some other system to monitor when an active account letter was sent to a customer from the branch offices. Moreover, there was no consistent practice of tracking returned letters and no consistent practice on follow-up of letters that had not been returned. If information in the returned active account letter did not indicate changes from the customer's original application, the returned active account letter was maintained at the branch office. According to Aura's Chief Compliance Officer ("CCO") branch managers were supposed to call, or have an RR call, customers and send out additional active account letters if customers did not return their letters, but the firm did not have a procedure to ensure that the branch managers complied. Further, there is no evidence that Aura had a mechanism to implement other aspects of the firm's procedures such as monitoring whether branch managers gave accounts with a turnover ratio of greater than six immediate attention, reviewed a larger sample size, or consistently took steps to close the trading activity in customers' accounts if customers did not confirm that such trading activity was acceptable.

E. BELLIA'S FAILURE REASONABLY TO SUPERVISE

13. Bellia failed reasonably to supervise RR1, from January 2008 through December 2008, and RR2, from April 2008 through August 2008, while they were registered with Aura and subject to Bellia's supervision in Aura's Islandia, New York branch office. The level of trading in the accounts of RR1's customers and RR2's customers was not merely indicative of potential churning, but was extreme.

14. While Bellia supervised RR1 and RR2, during at least each quarter of 2008, Bellia received excerpts of reports from Aura's Compliance Department containing, among other account information, annualized turnover ratios and break even ratios for the largest commission producing accounts from his branch. These reports included the names of RR1 and RR2's churning victims, all of whom had at least double digit annualized turnover rates. The turnover rates listed were far

in excess of the turnover rate of six that Aura's WSPs cautioned warranted immediate attention and review by the supervisor.

15. As reflected in the quarterly reports for 2008, RR1's victims had annualized turnover rates of 20 to 94 and cost to equity ratios of 87% to 2058%. With each successive quarter of 2008, RR1's victims grew in number or their turnover rates and cost to equity ratios increased in value. One of RR1's victims appeared on the report sent to Bellia in the first quarter with a turnover rate of 20 and a cost to equity ratio of 87%. In the second quarter, that victim's turnover rate increased to 43 and his cost to equity ratio increased to 188. In the third quarter, two of RR1's victims appeared on the report with turnover rates up to 59 and cost to equity ratios up to 2050%. By the fourth quarter, five of RR1's victims appeared on the report, with turnover rates up to 94 and cost to equity ratios up to 2058%. RR2's victims appeared on the report for the second quarter with annualized turnover rates of 40 and 59 and cost to equity ratios of 144% and 418%, respectively.[2]

16. Pursuant to Aura's Active Account Letter procedure, Bellia was required to send Active Account Letters to all customers with turnover rates exceeding six. Despite such requirements, and, notwithstanding that RR1 was under heightened supervision, Bellia and Aura were only able to produce Active Account Letters for two of RR1's five customers and for none of RR2's two customers. Bellia did not keep a log or otherwise track whether the letters were returned. When the letters did not come back, Bellia informed the registered representatives. Bellia did nothing else to follow up. Bellia did not follow-up on the unreturned active account letters.

17. The failure to contact RR1's customers is particularly egregious because RR1 was on heightened supervision due to his history. RR1's disciplinary history at the time the Commission filed its complaint against him showed fourteen customer complaints, including six from Aura customers. Two of the Aura customer complaints alleged churning and the other four alleged that customers had not in fact signed their own account paperwork. FINRA was investigating RR1 for falsifying customer records to open accounts and conducting unauthorized trading during his 2005 association with another broker-dealer. RR1 was discharged from broker-dealers in 2002 and 2005, both times for unauthorized trading, and was permitted to resign from a broker-dealer in 2006 for unauthorized use of a sales script.

18. RR2's history also was questionable. Before coming to Aura in March 2008, RR2 had been associated with seventeen other broker-dealers since 2000, including prior tenures at Aura for two months in 2007 and six months in 2005. RR2's known history at the time the Commission filed its complaint against him showed thirteen customer complaints, including two from Aura customers. One Aura customer complaint was pending and claimed damages of $69,000 from unauthorized trading; the other complaint claimed failure to follow customer instructions and settled for $12,500. In 2006, FINRA fined RR2 $15,000 and suspended him for ninety days for unauthorized trading while he was employed at another firm. From 2006 through

[2] RR2 was voluntarily terminated from Aura in August 2008 for reasons purportedly unrelated to churning.

2009, RR2 was either discharged or permitted to resign from five other broker-dealers for various reasons.

19. If Bellia had reasonably followed up on the red flags of high trading in the customer accounts of RR1 and RR2 or if he had diligently followed the heightened supervisory procedures for RR1, it is likely that he would have prevented or detected the RRs' violations.

F. BLUM'S FAILURE REASONABLY TO SUPERVISE

20. Blum failed reasonably to supervise RR3, from January 2008 through December 2008 while he was registered with Aura and subject to his supervision in Aura's Miami, Florida branch office. The level of trading in the accounts churned by RR3 was high enough to warrant increased review and customer contact. As reflected in the quarterly reports for 2008 sent to Blum, RR3's two victims had annualized turnover rates of 6 to 54 and cost to equity ratios of 14% to 54%.[3]

21. With each successive quarter of 2008, RR3's victims' turnover rates and cost to equity ratios increased in value. One of RR3's victims appeared on the report sent to Blum in the first quarter with a turnover rate of 6 and a cost to equity ratio of 14%. In the second quarter, that victim's turnover rate increased to 33 and his cost to equity ratio increased to 23%. RR3's second churning victim appeared on the report with a turnover rate of 7 and a cost to equity ratio of 19%. In the third quarter, these victims appeared on the report with turnover rates of 41 and 9 and cost to equity ratios of 36% and 32%, respectively. By the fourth quarter, one victim had a turnover rate of 54 and cost to equity ratio of 54%. The turnover rate for the second victim was blank on this report although his cost to equity ratio was shown as 43%.

22. The high levels of trading were brought to Blum's attention and Blum did send out active account letters. However, Blum did little to follow up on the red flags presented in the active account letters returned by RR3's two churning victims. While Blum and Aura were able to produce signed active account letters from both of RR3's churning victims, which were dated at the end of June 2008, both victims stated in their declarations that they did not fill out the information contained in these letters. The handwriting contained in the blanks of these customers' active account letters appears similar. Moreover, one of RR3's customers did not recall receiving the letter and questioned whether he actually signed the letter despite a signature on the letter that purported to be his.

23. Blum treated the active account letter as a "negative response letter" In effect expecting the letter to be returned if the customer had a problem with the account. If the letters were not returned or were missing information, his practice was not to contact customers, himself. Instead, Blum left it to the RRs to follow-up with their customers.

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3 Aura's WSPs provided, among other things, that an account with a turnover ratio greater than two and less than or equal to six "warrants further review."

24. RR3 had a complaint history that would have reinforced the need to contact customers, where unusual trading was apparent. RR3's history at the time the Commission filed its complaint showed three pending customer complaints: Two complaints filed in April 2009 and June 2008 both cited unauthorized trading. A third complaint filed in September 2008 alleged $150,000 in damages for not following customer instructions.

25. If Blum had reasonably followed-up on the red flags of high trading in the accounts of RR3, it is likely that he would have prevented or detected the RR's securities law violations.

G. GAUTNEY'S FAILURE TO REASONABLY SUPERVISE

26. Gautney, as Aura's president, was responsible for developing and implementing reasonable policies, procedures, and systems to prevent and detect the churning of the three RRs at Aura. Gautney failed to put in place effective controls to confirm that active account letters were sent and returned on a timely basis to Aura's branch offices. Gautney did not know if someone was monitoring Aura's active account letters. Aura's system relied on branch managers to supervise RRs, but did virtually nothing to determine whether the branch managers were effectively supervising the RRs in connection with implementing firm procedures to address high levels of trading in customer accounts. There were no controls to make sure that branch managers followed the active account letter procedures or otherwise reasonably followed up on red flags of churning. Gautney was also generally aware of the high turnover in many Aura customer accounts. Gautney had access to the reports containing the turnover and cost to equity ratios and, in 2007, was notified by FINRA that fifty customer accounts appeared to be excessively traded, including the account of a customer of RR3.

27. If Gautney had reasonably implemented the firm's procedures for addressing potential churning in customer accounts, it is likely that he and the firm would have prevented and detected the RRs' misconduct.

VIOLATIONS

28. As a result of the conduct described above, Bellia and Gautney failed reasonably to supervise RR1 And RR2 and Blum and Gautney failed reasonably to supervise RR3, within the meaning of Section 15(b)(6) of the Exchange Act, which incorporates by reference Section 15(b)(4)(E) of the Exchange Act and Gautney failed reasonably to supervise all three RRs within the meaning of Section 203(e) of the Advisers Act, with a view to preventing and detecting their violations of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

III.

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

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

B. What, if any, remedial action is appropriate in the public interest against Respondents pursuant to Section 15(b) of the Exchange Act including, but not limited to, disgorgement and civil penalties pursuant to Section 21B of the Exchange Act; and

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

IV.

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

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

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

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

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 300 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

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

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3091 / September 29, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13714

In the Matter of **Ark Asset Management Co., Inc.,** **Respondent.**	**ORDER MAKING FINDINGS AND IMPOSING SANCTIONS PURSUANT TO SECTION 203(k) OF THE THE INVESTMENT ADVISERS ACT OF 1940**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest to enter this Order Making Findings and Imposing Remedial Sanctions Pursuant to Section 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against Ark Asset Management Co., Inc., ("Ark" or "Respondent").

II.

Following the institution of these proceedings on December 14, 2009, Respondent has submitted an Offer of Settlement ("Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Making Findings and Imposing Remedial Sanctions Pursuant to Section 203(k) of the Investment Advisers Act of 1940 ("Order"), as set forth below.

III.

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

Summary

1. These proceedings arise out of fraudulent trade allocation, disclosure and books and records violations by Ark Asset Management Co., Inc. between August 2000 and December 2003 ("Relevant Period"). During the Relevant Period, a now-deceased portfolio manager ("Portfolio Manager") of Ark engaged in fraudulent trade allocation practices – "cherry-picking" – by favoring the Proprietary accounts over the Client accounts in the allocation of securities. Ark did not disclose this scheme to its clients. As a result of this fraudulent conduct, Ark realized at least $19 million of ill-gotten gains in the form of performance fees from the Proprietary accounts. Additionally, Ark's Form ADV filings during the Relevant Period were materially misleading. Contrary to its stated goal of being "fundamentally fair" in the allocation of securities between the Proprietary and Client accounts, Ark failed to disclose to its adversely affected clients that it favored the Proprietary accounts in the allocation of securities. Ark also committed books and records violations by failing to make and keep true and accurate order memoranda.

Respondent

2. **Ark Asset Management Co., Inc.,** a New York corporation headquartered in New York, New York, was registered with the Commission as an investment adviser from August 21, 1989 through March 2, 2009, when it withdrew its registration. It was the wholly-owned, operating subsidiary of Ark Asset Holdings, Inc. ("Ark Holdings"). Ark was originally the investment management arm of Shearson Lehman Brothers Inc. Ark ceased operations on February 27, 2009 and sold substantially all of its assets. On or about March 30, 2009, Ark Holdings consented to an involuntary bankruptcy proceeding under Chapter 7 of the Bankruptcy Code. Ark is being liquidated under the supervision of a Chapter 7 Trustee and has limited assets available for distribution to creditors.

Relevant Entities

3. **NorthStar Funds** ("Proprietary" accounts or funds) was a set of hedge funds created by Ark in 2000, in which certain Ark employees had ownership interests. In December 2003, the Portfolio Manager responsible for trading for both NorthStar and the Specialty Growth

[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.

accounts (defined below) left Ark and created a separate entity, NorthStar Capital Funds, LLC, which took over the management of the NorthStar Funds.

4. **Specialty Growth** ("Client" accounts) was a certain set of advisory accounts created by Ark in 1986 and managed using a growth strategy. Specialty Growth clients included large institutional investors, such as retirement plans, pension funds and charitable organizations.

Background

5. In August 2000, Ark launched the Proprietary Funds in which numerous Ark employees, their friends and family, traders and board members invested, as well as certain outside investors. The Portfolio Manager made all investment decisions with respect to, and had sole trading authority over, both the Proprietary accounts and the Client accounts, and, along with other Ark employees, was also invested in Proprietary accounts. Both the Proprietary accounts and the Client accounts engaged in day-trading and investing in initial public offerings. In fact, the Proprietary funds realized most of their profits from day-trading stocks. The Portfolio Manager often traded the same securities for the Proprietary and Client accounts.

The Cherry-Picking Scheme

6. At or soon after the launch of the Proprietary funds, the Portfolio Manager began to execute a cherry-picking scheme that favored the Proprietary accounts in the allocation of securities. The Portfolio Manager accomplished this cherry-picking by placing orders for securities, but delaying allocation of the purchases and sales until after the order had been filled and the price of the security had been obtained. Sometimes the Portfolio Manager did not allocate until, or made changes to allocations at, the end of the day. The Portfolio Manager allocated mostly favorable trades to the Proprietary accounts and allocated a significantly lower percentage of favorable trades to the Client accounts even though the Client accounts were legally and financially able to engage in the trades that were disproportionately allocated to the Proprietary accounts.

7. When placing trades, neither the Portfolio Manager nor the traders who worked for him documented how the trade would ultimately be allocated between the two sets of accounts. While each set of accounts had different order tickets, orders were routinely written on an order ticket for one of the two sets of accounts. The order tickets, however, did not reflect how the Portfolio Manager would ultimately decide to allocate the securities. Instead, after an order was filled, the Portfolio Manager would sometimes decide to keep the entire allocation with one set of accounts (i.e., the Proprietary or Client accounts), would sometimes move part of the allocation to the other set of accounts, or would sometimes decide to allocate the entire trade to the other set of accounts. In some instances, traders were directed to move an order from one set of accounts to the other by creating a new order ticket, transferring the security to that ticket, and discarding the old order ticket.

8. Allocations by Ark to the Proprietary accounts were much more likely to be profitable on the day of the allocation than were allocations to the Client accounts, with a difference in profitability of approximately 68% to approximately 37% respectively. Additionally, approximately 75% of Proprietary funds' long day-trades were profitable while only approximately 37% of Client accounts' long day-trades were profitable. Consequently, there was a significant overall performance differential between the Proprietary funds and the Client funds for most of the Relevant Period.

9. The cherry-picking resulted in enhanced first-day profitability (realized and unrealized gains) for the Proprietary accounts of approximately $230 million. Favorable day-trades generated approximately $81 million in profits for the Proprietary accounts during the Relevant Period.

10. The officers and directors of Ark knew about the disparity in performance between the Proprietary accounts and the Client accounts. Directors and officers were informed at board meetings throughout the Relevant Period about the performance of the Client accounts. In addition, many of Ark's officers and directors were investors in the Proprietary funds and thus knew about the performance of the Proprietary funds.

Disclosures and Books and Records Violations

11. Ark's Form ADV became materially inaccurate in 2000 when the Portfolio Manager began allocating better trades to the NorthStar accounts than the Specialty Growth accounts, either for profit or to minimize losses to the NorthStar accounts. Ark's Form ADV stated that its "goal is to be fundamentally fair on an overall basis with respect to all clients invested in [both NorthStar and Specialty Growth accounts]... ." Even though Ark filed amendments to its Form ADV between 2000 and 2003, it failed to correct the materially inaccurate statement by not disclosing that it favored NorthStar clients over Specialty Growth clients when allocating trades.

12. Moreover, Item 11 of Part I of Ark's Form ADV requires an adviser to disclose information about the disciplinary record of the adviser and its advisory affiliates – which include persons who are controlled by the adviser. The head trader for both the Proprietary and Client accounts was controlled by Ark and was listed as a "control person" on Ark's Form ADV. In June 2003, that head trader, who was under investigation by the New York Stock Exchange at the time Ark hired him in 2000, settled with the NYSE and consented to a censure and a fine. Ark did not amend its disclosure to reflect this disciplinary action in response to Item 11 of Part I of its Form ADV.

13. Finally, Ark failed to make and keep accurate order tickets that reflected allocation determinations contemporaneous with the order, failed to make and keep accurate memoranda showing modifications or cancellations of certain orders, discarded certain order tickets, and altered order memoranda after execution of orders.

Violations

14. By knowingly or recklessly allocating profitable trades to the Proprietary accounts at the expense of the Client accounts and not disclosing this scheme to clients, Ark violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, which prohibit fraudulent conduct in connection with the purchase or sale of securities. In addition, through this cherry-picking scheme and by failing to disclose the scheme, Ark violated Sections 206(1) and 206(2) of the Advisers Act, which, in pertinent part, prohibit investment advisers from employing any device, scheme, or artifice to defraud any client and from engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client.

15. Ark engaged in a scheme to defraud by allocating profitable trades to the Proprietary accounts at the expense of the Client accounts without disclosing this practice. As an investment adviser, and therefore a fiduciary, Ark had an affirmative duty of loyalty not to put its interests ahead of its clients and to disclose material information to its clients. However, during the relevant period, Ark failed to disclose to the adversely affected clients that Ark was favoring the hedge funds when allocating trades. Accordingly, Ark violated Sections 206(1) and (2) of the Advisers Act.

16. Ark's Form ADV became materially misleading in 2000 when the Portfolio Manager began allocating better trades to the Proprietary accounts than the Client accounts, either for profit or to minimize losses to the Proprietary accounts. Ark failed to amend the form, as required by Section 204 of the Advisers Act and Rule 204-1(a)(2) thereunder. Ark's Form ADV stated that its "goal is to be fundamentally fair on an overall basis with respect to all clients invested in [both the Proprietary and Client accounts]... ." Ark failed to correct the materially inaccurate statement by not disclosing that it favored the Proprietary funds over the Client accounts in the allocation of securities. Accordingly, Ark violated Section 204 of the Advisers Act and Rule 204-1(a)(2) thereunder.

17. Ark also failed to file an amendment to Item 11 of Part I of Form ADV, which requires an adviser to disclose information about the disciplinary record of the adviser and its advisory affiliates – which include persons who are controlled by the adviser. The head trader for both sets of accounts was controlled by Ark and was listed as a "control person" on Ark's Form ADV. Therefore Ark was obligated to amend Item 11 to disclose that an investigation of the head trader by the New York Stock Exchange resulted in a settlement in which the head trader consented to a censure and fine in June 2003. Accordingly, Ark violated Sections 204 and 207 of the Advisers Act and Rule 204-1(a)(2) thereunder.

18. Ark violated Section 204 of the Advisers Act and Rule 204-2(a)(3) thereunder, which require registered investment advisers to make and keep true, accurate and current order memoranda for the purchase and sale of any security on behalf of a client by failing to make accurate order tickets that contained all the information required by those rules. Ark's order tickets failed to reflect and/or inaccurately reflected the "terms and conditions" of certain orders in violation of these Rules. Specifically, Ark failed to make and keep accurate memoranda

showing modifications or cancellations of certain orders, discarded certain order tickets, and altered order memoranda after execution of orders. Accordingly, Ark violated Section 204 of the Advisers Act and Rule 204-2(a)(3) thereunder.

Undertakings

Respondent undertakes to:

19. Ensure that all Ark assets are used to satisfy creditor claims asserted against Ark and none of Ark's assets will be distributed to Ark Holdings except to the extent necessary to satisfy administrative priority expenses of the Ark Holdings bankruptcy estate.

IV.

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

Accordingly, it is hereby ORDERED that:

A. Respondent shall comply with the undertakings enumerated in Section III.19. above.

B. Respondent shall, within 5 days of the entry of this Order, pay disgorgement of $19,800,000 to the Securities and Exchange Commission. In view of the limited assets available in the Ark estate, Ark's disgorgement obligation to the Securities and Exchange Commission pursuant to this Order shall be deemed satisfied in full by the payment of $750,000 without further recourse against the Ark estate. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the 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 Ark Asset Management Co., 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 Alison Conn, Assistant Regional Director, Division of Enforcement, Securities and Exchange Commission, New York Regional Office, 3 World Financial Center, New York, New York 10281.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 63006 / September 29, 2010

INVESTMENT ADVISERS ACT OF 1940
Release No. 3090 / September 29, 2010

ADMINISTRATIVE PROCEEDINGS
File No. 3-14072

In the Matter of **VALENTINE CAPITAL ASSET MANAGEMENT, INC. and JOHN LEO VALENTINE** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 15(b)(6) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND CEASE-AND-DESIST ORDERS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 15(b)(6) of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against Valentine Capital Asset Management, Inc. ("VCAM") and John Leo Valentine ("Valentine") (collectively "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 15(b)(6) of the Securities Exchange Act of 1934 and Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and Cease-and-Desist Orders ("Order"), as set forth below.

III.

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

Summary

This matter involves an investment adviser's failure to fully and adequately disclose a material conflict of interest relating to the commissions received as a result of an investment recommendation. The adviser, Respondent VCAM, and its principal, Respondent Valentine, failed to fully disclose to clients that Valentine would receive additional commissions through Valentine's association with the registered broker-dealer that executed the clients' transactions, if clients accepted the recommendation to exchange one series of a managed futures fund (the "Fund") for another series of the Fund. Respondents also failed to fully and adequately disclose that these exchanges would cost clients additional commissions. Respondents received nearly $400,000 in additional revenue as a result of commissions from the clients' exchanges.

Respondents' failure to fully disclose these conflicts of interest relating to the receipt of commissions violated Section 206(2) of the Advisers Act.

Respondents

1. Respondent VCAM, a California corporation located in San Ramon, California, is an investment adviser registered with the Commission. In its most recent Form ADV, VCAM disclosed that it had approximately $211 million in assets under management and over 500 clients.

2. Respondent Valentine, age 48, is the president and owner of VCAM and has been since the firm's inception. At the end of 2007, Valentine also managed an additional $400 million in assets as a registered representative with an independent broker-dealer. Valentine recommended that his clients open brokerage accounts at this broker-dealer to hold their investments in the Fund, among other holdings. Valentine provided investment advice in connection with these accounts. The broker-dealer executed the Fund transactions and paid commissions to Valentine.

Background

3. The Fund is a managed futures fund and commodity pool with both Series A and Series B limited partnership units. Series A and Series B follow the same investment philosophy and typically hold the same investments, with leverage as the primary difference between the two series. Series A of the Fund invests 20% of its assets in commodities futures and keeps the remaining 80% in cash and cash instruments, while Series B invests 30% of its assets in commodities futures and keeps the remaining 70% in cash and cash instruments. In other words, Series B has 50% greater exposure to commodities than Series A, but with increased risk, volatility, and a 17% increase in costs.

4. Investors paid to the Fund a 4% annual commission, which was capped once it reached a total of 10% of the initial investment. The broker-dealer that executed the Fund transactions passed on this commission to Valentine, the selling agent in this case. Investors reached the 10% commissions cap after holding the Fund for approximately 2.5 years. Once an investor paid the maximum in total commissions, the Fund then no longer passed commissions on to the selling agent. Instead, the Fund collected the commissions monthly and then simultaneously returned them to investors in-kind in the form of additional Fund units.

5. Valentine first learned of the Fund in mid-2005, when searching for non-correlated investments that were designed to perform independently of broader markets. After considering the alternatives, Valentine advised his clients to invest in Series A of the Fund. As of August 2007, two-thirds of Valentine's client base had invested in the Fund, the vast majority of which was in Series A. Approximately 450 of Valentine's 700 clients had invested over $40 million in Series A, with Valentine's firm earning approximately $3 million in commissions from these transactions. Only 10 of Valentine's clients were invested in Series B, for less than $1 million in total investments.

The Fund Exchanges

6. In December 2007, Valentine began advising many of his clients to exchange at least some portion of their Series A holdings for Series B. During the staff's investigation, Valentine indicated that he had been monitoring the housing and banking markets for some time and decided that reallocation was appropriate due to those factors and others. Accordingly, Valentine advised many of his clients to exchange their Series A shares for Series B to increase the leverage on their positions and thus increase their exposure to expected gains in the non-correlated investment sector.

7. Over the next few months, Valentine and his advisory representatives met with clients to receive their consent for the exchange from Series A to Series B. Between December 2007 and May 2008, approximately 140 clients switched from Series A to Series B. The vast majority of these clients had reached or were very close to reaching their 10% commissions limit. VCAM periodically received data on which investors had reached or would soon reach the 10% commissions cap.

8. For any client who had reached the 10% commissions limit on Series A, switching to Series B reset the clock on commissions, and any rebates that they were receiving from the Fund ceased. This also meant that they began paying a new commission on reallocated assets of 4% annually with a 10% maximum. For clients who had not yet reached the commissions cap when they switched from Series A to Series B, they lost any progress they had made in their Series A investment towards the commissions limit. For these investors, many of whom were within a few months of reaching the commissions cap when they switched from Series A to Series B of the Fund, the exchanges increased the amount of commission that Valentine received.

VCAM and Valentine Failed to Fully and Adequately Disclose Their Conflict of Interest

9. Section 206 of the Advisers Act prohibits fraud by investment advisers against clients and prospective clients. Investment advisers owe a fiduciary duty to their clients under Section 206. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963). As such, they must act in "utmost good faith," use reasonable care to avoid misleading clients, and fully and fairly disclose conflicts of interest. Id. at 194, 201. "[A] violation of Section 206(2) of the Advisers Act may rest on a finding of simple negligence." SEC v. Steadman, 967 F.2d 636, 643 n. 5 (D.C. Cir. 1992) (citing Capital Gains, 375 U.S. at 195).

10. An investment adviser has a duty to fully disclose to its clients all material information that is intended "to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser - consciously or unconsciously - to render advice which was not disinterested." Capital Gains, 375 U.S. at 191-92; *see also* Vernazza v. SEC, 327 F.3d 851, 859 (9th Cir. 2003) (stating that "[i]t is indisputable that potential conflicts of interest are 'material' facts with respect to clients"). Failure to disclose an economic self-interest constitutes a breach of an investment adviser's fiduciary duty under Section 206. SEC v. Wall Street Publ'g Inst., Inc., 591 F. Supp. 1070, 1084 (D.D.C. 1984). Similarly, an investment adviser has a duty to disclose to clients all material information that might affect an investment adviser's ability to render unbiased advice. In re Renaissance Cap. Advisors, Inc., Investment Advisers Act Rel. No. 1688, 1997 WL 794479, at *3 (Dec. 22, 1997).

11. Valentine was aware that his advice to his clients to exchange Series A shares for Series B shares would increase the brokerage commissions he received. Valentine's clients expected VCAM and Valentine to act as fiduciaries in connection with these investment recommendations. However, despite this, VCAM and Valentine failed to fully disclose their conflict to their clients.

12. The Fund's Prospectus and exchange paperwork disclosed information about the switches. For example, the Fund's Prospectus stated that once an investor reached the 10% cap on commissions, the investor would receive rebated units from the Fund equal to the value of the monthly commissions. Similarly, the Fund's Series Exchange Subscription Agreement contained language informing investors that they would be charged the maximum 10% commissions for Series B regardless of any previous investment in Series A. Each client who made the switch signed the Series Exchange Subscription Agreement. However, VCAM and Valentine were still required to make full and clear disclosures about any conflict of interest in recommending the exchanges.

13. As a result of the conduct described above, VCAM and Valentine willfully[1] violated Section 206(2) of the Advisers Act, which makes it unlawful for an adviser to engage in any transaction, practice, or course of business that operates as a fraud or deceit upon any client.

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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

Undertakings

14. Within thirty (30) days of the issuance of this Order, Respondents undertake to mail a copy of the Form ADV which incorporates the paragraphs contained in the Summary section of this Order to each of VCAM's existing clients, and specify that the entire Order will be posted on VCAM's website. Within thirty (30) days of the issuance of this Order, Respondents also undertake to post a copy of this Order on VCAM's website and maintain this copy of the Order on VCAM's website for a period of six (6) months. Respondents shall also provide a copy of the Form ADV to any new client that engages VCAM or Valentine within one (1) year of the date of this Order.

IV.

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

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

A. Respondents Valentine Capital Asset Management, Inc. and John Leo Valentine cease and desist from committing or causing any violations and any future violations of Section 206(2) of the Advisers Act;

B. Respondents Valentine Capital Asset Management, Inc. and John Leo Valentine are censured.

C. Respondent Valentine Capital Asset Management, Inc. shall, within 6 months of the entry of this Order, pay disgorgement of $394,710.82 and prejudgment interest of $37,296.71 to the affected advisory clients who invested in the Fund during the relevant period, through a distribution calculation which has been reviewed and approved by the staff of the Commission. Said calculation must be submitted to the staff within 90 days from the entry of this Order and must include specific information as to each client's investment amount, investment timeline, and amount to be paid. Proof and documentation of such payment (whether in the form of fee credits, cancelled checks, or otherwise) shall be submitted within 14 days of payment under cover letter that identifies Valentine Capital Asset Management, Inc. as a Respondent in these proceedings and the file number of these proceedings, to Marc J. Fagel, San Francisco Regional Office, Securities and Exchange Commission, 44 Montgomery Street, Suite 2600, San Francisco, CA 94104. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. In the event that Respondent fails to complete the distribution under the terms set forth in this Order, payment of the full distribution amount (or the balance thereof) shall be due and payable immediately to the Commission, without further application.

"'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)).

D. Respondent John Leo Valentine shall pay a civil money penalty in the amount of $70,000.00 to the United States Treasury. Payment shall be made in the following installments: $25,000.00 within thirty (30) days of entry of this Order and (2) the remaining $45,000.00 within 360 days of the entry of this Order. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Such payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies John Leo Valentine 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 Marc J. Fagel, San Francisco Regional Office, Securities and Exchange Commission, 44 Montgomery Street, Suite 2600, San Francisco, California 94104.

E. Valentine Capital Asset Management, Inc. and John Leo Valentine shall comply with the undertakings enumerated in Section III, Paragraph 14 above.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 63008 / September 29, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14073

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

I.

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

II.

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

III.

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

1. Clamens, age 45, was the chairman and chief executive officer of FTC Capital Markets, Inc. ("FTC"), a broker-dealer registered with the Commission during the relevant period. From approximately August 2005 through May 2009, Clamens was a registered representative of FTC. Throughout the relevant period, Clamens maintained a residence in New York, New York. Clamens is a citizen of Venezuela where he currently resides.

2. On August 26, 2010, a final judgment was entered by consent against Clamens, permanently enjoining him from violating Section 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Exchange Act, and Exchange Act Rule 10b-5, and from aiding and abetting violations of Sections 15(a) and 15(c) of the Exchange Act in the civil action entitled Securities and Exchange Commission v. FTC Capital Markets, Inc., et al., Civil Action Number 09 Civ. 4755 (PGG), in the United States District Court for the Southern District of New York.

3. The Commission's complaint alleged that Clamens engaged in a fraudulent scheme through FTC in which he engaged in tens of millions of dollars of unauthorized securities trading in the accounts of two FTC customers, and concealed those transactions from the customers by sending them fake account statements, and that he did so in part to conceal his prior fraudulent sale of $50 million in non-existent securities to a customer of FTC Emerging Markets, Inc., also d/b/a FTC Group, another Clamens-controlled entity, which illegally acted as an unregistered broker-dealer.

IV.

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

Accordingly, it is hereby ORDERED:

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

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Casey and Commissioner Walter not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 63009 / September 29, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14074

In the Matter of **LINA LOPEZ A/K/A NAZLY CUCUNUBA LOPEZ,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondent Lina Lopez a/k/a Nazly Cucunuba Lopez ("Respondent" or "Lopez").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over her and the subject matter of these proceedings, and the findings contained in Sections III..2 and III.4 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Lopez, age 34, was an employee of FTC Capital Markets, Inc. ("FTC"), a registered broker-dealer, and worked for FTC and various FTC affiliates from 2006 through May 2009.

Throughout the relevant period, Lopez was a permanent resident of the United States who maintained a residence in Miami, Florida.

2. On August 26, 2010, a final judgment was entered by consent against Lopez, permanently enjoining her from violating Section 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Exchange Act, and Exchange Act Rule 10b-5, and from aiding and abetting violations of Sections 15(a) and 15(c) of the Exchange Act in the civil action entitled Securities and Exchange Commission v. FTC Capital Markets, Inc., et al., Civil Action Number 09 Civ. 4755 (PGG), in the United States District Court for the Southern District of New York.

3. The Commission's complaint alleged that, from April through November 2008, Lopez engaged in a fraudulent scheme through FTC in which she concealed tens of millions of dollars of unauthorized securities trading in the accounts of two FTC customers by creating and sending the customers fake account statements. The complaint also alleged that Lopez prepared monthly account statements for customers of FTC Emerging Markets, Inc., also d/b/a FTC Group, which illegally acted as an unregistered broker-dealer.

4. On October 16, 2009, Lopez pleaded guilty to one count of conspiracy to commit securities and wire fraud in violation of Title 18, United States Code, Section 371 and one count of securities fraud in violation of Title 15, United States Code, Sections 78j(b) and 78ff, and Title 17, Code of Federal Regulations, Section 240.10-b-5, before the United States District Court for the Southern District of New York, in United States v. Nazly Cucunuba Lopez a/k/a Lina Lopez, 09 Cr. 985 (RPP), in connection with the above-referenced fraudulent scheme.

IV.

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

Accordingly, it is hereby ORDERED:

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

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 63011 / September 29, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14075

In the Matter of **Amereco, Inc.,** **American Atlas Resources Corp.,** **American Classic Voyages Co.,** **American Consolidated Growth Corp.,** **AmeriKing, Inc.,** **Ametech, Inc., and** **Ampace Corp.,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Amereco, Inc., American Atlas Resources Corp., American Classic Voyages Co., American Consolidated Growth Corp., AmeriKing, Inc., Ametech, Inc., and Ampace Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Amereco, Inc. (CIK No. 793376) is an expired Utah corporation located in Englewood, Colorado with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Amereco is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 1997, which reported a net loss of over $1.36 million for the prior nine months.

2. American Atlas Resources Corp. (CIK No. 752388) is a Delaware corporation located in Brighton, Colorado with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Atlas 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, 1998, which reported a net loss of $59,200 for the prior three months.

3. American Classic Voyages Co. (CIK No. 315136) is a forfeited Delaware corporation located in Chicago, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Classic 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 over $20 million for the prior six months. The company has also violated a June 25, 2001 cease-and-desist order of the Commission against it prohibiting future violations of Exchange Act Section 13(a). On October 19, 2001, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Delaware that is still pending as of September 27, 2010. As of September 27, 2010, the company's stock (symbol "AMCVQ") was traded on the over-the-counter markets.

4. American Consolidated Growth Corp. (CIK No. 812407) is a void Delaware corporation located in Denver, Colorado with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Consolidated 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, 1997. As of September 27, 2010, the company's stock (symbol "AMGC") was traded on the over-the-counter markets.

5. AmeriKing, Inc. (CIK No. 1014599) is a Nevada corporation located in Westchester, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). AmeriKing 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 1, 2002, which reported a net loss of over $18.7 million for the prior six months. On December 4, 2002, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Delaware, which was converted to Chapter 7 and was still pending as of September 27, 2010.

6. Ametech, Inc. (CIK No. 1969) is an expired Oklahoma corporation located in Oklahoma City, Oklahoma with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Ametech is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended March 31, 1997, which reported a net loss of $404,000 for the prior three months. On February 2, 1998, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Western District of Oklahoma, which was terminated on February 14, 2002.

7. Ampace Corp. (CIK No. 935678) is a void Delaware corporation located in Knoxville, Tennessee with a class of securities registered with the Commission pursuant

to Exchange Act Section 12(g). Ampace is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 1998, which reported a net loss of over $1.64 million for the prior three months.

B. DELINQUENT PERIODIC FILINGS

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

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

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

III.

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

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

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 63012 / September 29, 2010

ADMINISTRATIVE PROCEEDING
File No. 3- 14076

In the Matter of American Aircarriers Support, Inc., American Artists Entertainment Corp., American Complex Care, Inc., American Prepaid Legal Services, Inc., and Amtech Financial Corp., Respondents.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents American Aircarriers Support, Inc., American Artists Entertainment Corp., American Complex Care, Inc., American Prepaid Legal Services, Inc., and Amtech Financial Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. American Aircarriers Support, Inc. (CIK No. 1056286) is a forfeited Delaware corporation located in Fort Mill, South Carolina with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Aircarriers 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, 2000, which reported a net loss of over $2.8 million for the prior six months. On October 31, 2000, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Delaware, which was terminated on March 5, 2003.

2. American Artists Entertainment Corp. (CIK No. 1001593) is a dissolved Missouri corporation located in Atlanta, Georgia with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Artists is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended April 30, 1999, which reported a net loss of over $1.05 million for the prior nine months.

3. American Complex Care, Inc. (CIK No. 812790) is a void Delaware corporation located in Miramar, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Complex 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 April 30, 1995, which reported a net loss of over $4.2 million for the prior nine months.

4. American Prepaid Legal Services, Inc. (CIK No. 1163460) is a Nevada corporation located in Miami, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Prepaid 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 $72 for the prior six months.

5. Amtech Financial Corp. (CIK No. 1125090) is a dissolved Florida corporation located in Miami, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Amtech is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-SB registration statement on May 8, 2001, which reported an accumulated deficit of $2,102 for the year ended December 31, 1999.

B. DELINQUENT PERIODIC FILINGS

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

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

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

III.

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

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

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 63013 / September 29, 2010

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3190 / September 29, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14077

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

I.

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

[1] Rule 102(e)(3)(i) provides, in relevant part, that:

> The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . suspend from appearing or practicing before it any . . . accountant . . . who has been by name . . . permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

II.

The Commission finds that:

A. RESPONDENT

1. Durland, age 56, resides in West Palm Beach, Florida, and has been CFO of Pegasus Wireless Corporation ("Pegasus") since 2005. He is a CPA currently licensed in New York. His firm, Durland & Company, CPAs, P.A., has performed auditing work for several microcap companies. The firm was registered with the Public Company Accounting Oversight Board ("PCAOB"), but is no longer. During the staff's investigation of Pegasus, Respondent refused to answer the staff's questions in testimony based on his Fifth Amendment privilege against self-incrimination.

B. CIVIL INJUNCTION

3. On May 27, 2009, the Commission filed a complaint against Durland in SEC v. Pegasus Wireless Corp. (Civil Action No. CV 09-2302) in the United States District Court for the Northern District of California. On September 28, 2010, the court entered a judgment against Durland permanently enjoining him from future violations, direct or indirect, of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933, Sections 10(b), 13(b)(5), and 16(a) of the Securities Exchange Act of 1934, and Rules 10b-5, 13a-14, 13b2-1, 13b2-2 and 16a-3 thereunder and from aiding and abetting violations of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder.

4. The Commission's complaint alleged, among other things, that Durland and another Pegasus officer defrauded investors by creating backdated promissory notes memorializing a phony debt, which they used to get unrestricted shares of Pegasus stock into the hands of individuals and entities they controlled. Durland caused Pegasus to issue nearly 480 million shares – 75% of its outstanding shares – based on the fake, backdated promissory notes, resulting in massive dilution of the existing shareholders' ownership interest. The individuals and entities who received shares dumped the stock on the open market and funneled many millions in proceeds to Durland and the other Pegasus officer. Durland also made numerous misrepresentations and omissions in SEC filings about Pegasus' financing for acquisitions.

III.

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

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

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

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

This Order shall be served upon Durland personally or by certified mail at his last known address.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 63014 / September 29, 2010

INVESTMENT ADVISERS ACT OF 1940
Release No. 3092 / September 29, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14078

In the Matter of

SANDRA VENETIS,

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 Sandra Venetis ("Venetis" 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 her and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Venetis was the president, sole owner and sole principal of Systematic Financial Associates, Inc. ("SFA"), an investment adviser registered with the Commission, and was also the sole owner of Systematic Financial Services, Inc. ("SFS Notes"), Systematic Financial Services, LLC ("SFS Tax"), and Venetis LLC, all of which she operated from the same office. Venetis holds Series 6 and 7 licenses and is a certified financial planner and chartered financial consultant. Venetis, 59 years old, is a resident of Branchburg, New Jersey.

2. On September 2, 2010, a judgment was entered by consent against Venetis, permanently enjoining her from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Advisers Act, in the civil action entitled <u>Securities and Exchange Commission v. Sandra Venetis, et al.</u>, Civil Action Number 10-cv-4493-JAP, in the United States District Court for the District of New Jersey.

3. The Commission's complaint alleged, among other things, that, since at least 1997, Venetis designed and orchestrated an offering fraud and multi-million dollar Ponzi scheme, whereby she fraudulently obtained over $11 million from at least 100 investors. The complaint further alleged that Venetis, operating through SFA, SFS Tax, and SFS Notes, fraudulently offered and sold promissory note securities in unregistered transactions. In connection with the sale of the notes, Venetis falsely stated to investors that the notes funded loans to doctors, the investments would generate tax-free annual returns, and the doctors receiving the loans acknowledged their repayment obligations by co-signing the notes. The complaint also alleged that Venetis systematically misappropriated and misused investor funds, falsely stated to investors that their funds were invested, sent out false account statements indicating that investor funds earned the promised returns, and otherwise engaged in a variety of conduct which operated as a fraud and deceit on investors.

IV.

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

Accordingly, it is hereby ORDERED:

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

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, prejudgment interest and civil money penalties ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement, prejudgment interest and civil money penalties; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

III.

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

1. SFA is a New Jersey corporation with its principal place of business in Branchburg, New Jersey. SFA is wholly owned by Sandra Venetis ("Venetis") and is an investment adviser registered with the Commission.

2. On September 2, 2010, a judgment was entered by consent against SFA, permanently enjoining it from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Advisers Act, in the civil action entitled Securities and Exchange Commission v. Sandra Venetis, et al., Civil Action Number 10-cv-4493-JAP, in the United States District Court for the District of New Jersey.

3. The Commission's complaint alleged, among other things, that, since at least 1997, Venetis designed and orchestrated an offering fraud and multi-million dollar Ponzi scheme, whereby she fraudulently obtained over $11 million from at least 100 investors. The complaint further alleged that Venetis, operating through SFA and two other entities, fraudulently offered and sold promissory note securities in unregistered transactions. In connection with the sale of the notes, Venetis falsely stated to investors that the notes funded loans to doctors, the investments would generate tax-free annual returns, and the doctors receiving the loans acknowledged their repayment obligations by co-signing the notes. The complaint also alleged that Venetis systematically misappropriated and misused investor funds, falsely stated to investors that their funds were invested, sent out false account statements indicating that investor funds earned the promised returns, and otherwise engaged in a variety of conduct which operated as a fraud and deceit on investors.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 203(e) of the Advisers Act, that the investment adviser registration of Respondent SFA be, and hereby is, revoked.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3093 / September 29, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14079

In the Matter of **SYSTEMATIC FINANCIAL ASSOCIATES, INC.,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 203(e) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(e) of the Investment Advisers Act of 1940 ("Advisers Act") against Systematic Financial Associates, Inc. ("SFA" 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, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(e) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 243

[Release Nos. 33-9146; 34-63003; IC-29448; File No. S7-23-10]

REMOVAL FROM REGULATION FD OF THE EXEMPTION FOR CREDIT RATING AGENCIES

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: This amendment implements Section 939B of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which requires that the Securities and Exchange Commission amend Regulation FD to remove the specific exemption from the rule for disclosures made to nationally recognized statistical rating organizations and credit rating agencies for the purpose of determining or monitoring credit ratings.

DATES: Effective Date: **[insert date of publication in the Federal Register]**

FOR FURTHER INFORMATION CONTACT: Steven G. Hearne, Special Counsel in the Office of Rulemaking, Division of Corporation Finance, at (202) 551-3430, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Commission is deleting Rule 100(b)(2)(iii)[1] under Regulation FD.[2]

I. Overview of the Amendment

Regulation FD provides that when an issuer, or person acting on its behalf, discloses material nonpublic information to certain enumerated persons (in general, securities market professionals and holders of the issuer's securities who may trade on the basis of the

1 17 CFR 243.100(b)(2)(iii).

2 17 CFR 243.100 et seq.

information), it must make public disclosure of that information.[3] Section 939B of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act") requires the Commission to "revise Regulation FD (17 CFR 243.100) to remove from such regulation the exemption for entities whose primary business is the issuance of credit ratings (17 CFR 243.100(b)(2)(iii))" within 90 days after the date of enactment.[4] The effective date of the legislation is July 21, 2010 and our revised rule will be effective for disclosure made on or after [insert date of publication in the Federal Register].

II. Discussion of the Amendment

As required by the Act, we are amending Regulation FD to remove the specific exemption provided to nationally recognized statistical rating organizations and credit rating agencies for disclosure made to them for the purpose of determining or monitoring a credit rating. To effectuate this change, we are removing Rule 100(b)(2)(iii) of Regulation FD. Due to the removal of Rule 100(b)(2)(iii), we are re-designating Rule 100(b)(2)(iv) as Rule 100(b)(2)(iii).

Regulation FD is designed to address the problem of selective disclosure made to those who would reasonably be expected to trade securities on the basis of the information or provide others with advice about securities trading.[5] Under Regulation FD, the timing of the required public disclosure of material nonpublic information that is provided by an issuer, or persons acting on its behalf, to certain enumerated persons depends on whether the selective

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3 17 CFR 243.100(a). See Selective Disclosure and Insider Trading, Release No. 34-43154 (Aug. 15, 2000) [65 FR 51716] at 51716 (the "Regulation FD Adopting Release").

4 Pub. L. No. 111-203 (July 21, 2010).

5 Regulation FD Adopting Release, supra note 3, at 51719.

disclosure was intentional. For an intentional selective disclosure, the issuer must make public disclosure simultaneously. In other circumstances, the issuer must make public disclosure promptly. Under the regulation, the required public disclosure may be made by filing or furnishing a Form 8-K,[6] or by another method or combination of methods that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public.[7]

Under Rule 100(b)(2)(iii) of Regulation FD, the issuer or person acting on the issuer's behalf need not make the public disclosure if the disclosure of material nonpublic information is made to a credit rating agency that makes its credit ratings publicly available, or is made pursuant to Rule 17g-5(a)(3) [8] to a nationally recognized statistical rating organization. As required by Section 939B of the Act, we are removing the exemption specifically available to these entities under Regulation FD. [9]

III. Procedural and Other Matters

The Administrative Procedure Act ("APA") generally requires an agency to publish notice of a proposed rulemaking in the Federal Register.[10] This requirement does not apply, however, if the agency "for good cause finds . . . that notice and public procedure thereon are

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6 17 CFR 249.308.

7 17 CFR 243.101(e).

8 17 CFR 240.17g-5(a)(3).

9 Regulation FD also provides exemptions for communications made to a person who owes the issuer a duty of trust or confidence -- i.e., a "temporary insider" -- such as an attorney, investment banker, or accountant (17 CFR 243.100(b)(2)(i)), to any person who expressly agrees to maintain the information in confidence (17 CFR 243.100(b)(2)(ii)), and in connection with most offerings of securities registered under the Securities Act (17 CFR 243.100(b)(2)(iv)). These exemptions are unaffected by the Act.

10 See 5 U.S.C. 553(b).

impracticable, unnecessary, or contrary to the public interest."[11] The revision to Regulation FD that the Commission is adopting is required by Section 939B of the Act by the legislatively required date. Unless the rule and form amendments become effective by that date, issuers may be confused regarding their disclosure and reporting obligations. The Commission is required by statute to remove the specific exemption for disclosure provided to nationally recognized statistical rating organizations and credit rating agencies. Because this revision is required by Congress, it does not involve the exercise of Commission discretion or policy judgments. For these reasons, the Commission finds that good cause exists to dispense with a public notice and comment period for these amendments because notice and comment would be unnecessary, impracticable and contrary to the public interest.[12]

The Commission is taking this action to implement the Act. Thus, any costs and benefits to the economy resulting from the amendments are mandated by the Act. Section 23(a)(2)[13] of the Securities Exchange Act of 1934 ("Exchange Act")[14] requires us, when adopting rules under the Exchange Act, to consider the anti-competitive effect of any rules we adopt. Further, Section 3(f) of the Exchange Act[15] and Section 2(c) of the Investment

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11 5 U.S.C. 553(b).

12 The Regulatory Flexibility Act requires agencies to prepare analyses for rulemaking only when the APA requires general notice of proposed rulemaking. 5 U.S.C. §603(a). The Regulatory Flexibility Act does not apply to the rules we adopt today because, as noted above, the Commission is not required to solicit public comment when using the expedited rulemaking procedures under Section 553(b) of the APA.

13 15 U.S.C. 78w(a)(2).

14 15 U.S.C. 78a et seq.

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

Company Act of 1940[16] require us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation. While the amendments may affect efficiency, competition and capital formation, the action we are taking today is required by the Act and imposes no burden on efficiency, competition and capital formation that is not consistent with implementation of the Act.

IV. Paperwork Reduction Act

Certain provisions of Regulation FD contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[17] 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. Compliance with the disclosure requirements is mandatory. There is no mandatory retention period for the information disclosed, and responses to the disclosure requirements will not be kept confidential.

The titles for the collections are (1) Form 8-K, and (2) Reg FD-Other Disclosure Materials. OMB approved the regulation's information collection requirements. Form 8-K (OMB Control No. 3235-0060) was adopted pursuant to Sections 13,[18] 15,[19] and 23[20] of the

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16 15 U.S.C. 80a-2(c).

17 44 U.S.C. 3501 et seq.

18 15 U.S.C. 78m.

19 15 U.S.C. 78o.

20 15 U.S.C. 78w.

Exchange Act, and Regulation FD-Other Disclosure Materials (OMB Control No. 3235-0536) was adopted pursuant to Sections 13, 15, 23, and 36[21] of the Exchange Act.

As discussed in the Regulation FD proposing[22] and adopting releases,[23] in many cases, information disclosed under Regulation FD would be information that an issuer ultimately was going to disclose to the public. Under Regulation FD, that issuer likely will not make any more public disclosure than it otherwise would, but it may make the disclosure sooner and it is required to file or disseminate that information in a manner reasonably designed to provide broad, non-exclusionary distribution of the information to the public. Following the amendments adopted today, reporting persons will remain obligated to disclose the same information that they were previously required to report on these forms. We therefore believe that the overall information collection burden will remain approximately the same because the same transactions will remain reportable.

V. Statutory Authority and Text of the Amendment

The amendments described in this release are being adopted under the authority set forth in Sections 10, 19(a), and 28 of the Securities Act of 1933, Sections 3, 9, 10, 13, 15, 23, and 36 of the Securities Exchange Act of 1934, Section 30 of the Investment Company Act of 1940, and Section 939B of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

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21 15 U.S.C. 78mm.

22 See Selective Disclosure and Insider Trading, Release No. 34-42259 (Dec. 20, 1999) [64 FR 72590].

23 See Regulation FD Adopting Release, supra note 3.

List of Subjects

17 CFR Part 243

Reporting and recordkeeping requirements, Securities.

Text of Amendments

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

PART 243 -- REGULATION FD

1. The authority citation for part 243 continues to read as follows:

Authority: 15 U.S.C. 78c, 78i, 78j, 78m, 78o, 78w, 78mm, and 80a-29, unless otherwise noted.

* * * * *

2. Section 243.100 is amended by removing paragraph (b)(2)(iii) and re-designating paragraph (b)(2)(iv) as (b)(2)(iii).

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: September 29, 2010

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-63025; File No. SR-MSRB-2010-08)

September 30, 2010

Self-Regulatory Organizations; Municipal Securities Rulemaking Board; Notice of Filing of Amendment No. 1 to and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, to Amend Rule A-3, on Membership on the Board, to Comply with the Dodd-Frank Wall Street Reform and Consumer Protection Act

On August 27, 2010, the Municipal Securities Rulemaking Board ("Board" or "MSRB") 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 to amend MSRB Rule A-3, on membership on the Board, to comply with the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[3] The Commission published the proposed rule change for comment in the Federal Register on September 8, 2010.[4] The Commission received ten comment letters, the MSRB's response, and a supplemental response to the MSRB's response.[5] On September 30, 2010, the

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

2 17 CFR 240.19b-4.

3 See Pub. L. No. 111-203, 124 Stat. 1376 (2010).

4 See Securities Exchange Act Release No. 62827 (September 1, 2010), 75 FR 54673.

5 See email from Peter Shapiro, Managing Director, Swap Financial Group, LLC, dated September 14, 2010 ("Swap Financial Letter"); email from Kevin Olson, dated September 17, 2010 ("Olson Letter"); letter from Mike Nicholas, Chief Executive Officer, Bond Dealers of America, dated September 17, 2010 ("Bond Dealers Letter"); letter from Robert W. Doty, President, American Governmental Financial Services, dated September 21, 2010 ("AGFS Letter I"); letter from Joy A. Howard, Principal, WM Financial Strategies, dated September 21, 2010 ("WM Financial Letter"); letter from Steve Apfelbacher, President, National Association of Independent Public Finance Advisors, dated September 22, 2010 ("NAIPFA Letter"); letter from Michael Decker, Managing Director and Co-Head, Municipal Securities Division, Securities Industry and Financial Markets Association, dated September 22, 2010 ("SIFMA Letter"); letter from Susan Gaffney, Director, Federal Liaison Center, Government Finance Officers Association, dated September 22, 2010 ("GFOA Letter"); letter from Thomas M. DeMars, Managing Principal, Fieldman, Rolapp & Associates, dated September 22, 2010

MSRB filed Amendment No. 1 to the proposed rule change.[6] This notice and order provide notice of Amendment No.1 to the proposed rule change and approves the proposed rule change, as modified by Amendment No. 1, on an accelerated basis.

I. Background and Description of the Proposal

A. Dodd-Frank Act

The Dodd-Frank Act, among other things, amended provisions of Section 15B of the Exchange Act governing the nomination, election and composition of members of the Board.[7] These amendments to Section 15B of the Exchange Act will be effective on October 1, 2010.[8]

Prior to enactment of the Dodd-Frank Act, Section 15B(b)(1) of the Exchange Act provided that the Board must be composed initially of fifteen members appointed by the Commission.[9] In addition, the Exchange Act required that the initial members of the Board must

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("Fieldman Letter"); letter from Lawrence P. Sandor, Senior Associate General Counsel, MSRB, dated September 23, 2010 ("MSRB Response Letter"); email from Robert W. Doty, President, American Governmental Financial Services, dated September 27, 2010 ("AGFS Letter II"); letter from Lawrence P. Sandor, Senior Associate General Counsel, MSRB, dated September 30, 2010 ("MSRB Supplemental Response Letter").

6 In Amendment No. 1, to address concerns raised by commenters, MSRB proposes that advisor representatives (as defined below) shall not be associated with a broker, dealer or municipal securities dealer. In addition, in Amendment No. 1, the MSRB proposes to amend Rule A-3(i)(iv) to provide that on or after October 1, 2010 the MSRB will propose amendments to its rules that would assure that for future board elections that the Nominating Committee will be composed of a majority of public representatives and that would assure fair representation of bank representatives, broker-dealer representatives and advisor representatives (as such terms are defined below) on the Nominating Committee.

7 See Section 975(b) of the Dodd-Frank Act.

8 See Section 975(i) of the Dodd-Frank Act.

9 Section 15B(b)(1) of the Exchange Act also provided that "[p]rior to the expiration of the terms of office of the initial members of the Board, an election shall be held under rules adopted by the Board (pursuant to subsection (b)(2)(B) of this section) of the members to succeed such initial members."

consist of five individuals who are public representatives,[10] five individuals who are broker-dealer representatives[11] and five individuals who are bank representatives.[12] Consistent with the requirements of the Exchange Act, the MSRB adopted Rule A-3 regarding membership on the Board. MSRB Rule A-3, among other things, provided that the Board shall be composed of 15 members, at all times equally divided among public representatives, broker-dealer representatives and bank representatives.

The Dodd-Frank Act amended Section 15B(b)(1) of the Exchange Act to provide that the members of the Board shall consist of two separate groups: eight "public representatives" and seven "regulated representatives." Section 15B(b)(1)(A) of the Exchange Act defines "public representatives" to mean individuals who are independent of any municipal securities broker, municipal securities dealer, or municipal advisor, at least one of whom shall be representative of institutional or retail municipal securities investors ("investor representative"), at least one of whom shall be representative of municipal entities ("issuer representative"), and at least one of whom shall be representative of the public with knowledge of or experience in the municipal industry ("general public representative").[13] Section 15B(b)(1)(B) of the Exchange Act defines

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10 Section 15B(b)(1)(A) defined the term "public representatives" to mean individuals who are not associated with any broker, dealer, or municipal securities dealer (other than by reason of being under common control with, or indirectly controlling, any broker or dealer which is not a municipal broker, municipal dealer or municipal securities dealer), at least one of whom shall be representative of investors in municipal securities, and at least one of whom shall be representative of issuers of municipal securities.

11 Section 15B(b)(1)(B) defined the term "broker-dealer representatives" to mean individuals who are associated with and representative of municipal securities brokers and municipal securities dealers which are not banks or subsidiaries or departments or divisions of banks.

12 Section 15B(b)(1)(C) defined the term "bank representatives" to mean individuals who are associated with and representative of municipal securities dealers which are banks or subsidiaries or departments or divisions of banks.

13 See 15 U.S.C. 78o-4(b)(1)(A) (as amended by the Dodd-Frank Act).

"regulated representatives" to mean individuals who are associated with a broker, dealer, municipal securities dealer, or municipal advisor, including at least one individual who is associated with and representative of brokers, dealers, or municipal securities dealers that are not banks or subsidiaries or departments or divisions of banks ("broker-dealer representative"), at least one individual who is associated with and representative of municipal securities dealers which are banks or subsidiaries or departments or divisions of banks ("bank representative"), and at least one individual who is associated with a municipal advisor ("advisor representative").[14] In addition, Section 15B(b)(1) of the Exchange Act provides that each member of the Board must be knowledgeable of matters related to the municipal securities markets.[15]

The Dodd-Frank Act also amended Section 15B(b)(2)(B) of the Exchange Act to provide that the Board shall establish fair procedures for the nomination and election of the members of the Board, and shall assure fair representation in such nominations and elections of public representatives, broker-dealer representatives, bank representatives and advisor representatives.[16] Further, the Dodd-Frank Act amended Section 15B(b)(2)(B) to provide that the Board shall establish rules that: set forth requirements regarding the independence of public representatives; provide that the number of public representatives at all times exceed the number of regulated representatives; and provide that membership on the Board is at all times as evenly divided as possible between public and regulated representatives. In addition, the Dodd-Frank Act amended Section 15B(b)(2)(B) to provide that the MSRB, by rule, may increase the number of members on the Board, provided that such number is an odd number.[17]

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14 See 15 U.S.C. 78o-4(b)(1)(B) (as amended by the Dodd-Frank Act).

15 See 15 U.S.C. 78o-4(b)(1) (as amended by the Dodd-Frank Act).

16 See 15 U.S.C. 78o-4(b)(2)(B) (as amended by the Dodd-Frank Act).

17 See id.

B. Proposal

To implement the terms of the Dodd-Frank Act by the effective date of October 1, 2010, the MSRB proposes to add subsection (i) to Rule A-3 to implement, among other things, a transitional provision for the Board's fiscal year commencing October 1, 2010 that would increase the size of the Board from 15 members to 21 members (who are knowledgeable of matters related to the municipal securities markets), with 11 public representatives and 10 regulated representatives. This transitional provision would be in effect until September 30, 2012. In addition, prior to October 1, 2010, the MSRB proposes to elect 11 new Board members, of which eight would be public representatives and three would be municipal advisor representatives. The MSRB proposes that the terms of these new Board members would expire on September 30, 2012.

Of the 11 public representatives, the MSRB proposes that at least one would be an investor representative, at least one would be an issuer representative, and at least one would be a general public representative. With respect to the 10 regulated representatives, the MSRB proposes that at least one would be a broker-dealer representative, at least one would be a bank representative, and at least one (but not less than 30% of the total number of regulated representatives) would be an advisor representative, who shall not be associated with a broker, dealer or municipal securities dealer.

For purposes of determining whether an individual is a "public representative," the MSRB proposes to add Rule A-3(h), among other things, to define the term "independent of any municipal securities broker, municipal securities dealer, or municipal advisor" to mean the individual has "no material business relationship" with any municipal securities broker, municipal securities dealer, or municipal advisor. The term "no material business relationship," in turn, would mean that, at a minimum, the individual is not and, within the last two years, was not associated with a municipal securities broker, municipal securities dealer, or municipal advisor, and that the individual does not have a relationship with any municipal securities broker, municipal securities dealer, or municipal advisor, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision making of the individual. The Board, or by delegation, its Nominating Committee, could also determine that additional circumstances involving the individual could constitute a "material business relationship" with a municipal securities broker, municipal securities dealer, or municipal advisor.

To help ensure a fair nomination process, the MSRB also proposes, in its transitional provision under MSRB Rule A-3(i), to allow the Nominating Committee to solicit nominations for municipal advisor representatives by publishing a notice in a financial journal having general national circulation among members of the municipal securities industry on or after enactment of the Dodd-Frank Act. The proposal provides that the Nominating Committee shall accept recommendations for 14 days following the date of publication of such notice and shall make the names publicly available.[18]

The proposal also provides that prior to the formation of the Nominating Committee for purposes of nominating potential new members to the Board with terms commencing on October 1, 2011, the Board shall amend the provisions of subsection (c) of Rule A-3 relating to the composition and procedures of the Nominating Committee to reflect the composition of the Board as provided under the Dodd-Frank Act, to assure that the Nominating Committee shall be composed of a majority of public representatives and to assure fair representation of bank

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18 The Dodd-Frank Act was signed into law on July 21, 2010. The MSRB published a notice on July 22, 2010, pursuant to which it received a number of additional recommendations for persons to serve as municipal advisor representatives on the Board. See MSRB Notice 2010-22 (July 22, 2010).

representatives, broker-dealer representatives and advisor representatives, and "to reflect such other considerations consistent with the provisions of the Act and the Dodd-Frank Act as the Board shall determine are appropriate."

II. Discussion of Comments and MSRB's Response

The Commission received ten comment letters and the MSRB's responses.[19] The MSRB provided two responses to the comments.[20] The comments and the MSRB's responses are discussed in greater detail below.

1. Comments regarding Requirements relating to Independence of Public Representatives

Some commenters disagreed with the MSRB's proposed definition of the term "independent of any municipal securities broker, municipal securities dealer, or municipal advisor."[21] In particular, these commenters did not agree with the proposed definition of "no material business relationship" and the requirement that an individual is not and, within the last two years, has not been, associated with a municipal securities broker, municipal securities dealer, or municipal advisor.[22] One commenter suggested that a five-year "cooling off" period would be more appropriate.[23] Another commenter stated that under the proposed definition of the term "independent of any municipal securities broker, municipal securities dealer, or municipal advisor," it is unclear whether any independent municipal advisor would be appointed to the Board because potentially 100% of the Board members could be, or could have been,

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19 See supra note 5.

20 See MSRB Response Letter; see also MSRB Supplemental Response Letter

21 See AGFS Letter I; WM Financial Letter.

22 See id.

23 See AGFS Letter I.

associated with, or employed by, a municipal securities broker or dealer.[24] This commenter stated that it believes that an individual who has been affiliated with, or employed by, a municipal securities broker, dealer, or municipal advisor cannot be truly independent, regardless of when the affiliation or employment ended.[25] Thus, the commenter recommended that public representatives of the Board should consist solely of individuals "who have never been associated with, employed by and do not otherwise possess a material business relationship with a [sic] municipal securities brokers, municipal securities dealers, or municipal advisors."[26]

In response to these comments, the MSRB stated that it believes that "the two-year cooling off period is appropriate as a standard for independence" and referenced the one year cooling-off period imposed by other self-regulatory organizations ("SROs") in determining the independence of public members.[27] Further, the MSRB noted that the Board or the Nominating Committee could determine whether other circumstances involving the individual would constitute a "material business relationship" that would result in the person not being viewed as independent.[28]

The Commission understands commenters' concerns regarding whether a public representative would be "independent of any municipal securities broker, municipal securities dealer, or municipal advisor" if the public representative previously has been associated with a municipal securities broker, municipal securities dealer, or municipal advisor, even where such association occurred at least two years prior to membership on the Board. Under Section

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24 See WM Financial Letter.

25 See id.

26 See id.

27 See MSRB Response Letter; see also infra note 30.

28 See MSRB Response Letter.

15B(b)(2)(B)(iv) of the Exchange Act,[29] the MSRB must have rules establishing requirements regarding the independence of public representatives. The Commission believes the proposed requirements in Rule A-3(h) are consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the MSRB. In particular, as noted by the MSRB in the MSRB Response Letter, the proposal is consistent with and indeed, stricter than, cooling-off periods required by other SROs in determining whether public members are independent.[30] Further, the proposed two-year cooling off period is a minimum requirement and, as noted by the MSRB in the MSRB Response Letter, the proposal would allow the Board, or by delegation, its Nominating Committee, to determine additional circumstances involving the individual that would constitute a "material business relationship" with a municipal securities broker, municipal securities dealer, or municipal advisor.

2. Comments regarding Composition of the Board

Several commenters expressed concerns that the representation of municipal advisors on the proposed Board is inadequate.[31] For example, one commenter noted that during the transitional period (from October 1, 2010 to September 30, 2012), advisor representatives would constitute less than 15% of the entire Board and consequently may be outnumbered by broker-dealer representatives and bank representatives on the Board.[32] This commenter suggested that four out of the ten regulated representatives should be advisor representatives and that these four

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29 15 U.S.C. 78o-4(b)(2)(B)(iv) (as amended by the Dodd-Frank Act).

30 See Independence Policy of the NYSE Euronext Board of Directors (stating a "Director is not independent if he or she is, or within the last year was, or has an immediate family member who is, or within the last year was a Member, allied member or allied person or approved person…").

31 See NAIPFA Letter; Swap Financial Group Letter; AGFS Letter I; AGFS Letter II; WM Financial Letter; see also GFOA Letter.

32 See Swap Financial Group Letter.

advisor representatives should represent a variety of advisors.[33] Another commenter recommended that five out of the ten regulated representatives should be advisor representatives, four of whom would be independent municipal advisors who are not, and have not been, associated with, or employed by, a municipal securities broker, dealer, bank or underwriter.[34] This commenter, however, noted that even with this increase in the number of municipal advisor representatives, such representatives would constitute only 19% of the entire Board.[35] Another commenter suggested that the number of independent advisor representatives on the Board should be equal to the number of bank and broker-dealer representatives on the Board.[36] One commenter stated that due to the different services offered by municipal advisors, a strict limitation on the number of advisor representatives could not adequately represent this diversity.[37] Five commenters stated that advisor representatives should be independent of bank and broker-dealer representatives because bank dealers and broker-dealers are already represented on the Board.[38]

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33 See id. The commenter suggested that the four advisor representatives should represent each of the following categories: (1) general financial advisory firm with a national scope; (2) regional financial advisory firm whose client base is principally governmental entities; (3) financial advisory firm whose client base is obligors who borrow through tax-exempt conduit agencies; and (4) swap or financial products advisor.

34 See WM Financial Letter.

35 See id.

36 See GFOA Letter; see also AGFS Letter II (stating that independent advisor representatives should be equal in numbers to broker-dealer representatives and bank representatives as municipal securities dealers are in an adverse role in relation to municipal issuers, while municipal advisors represent only the municipal issuers).

37 See AGFS Letter I.

38 See WM Financials Letter; NAIPFA Letter; GFOA Letter; Fieldman letter; AGFS Letter II.

One commenter stated that the Board should not require that at least 30% of regulated representatives be advisor representatives.[39] This commenter stated that the proposal goes beyond the requirements of the Dodd-Frank Act and effectively increases the minimum number of advisor representatives.[40] This commenter further stated that advisors who work for dealers should be eligible as advisor representatives.[41] Another commenter generally supported the proposed amendments to Rule A-3, but suggested that after the transitional period, the Board should consider reducing its size back to 15 members and, at that time, reduce the number of advisor representatives on the Board to less than 30% of the regulated representatives.[42] This commenter further noted that the Board should not establish, as a matter of policy, that advisors make up at least 30% of regulated representatives, especially because the Board has not established a minimum number of dealer or bank representatives.[43] This commenter also stated that it believes that the requirement that at least one member of the Board be an advisor representative can be satisfied by representatives of "independent" municipal advisors or of dealers or banks whose firms also provide municipal advisory services.[44]

One commenter suggested that the proposed MSRB Board does not provide adequate issuer representation.[45] This commenter recommended that the public representatives on the

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39 See BDA Letter.

40 See id.

41 See id.

42 See SIFMA Letter.

43 See id.

44 See id.

45 See GFOA Letter; see also NAIPFA Letter (stating that "fair representation also means that the issuers of municipal securities are appropriately represented").

Board be comprised of four issuers, four investors, and three general public members.[46] The commenter believes that the issuer members should represent various-sized state and local governments.[47] This commenter also recommended that "[a]s the MSRB determines the composition of future boards, these numbers – as a percentage of the total number of board members – should not be altered."[48] Another commenter stated that the Board should be comprised of five investor representatives, five issuer representatives, and five vendor representatives.[49]

In its response, the MSRB stated that it believes that, during the transitional period, 30% regulatory representation on the Board for municipal advisors is appropriate because it will ensure fair representation of such entities, will assist the Board in its rulemaking process with respect to municipal advisors and "will inform the Board's decisions regarding other municipal advisory activities while not detracting from the Board's ability to continue its existing rulemaking duties with respect to broker-dealer and bank activity in the municipal securities markets."[50] The MSRB also noted that, during the transitional period, the three municipal advisors on the Board are expected to be "advisors that are not affiliated with broker-dealers or banks."[51]

At the same time, the MSRB noted that it does not believe that setting the minimum advisor representation at 30% of regulated representatives is too low.[52] In support, the MSRB

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46 See GFOA Letter.

47 See id.

48 See id.

49 See Olson Letter.

50 See MSRB Response Letter.

51 See id.

52 See id.

noted the processes it has, or will have, in place, to maximize municipal advisor participation in the rulemaking process.[53] The MSRB also stated that, having reviewed the composition requirements of other SROs, "it is comfortable that the proposed size and composition of the MSRB represents best practices in SRO governance and will be effective in meeting the full range of obligations that the MSRB will be undertaking beginning on October 1, 2010."[54]

With respect to comments regarding the composition of public representatives on the Board, the MSRB stated that "it is comfortable that the expanded number of public representatives will provide ample opportunity for municipal entity representation on the Board at levels above those that have historically occurred under the prior Board composition formulation that limited public representation to only five members."[55] In addition, with respect to the one commenter that suggested that the Board should be comprised of five investor representatives, five issuer representatives, and five vendor representatives,[56] the MSRB noted that such composition formulation would not comply with the Dodd-Frank Act, which requires that of the public representatives, at least one must be an investor representative, at least one must be an issuer representative, and at least one must be a general public representative.

The MSRB noted that the Board is aware that municipal advisors are not homogeneous and is committed to seeking out all categories of members based on various criteria.[57] In addition, the MSRB stated that the proposal would establish the Board composition for a two year transitional period only and, at the end of the transitional period, the MSRB will be in a

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53 See id. (noting, for example, the establishment of a new advisory council to help address municipal advisor issues).

54 See id.

55 See MSRB Response Letter.

56 See Olson Letter.

57 See MSRB Response Letter.

better position to make "long-term decisions" regarding representation, size and related matters.[58]

The Commission believes that the proposal is consistent with the requirements of the Exchange Act, and the rules and regulations thereunder applicable to the MSRB, including the fair representation requirements of the Exchange Act. Section 15B(b)(2)(B) of the Exchange Act requires, among other things, that the rules of the Board establish fair procedures for the nomination and election of members of the Board and assure fair representation in such nominations and elections of public representatives, broker-dealer representatives, bank representatives, and advisor representatives.[59] Section 15B(b)(2)(B)(i) of the Exchange Act provides that the number of public representatives of the Board must at all times exceed the total number of regulated representatives.[60] The MSRB proposes that the Board consist of 11 public representatives and 10 regulated representatives. Of those 10 regulated representatives, the MSRB proposes that at least one, and not less than 30%, shall be advisor representatives.

Previously, the Commission has considered whether an SRO's proposed governance rules are consistent with the Exchange Act's requirements under Sections 6 and 15A for fair representation of SRO members generally.[61] For example, the Commission has approved an SRO's governance rules that require that the SRO's members as a whole be able select at least

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58 See id.

59 See 15 U.S.C. 78o-4(b)(2)(B) (as amended by the Dodd-Frank Act).

60 See 15 U.S.C. 78o-4(b)(2)(B)(i) (as amended by the Dodd-Frank Act).

61 Section 6(b)(3) of the Exchange Act provides that: "An exchange may not be registered as a national securities exchange unless the Commission determines that . . . (3) The rules of the exchange assure fair representation of its members in its selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer." 15 U.S.C. 78f(b)(3). Section 15A(b)(4) of the Exchange Act contains an identical requirement with respect to the rules of a national securities association. See 15 U.S.C. 78o-3(b)(4).

20% of the total number of directors of the exchange's or association's board.[62] In addition, the Commission has previously found SRO rules that provide sub-categories of regulated persons with the right to select a specified number of directors to be consistent with the Exchange Act.[63]

Under the MSRB proposal, of the 10 regulated representatives, at least one would be a broker-dealer representative, at least one would be a bank representative, and at least one, and not less than 30% of the total regulated representatives (i.e. three out of 10), would be an advisor representative. Section 15B(b)(2)(B)(i) of the Exchange Act requires the Board to consist of a majority of public representatives, leaving a minority of the Board available to achieve "fair representation" of the three sub-categories of regulated representatives.[64] Accordingly, "fair representation" of each of the sub-categories must necessarily mean something less than the 20%

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62 See, e.g., Securities Exchange Act Release No. 58324 (August 7, 2008), 73 FR 46936 (August 12, 2008) (stating that "the requirement under BSE By-Laws that at least 20% of the BSE Directors represent members... [is] designed to ensure the fair representation of BSE members on the BSE Board"); Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (stating that "the requirement in [Nasdaq's] By-Laws that twenty percent of the directors be 'Member Representative Directors'... provides for the fair representation of members in the election of directors . . . consistent with the requirement in Section 6(b)(3) of the Exchange Act"); Securities Exchange Act Release No. 48946 (December 17, 2003), 68 FR 74678 (December 24, 2003) (stating that the amended Constitution of the New York Stock Exchange, which gives Exchange members the ability to nominate no less than 20% of the directors on the Board, satisfies the Section 6(b)(3) fair representation requirement); see also Securities Exchange Act Release No. 50699 (November 18, 2004), 69 FR 71126 (December. 8, 2004) (stating that "[c]onsistent with the fair representation requirement, the [Commission's] proposed [SRO] governance rules would require that the Nominating Committee administer a fair process that provides members with the opportunity to elect at least 20% of the total number of directors ('member candidates').... This '20% standard' for member candidates comports with previously-approved SRO rule changes that raised the issue of fair representation").

63 See, e.g., Securities Exchange Act Release No. 56145 (July 26, 2007), 72 FR 42169 (August 1, 2007) (approving the composition of the FINRA (f/k/a NASD) Board of Governors to include three small firm Governors, one mid-size firm Governor, and three large-firm Governors, elected by members of FINRA according to their classification as a small firm, mid-size firm, or large firm).

64 See 15 U.S.C. 78o-4(b)(2)(B)(i) (as amended by the Dodd-Frank Act).

standard, in relation to an entire board, previously approved by the Commission for SRO members generally under Sections 6 and 15A of the Exchange Act.

The Commission also notes that Section 15B(b)(1) of the Exchange Act sets forth minimum representation requirements for bank, broker-dealer and advisor representatives.[65] It does not mandate the specific number of any class of representative that should serve on the Board, nor does it set forth maximum Board composition or representation requirements.[66] Thus, as with the interpretation of "fair representation" with respect to other SROs, the Commission has flexibility in determining what constitutes "fair representation" for purposes of the Board's composition under Section 15B of the Exchange Act. Based on the constraints of Section 15B(b)(2)(B)(i) noted above, and the Commission's consideration of "fair representation" in other contexts, the Commission believes that the MSRB's proposal to ensure that representatives of municipal advisors (that are not associated with a broker, dealer or municipal securities dealer), which, for the first time will be subject to MSRB rulemaking,[67] would constitute at least 30% of the directors that may be representatives of the three sub-categories of regulated representatives, is reasonable, and consistent with Section 15B(b)(2)(B) of the Exchange Act.[68]

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65 See 15 U.S.C. 78o-4(b)(1) (as amended by the Dodd-Frank Act).

66 See id.

67 See 15 U.S.C. 78o-4(b)(2) (as amended by the Dodd-Frank Act). In addition, the Dodd-Frank Act amended Section 15B of the Exchange Act to require municipal advisors to register with the Commission as of October 1, 2010. See Securities Exchange Act Release No. 62824 (September 1, 2010), 75 FR 54465 (September 8, 2010) (adopting interim final temporary Rule 15Ba2-6T under the Exchange Act to require the temporary registration of municipal advisors on Form MA-T).

68 See 15 U.S.C. 78o-4(b)(2)(B) (as amended by the Dodd-Frank Act).

3. Other Comments

Four commenters discussed the MSRB's process for determining the Board's leadership for the next year.[69] Three commenters made statements expressing concern about a lack of transparency to this leadership selection process, and stated their belief that the Board's action was contrary to the goals of the Dodd-Frank Act and disenfranchises the new Board.[70] Another commenter also expressed concern with the "secrecy around the election of officers during this past summer."[71] One commenter recommended "reversing the July election and allowing the reconstituted public majority Board to determine its leadership."[72] Two commenters suggested that there be substantially more transparency with regard to Board action.[73]

Although the provisions of the proposed rule change do not directly relate to these matters, the Commission notes that with respect to comments regarding the Board's election of its officers for the 2011 fiscal year, in its initial response, the MSRB noted that officer elections are governed by MSRB Rule A-5(b), and that the MSRB followed the process set out in that rule.[74] In addition, in a supplemental response, the MSRB has agreed to hold a ratification vote with respect to the prior election of the MSRB officers by the newly constituted Board at its first

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69 See NAIPFA Letter; GFOA Letter; Fieldman Letter; AGFS Letter II.

70 See NAIPFA Letter; Fieldman Letter; AGFS Letter II.

71 See AGFS Letter I. The commenter suggested that the Board release all staff and Board member analyses and communications relating to: (1) the selection of the new officers and Board members, and the composition and structure of committees and advisory groups; (2) the need for regulation of municipal advisors; or (3) contacts with members of Congress and congressional staff members regarding municipal advisor regulation and the composition of the new independent Board. The commenter also opposed the manner in which the Board considers and takes actions with regard to its rules. See also AGFS Letter II (calling for the MSRB to hold open meetings on all rulemaking actions and selection of Board members and officers).

72 See Fieldman Letter. See also GFOA Letter.

73 See AGFS Letter I; Fieldman Letter; AGFS Letter II.

74 See MSRB Response Letter.

meeting in October.[75] In addition, as noted above, the proposal provides that prior to the formation of the Nominating Committee for purposes of nominating potential new members to the Board with terms commencing on October 1, 2011, the Board shall amend the provisions of subsection (c) of Rule A-3 relating to the composition and procedures of the Nominating Committee to reflect, among other things, the composition of the Board as provided under the Dodd-Frank Act and to assure that the Nominating Committee shall be composed of a majority of public representatives and to assure fair representation of bank representatives, broker-dealer representatives and advisor representatives.

With respect to the comments regarding transparency of the Board's governance process, the MSRB stated that it believes that these processes are transparent.[76] The MSRB stated, however, that it would take the comments regarding these processes under advisement as its new Board is seated on October 1, 2010.[77]

III. Discussion and Commission's Findings

The Commission has carefully considered the proposed rule change, the comment letters received, and the MSRB's responses to the comment letters and finds that the proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the MSRB.[78] In particular, the proposed rule change is consistent with Section 15B(b)(1) of the Act, which requires, among other things, that the Board shall consist of at least eight public representatives (with at least one investor representative, at least one issuer

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75 See MSRB Supplemental Response Letter.

76 See MSRB Response Letter; see also MSRB Supplemental Response Letter

77 See id.

78 In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

representative, and at least one general public representative) and seven regulated representatives (with at least one broker-dealer representative, at least one bank representative, and at least one advisor representative). The proposed rule change is also consistent with Section 15B(b)(2)(B) of the Act,[79] which requires, among other things, that the rules of the Board shall establish fair procedures for the nomination and election of members of the Board and assure fair representation in such nominations and elections of public representatives, broker-dealer representatives, bank representatives, and advisor representatives.[80]

In the Commission's view, the proposed composition of the Board is consistent with the requirements of the Exchange Act that there is fair representation on the Board of public representatives, broker-dealer representatives, bank representatives and advisor representatives. In addition, the composition of the Board with respect to advisor representatives will help assure that municipal advisors will have appropriate representation on the Board during this period of transition when, for the first time, municipal advisors will be subject to MSRB rulemaking. The Commission further believes that the proposed two-year "cooling-off" period for public representatives is appropriate because it is a minimum requirement for establishing independence and it is consistent with other SRO requirements for establishing independence of board members.

The Commission notes that the proposed rule change with respect to the composition of the Board is being implemented as a transitional provision that will be effective for two years, until September 30, 2012. During this period, the MSRB will be able to monitor the effectiveness of the structure of the Board to determine to what extent, if any, proposed changes might be appropriate. The Commission is sensitive to commenters' concerns regarding fair

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79 15 U.S.C. 78o-4(b)(2)(B) (as amended by the Dodd-Frank Act).

80 See id.

representation. The Commission notes that the proposal by the MSRB for the establishment of a permanent Board structure must be filed with, and considered by, the Commission pursuant to Section 19(b) of the Exchange Act[81] before the proposal can be effective, as would rules the MSRB seeks to implement with respect to oversight of municipal advisors.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 1, including whether Amendment No. 1 is consistent with the Exchange Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-MSRB-2010-08 on the subject line.

Paper Comments:

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

All submissions should refer to File Number SR-MSRB-2010-08. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications

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81 See 15 U.S.C. 78s(b).

relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the MSRB. 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-MSRB-2010-08 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

V. Accelerated Approval of Proposed Rule Change, as Modified by Amendment No. 1

The Commission finds good cause for approving the proposed rule change, as modified by Amendment No. 1, before the 30th day after the date of publication in the Federal Register. The Commission notes that the proposal was published for notice and comment, and the Commission received ten comment letters, which comments have been discussed in detail above. Amendment No. 1 proposes to amend proposed Rule A-3(i)(i)(B)(3) to explicitly provide that, of the regulated representatives on the Board, "at least one, and not less than 30 percent of the total number of regulated representatives, shall be associated with and representative of municipal advisors and shall not be associated with a broker, dealer or a municipal securities dealer." The Commission notes that in the MSRB's Response Letter, the MSRB expressed its expectation that the advisor representatives would be "advisors that are not affiliated with broker-dealers or banks."[82] Amendment No. 1 provides additional clarification that the advisor representatives on

82 See MSRB Response Letter.

the Board during the transitional period will be independent advisors not associated with brokers, dealers or municipal securities dealers.

In addition, Amendment No. 1 proposes that, with respect to the formation of the Nominating Committee for purposes of nominating potential new members of the Board with terms commencing on October 1, 2011, the Board shall amend the provisions of section (c) of Rule A-3 relating to the composition and procedures of the Nominating Committee, among other things, to assure that the Nominating Committee shall be composed of a majority of public representatives and to assure fair representation of bank representatives, broker-dealer representatives and advisor representatives. Section 15B(b)(2)(B) of the Exchange Act provides that the MSRB's rules must, at a minimum, "establish fair procedures for the nomination and election of members of the Board and assure fair representation in such nominations and elections of public representatives, broker dealer representatives, bank representatives, and advisor representatives."[83] In addition, as discussed above, Section 15B(b)(2)(B)(i) of the Exchange Act provides that the MSRB's rules shall provide that the number of public representatives of the Board shall at all times exceed the total number of regulated representatives. Amendment No. 1 proposes that the Nominating Committee would reflect the new composition of the Board with a majority public representation and with fair representation of bank representatives, broker-dealer representatives and advisor representatives.

The Commission believes that Amendment No.1 is consistent with the requirements of the Exchange Act and finds good cause, consistent with Section 19(b)(2) of the Act,[84] to approve the proposed rule change, as modified by Amendment No. 1, on an accelerated basis.

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83 15 U.S.C. 78o-4(b)(2)(B) (as amended by the Dodd-Frank Act).

84 15 U.S.C. 78s(b)(2).

VI. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the MSRB, and in particular, Sections 15B(b)(1)[85] and 15B(b)(2)[86] of the Exchange Act.

IT IS THEREFORE ORDERED THAT, pursuant to Section 19(b)(2) of the Exchange Act,[87] the proposed rule change (SR-MSRB-2010-08), as modified by Amendment No. 1 be, and it hereby is, approved on an accelerated basis.

By the Commission.

Florence E. Harmon

Florence E. Harmon
Deputy Secretary

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85 15 U.S.C. 78o-4(b)(1) (as amended by the Dodd-Frank Act).

86 15 U.S.C. 78o-4(b)(2) (as amended by the Dodd-Frank Act).

87 15 U.S.C. 78s(b)(2).

Commissioner Casey and
Commissioner Walter
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9147 / September 30, 2010

SECURITIES EXCHANGE ACT OF 1934
Release No. 63018 / September 30, 2010

INVESTMENT ADVISERS ACT OF 1940
Release No. 3094 / September 30, 2010

INVESTMENT COMPANY ACT OF 1940
Release No. 29451 / September 30, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14081

In the Matter of **JOHN P. FLANNERY, AND JAMES D. HOPKINS,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940**

I.

The United States Securities and Exchange Commission (the "Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Section 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 John P. Flannery ("Flannery") and James D. Hopkins ("Hopkins") (collectively, "the Respondents").

II.

After an investigation, the Division of Enforcement alleges that:

A. SUMMARY

1. During the subprime mortgage crisis in 2007, State Street Bank and Trust Company ("State Street") and two of its employees, Hopkins and Flannery, engaged in a course of business and made material misrepresentations and omissions that misled investors about the extent of subprime mortgage-backed securities held in certain unregistered funds under State Street's management. The effect of this course of business and these misrepresentations was to cause the misled investors to continue to purchase or continue to hold their investments in these funds. As a result of State Street's and the Respondents' conduct, investors in State Street's funds lost hundreds of millions of dollars during the subprime market meltdown in mid-2007.

2. State Street offered investments in certain collective trust funds to institutional investors that were customers of State Street, including pension funds, employee retirement plans, and charities. These funds included two substantially identical funds – referred to together as the Limited Duration Bond Fund (the "Fund") – made available to different categories of investors. Other actively-managed bond funds and a commodity futures index fund managed by State Street ("the related funds") also invested in the Fund. State Street established the Fund in 2002 and State Street and Hopkins marketed the Fund by saying it utilized an "enhanced cash" investment strategy that was an alternative to a money market fund for certain types of investors. By 2007, however, the Fund was almost entirely invested in or exposed to subprime residential mortgage-backed securities and other subprime investments ("subprime investments"). Nonetheless, State Street and Hopkins continued to describe the Fund to prospective and current investors as having better sector diversification than a typical money market fund, while failing to disclose the extent of its exposure to subprime investments.

3. When the subprime market collapsed in mid-2007, many investors in the Fund and the related funds were unaware that the Fund had such significant exposure to subprime investments. In fact, the Fund's offering materials, such as quarterly fact sheets, presentations to current and prospective investors, and responses to investors' requests for proposal, all of which Hopkins was responsible for drafting or updating, contained misleading statements and/or omitted material information about the Fund's exposure to subprime investments and use of leverage. As a result, many investors either had no idea that the Fund held subprime investments and used leverage, or believed that the Fund had very modest exposure to subprime investments and used little or no leverage.

4. Beginning on July 26, State Street sent a series of shareholder communications concerning the effect of the turmoil in the subprime market on the Fund and the related funds that misled investors and continued State Street's and the Respondents' failure to disclose the Fund's concentration in subprime investments. Hopkins and Flannery played an instrumental role in drafting the misrepresentations in these investor communications. At the same time, State Street provided certain investors with accurate and more complete information about the Fund's subprime concentration. These other investors included clients of State Street's internal advisory groups, which provided advisory services to some of the investors in the Fund and the related funds. During 2007, State Street's advisory groups became aware, based on internal discussions and internally available information, that the Fund was concentrated in

subprime investments. Prior to July 26, 2007, at least one internal advisory group also learned that State Street was going to sell a significant amount of the Fund's distressed assets to meet significant anticipated redemptions. State Street's internal advisory groups, one of which reported directly to Flannery, subsequently decided to redeem or recommend redemption from the Fund and the related funds for their clients. State Street Corporation's pension plan was one of those clients. At the direction of Flannery and State Street's Investment Committee, State Street sold the Fund's most liquid holdings and used the cash it received from these sales to meet the redemption demands of these better informed investors, leaving the Fund with largely illiquid holdings.

5. By virtue of their conduct, the Respondents violated Section 17(a) of the Securities Act [15 U.S.C. §77(q)(a)], Section 10(b) of the Exchange Act [15 U.S.C. §§78j(b)] and Rule 10b-5 [17 C.F.R. §§240.10b-5] promulgated thereunder.

B. RESPONDENTS

6. *John P. Flannery* is a resident of Scituate, Massachusetts. In 1996, Flannery joined State Street, a Massachusetts trust company based in Boston, Massachusetts that is a subsidiary of publicly-traded State Street Corporation. In January 2006, Flannery became State Street's chief investment officer of the Americas, a position he held until State Street terminated him in November 2007 as part of a purported restructuring of State Street's investment groups. In 2007, Flannery was a member of State Street's executive management group, the group that was responsible for the overall management of State Street.

7. *James D. Hopkins* is a resident of Wellesley, Massachusetts. Hopkins joined State Street in 1998. From approximately 2004 to 2007, Hopkins was the product engineer for the Fund and several related funds. In July 2008, State Street promoted Hopkins to head of product engineering for North America.

C. OTHER RELEVANT ENTITIES

8. *State Street,* a subsidiary of publicly-traded State Street Corporation, is a Massachusetts trust company and a bank that is a member of the Federal Reserve System. The principal place of business of State Street and State Street Corporation is Boston, Massachusetts. Because State Street is a bank, it relies on the exclusion from the definition of investment adviser contained in Section 202(a)(11) of the Investment Advisers Act of 1940. The unregistered collective trust funds State Street advises, such as the Fund and the related funds, similarly rely on the exclusion from the definition of investment company under Section 3(c)(11) of the Investment Company Act.

9. *SSgA Funds Management, Inc.* ("SSgA FM"), a subsidiary of State Street Corporation, is the registered adviser for funds registered pursuant to the Investment Company Act. During his tenure as chief investment officer, Flannery was associated with SSgA FM because SSgA FM's portfolio managers and their managers reported to Flannery. Also, during his tenure as a product engineer, Hopkins was associated with SSgA FM because he was the product engineer for certain registered funds advised by SSgA FM.

D. ALLEGATIONS

Background – The Limited Duration Bond Fund ("the Fund")

10. State Street established the Fund in February 2002 as an actively-managed fund targeting a return of one-half to three-quarters of one percent per year over the London Inter-Bank Offer Rate (LIBOR), the interest rate that banks charge each other for short-term loans. Like a mutual fund governed by the Investment Company Act, the Fund offered daily redemptions, and investors purchased or sold units of the Fund based on the Fund's daily net asset value. However, as a bank-managed collective trust fund, State Street only offered the Fund and the related funds to certain investors. According to the Fund's offering materials, the Fund's minimum credit quality was BBB, but its average credit quality was always AA or AA+. In mid-June 2007, the Fund had assets of approximately $3 billion.

11. Over the years, the Fund consistently achieved its target performance by heavily concentrating in bonds backed by first lien mortgages to subprime borrowers. The Fund's consistent outperformance of its benchmark and low volatility resulted in State Street's decision to permit its portfolio managers of the related funds to invest up to 25% of those funds' assets in the Fund so those funds could beat their benchmarks.

12. By 2006, as it became harder to achieve benchmark performance by investing in other segments of the bond market, State Street, under the direction of Flannery or those who reported to Flannery, had decided to concentrate an even greater percentage of the Fund in subprime investments. Then, in 2006 and early 2007, State Street magnified the Fund's exposure to subprime investments by increasing the Fund's use of reverse repurchases, credit default swaps, and total return swaps tied to the outperformance of subprime investments. All of these investments had the effect of leveraging the Fund, and, ultimately, exposed the Fund to more risk and volatility.

Hopkins' Misrepresentations Regarding Subprime Investments, Use of Derivatives, and Leverage in Offering Documents and Investor Communications in The First Half of 2007

13. In 2006 and 2007, as the product engineer responsible for the Fund and certain of the related funds, Hopkins was responsible for drafting and updating offering documents and other communications about the Fund and related funds for investors and prospective investors. These offering documents and other communications stated that the Fund was sector-diversified and was an enhanced cash portfolio (or slightly more aggressive than a money market fund). In fact, the Fund was concentrated in subprime bond investments and derivatives tied to subprime investments. For example, in 2006 and 2007, the Fund's quarterly fact sheet for prospective and current investors stated:

> The Limited Duration Bond Strategy utilizes an expanded universe of securities that goes beyond typical money markets including: Treasuries, agencies, collateralized mortgage obligations, adjustable rate mortgages, fixed rate mortgages, corporate bonds, asset backed securities, futures, options, and swaps... When compared to a typical 2 A-7 regulated money market portfolio, the Strategy has better sector diversification, higher average credit quality, and higher expected returns. The tradeoff is this fund purchases issues that are less liquid

> than money market instruments and these instruments will have more price volatility. This Strategy should not be used for daily liquidity. Returns to the Strategy are more volatile over short horizons than traditional cash alternatives and may not benefit the short-term investor.

In 2006 and 2007, this language misled investors into believing that the Fund had better sector diversification than a typical money market portfolio, when in reality by that time the Fund held primarily subprime investments.

14. In 2006 and 2007, Hopkins was the State Street product engineer responsible for the statements in the fact sheets quoted in the preceding paragraph. Furthermore, Hopkins knew by at least February 2007 that the Fund was concentrated in subprime investments and had an average credit quality that was lower than a money market fund. Hopkins also learned in the first half of 2007 that some investors and their State Street client service representatives believed that the Fund was sector diversified and not concentrated in subprime investments, but Hopkins never changed the quarterly fact sheets provided to investors as a marketing tool to correct these misrepresentations. Therefore, with regard to at least the Fund's 2007 fact sheets, Hopkins misled the Fund's investors and potential investors by causing State Street to send fact sheets to investors that contained statements concerning the Fund's sector diversification and average credit quality that Hopkins knew were false and misleading because, at the time, Hopkins knew the Fund was concentrated in subprime investments with lower average credit quality than a money market fund.

15. Also, in 2006 and 2007, many of State Street's investor presentations described the Fund's typical sector breakdown in a way that not only failed to disclose any exposure to subprime investments, but indicated a greater level of sector diversification than actually existed at the time. Hopkins was responsible for drafting or updating these presentations. In 2006 and 2007, Hopkins was also often responsible for presenting the information in these investor presentations directly to investors or their consultants. These presentations represented that the Fund's "typical" exposure to "ABS," or asset-backed securities, was 55%. However, throughout this time period, the Fund's investments were almost all subprime investments, and therefore the Fund's "typical" exposure to asset-backed securities was never 55%. Hopkins, in using this "typical" exposure slide in his presentations to investors and causing others at State Street to use the slide by drafting or failing to update the information on the slide to reflect accurate information, omitted these facts even though he knew the sector breakdown in his presentations was not the Fund's typical sector breakdown in 2006 or 2007.

16. For example, in a presentation about the Fund that Hopkins made on or around May 8, 2007 to a hospital that was invested in a passive commodities strategy that invested its cash in the Fund, Hopkins used the following slide that he was responsible for drafting or updating:

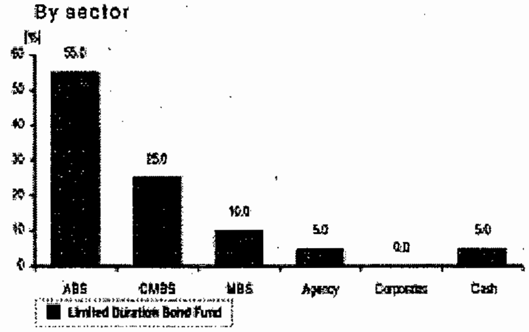
Typical Portfolio Exposures and Characteristics — Limited Duration Bond Strategy

- Exposure to non-correlated fixed income asset classes
- High quality
- No interest rate risk

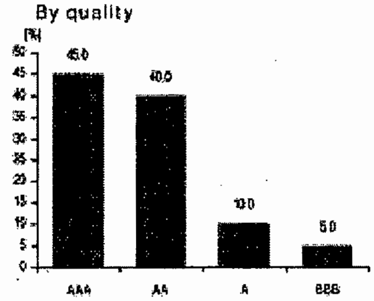
	Limited Duration Bond Fund
Average quality	AA
Modified adjusted duration	0.09 years
Yield over One Month LIBOR	50 bps
Average life	2.5 years

Breakdown by market value

By sector

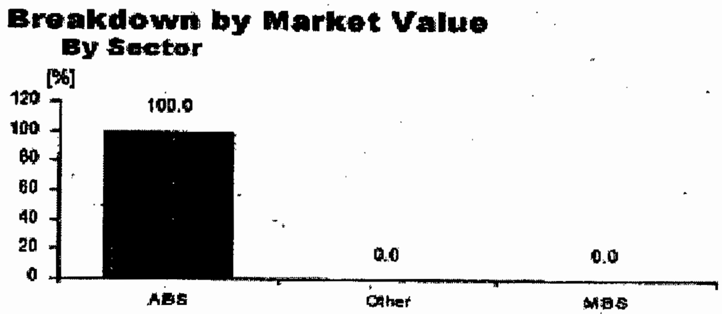


By quality



17. When he used this chart on or around May 8, 2007, Hopkins knew it was false or misleading for several reasons. First, by May 8, Hopkins knew that the Fund was concentrated in subprime investments that were highly correlated with each other. That is, Hopkins knew that a rise or fall in the value of one of the Fund's subprime investments was coinciding with a rise or fall in the value of the Fund's other subprime investments. Second, by May 2007, Hopkins knew that the Fund's typical "ABS" exposure had long exceeded 55% because Hopkins knew State Street categorized all of the Fund's subprime investments as "ABS" and Hopkins also knew that the Fund had been, and continued to be, invested in virtually all subprime investments. Finally, as alleged in more detail below, by May 8, 2007, Hopkins knew that the Fund had significant exposure to derivatives tied to the performance of other subprime investments and that the Fund's exposure to these derivatives was not included in the sector exposure on this slide.

18. In the Fund fact sheets and investor presentations that did describe the Fund's actual market value sector exposure at a snapshot in time, Hopkins also misrepresented or caused State Street to misrepresent the Fund's exposure to subprime investments. Through July 2007, the fact sheets and investor presentations for the Fund and related funds that Hopkins used or was responsible for drafting and/or updating presented market value sector exposures for "ABS," "MBS" (mortgage-backed securities), etc. For example, the standard Fund presentation and Fund fact sheet that Hopkins used or was responsible for drafting and/or updating during the second quarter of 2007 reflected the following exposures in the Fund:



The fact sheets and investor presentations did not define these sector categories. As a result, many investors and State Street client service personnel believed that the Fund and the related funds had very little or no exposure to subprime investments when the subprime turmoil commenced in 2007 because these materials showed little or no "MBS" in the funds. However, even after Hopkins became aware in the second quarter of 2007 that some investors and State Street client service personnel mistakenly believed from the fact sheets, investor presentations, and other documents drafted by Hopkins that the Fund had very little or no exposure to subprime investments, Hopkins did not update the fact sheets or investor presentations to reflect that the Fund's "ABS" exposure was virtually all subprime investments.

19. In 2006 and 2007, the Fund fact sheets and investor presentations that Hopkins used or was responsible for drafting and/or updating also misrepresented the extent of the Fund's exposure to subprime investment risk, including the Fund's exposure to leveraged subprime investments. During this period, the Fund was leveraged through reverse repurchases on its subprime bonds and through derivative contracts derived from the performance of other subprime investments. The notional value of a derivative contract is the total value of the derivative contract's assets, and a small amount invested in a derivative contract often controls a much larger notional value. Therefore, where a portfolio of assets includes derivative investments, a description of a portfolio's notional value relative to its market value may be necessary to determine a portfolio's exposure to leverage.

20. Up until 2005, the Fund's fact sheets and investor presentations reflected the Fund's exposure to derivative positions in descriptions of the Fund's sector exposures by showing exposures in excess of 100% of the net assets of the Fund. In 2005, however, State Street changed these materials to describe the Fund's sector exposures by using a presentation based on only the market value of exposures. This form of reporting displayed exposures totaling 100% (see chart in paragraph 18) without also disclosing that, on a notional basis, the Fund's exposure to subprime investments often exceeded 100% because of the Fund's investment in various subprime derivatives. As a result of State Street's change in disclosure, the Fund fact sheets and investor presentations that Hopkins used or was responsible for drafting and/or updating failed to inform investors in its descriptions of the Fund's sector exposures that the Fund's investment performance was tied to subprime and that its use of leverage magnified its exposure to subprime.

21. In a standard investor presentation concerning the Fund, which Hopkins used in his presentations to investors and was responsible for drafting and/or updating in all such investor presentations about the Fund, Hopkins represented that one of the Fund's objectives was "[m]odest use of leverage to manage risk and enhance returns." However, in 2007, the Fund's use of

leverage often resulted in exposure to the subprime market in excess of 150% of the Fund's market value. This leverage exposed the Fund to significant risks and, by July 2007, the Fund's leveraged investments far exceeded the Fund's risk budget based on the expected volatility of the Fund and its benchmark. At the time he used these presentations and was responsible for drafting and/or updating the presentations, Hopkins was aware that this leverage exposed the Fund to significant risks. As a result of State Street's and Hopkins' representations regarding leverage, many of the Fund's investors and State Street's client service personnel did not know the Fund had leveraged positions that magnified the Fund's exposure to subprime investments until long after the funds began a precipitous decline in mid-2007.

22. After a brief period of subprime market turmoil in February 2007, Hopkins drafted an internal alert to State Street's client service personnel concerning the subprime market and the Fund. Hopkins and others adapted the internal alert into a nearly identical letter that State Street sent to some investors in the Fund and the related funds in early March 2007. At the time, Hopkins was aware that the Fund's investments were virtually all subprime. However, the internal alert and letter stated that the Fund's recent underperformance was caused by the Fund's "modest" position in the lowest rated tranche of the ABX index, which represented credit default swaps on 20 different subprime investments rated BBB: "One of the alpha drivers in State Street's active strategies has been taking modest exposure in the investment grade triple B asset-backed securities market, specifically the sub-prime home equity market." Hopkins reiterated this statement in an update State Street sent to certain investors in April. All of these communications omitted that, besides the Fund's relatively small position in the BBB rated ABX investment, the Fund was concentrated in subprime bonds and other subprime derivative investments. Similarly, in various presentations to investors from April to June 2007, Hopkins represented that State Street had reduced its exposure to the BBB rated ABX investment. Hopkins' presentations concerning the Fund continued to make this representation even after Hopkins learned on April 25 that State Street had recently doubled the size of this investment after reducing it earlier in the year.

23. As a result of these communications and other presentations Hopkins made to investors in the first half of 2007, many of State Street's client service personnel and investors in the Fund believed that the Fund's relatively small BBB rated subprime investment was the Fund's only subprime investment. Some of these investors and client service personnel expressed their misunderstanding to Hopkins, but Hopkins did nothing to correct his and State Street's earlier misrepresentations to investors. Instead, as described below, in July 2007, Hopkins sought to strengthen State Street's statements about its risk controls while omitting the fact that the Fund was materially underperforming because of its concentration in higher rated subprime investments, a fact that Hopkins was aware of and knew or should have known that many investors did not understand.

24. As State Street and Hopkins were telling some investors in the Spring of 2007 that the Fund had a relatively small exposure to one subprime derivative investment, Hopkins was privately making light of the Fund's precarious situation. On May 11, 2007, a State Street client service person forwarded Hopkins an email he sent to Delta Airlines with information concerning the Fund and wrote: "I am trying to sell [the Fund] to Delta airlines for their corporate cash program...if I am successful do I get some sort of 'Salesman of the Millennium' award?" Hopkins responded: "Isn't there some rule that states that you can't sell an investment to an entity that has recently come out of bankruptcy that might send it back into bankruptcy."

State Street's Internal Advisory Groups Caused Their Investors to Redeem the Fund

25. Beginning in mid-June 2007, as the market for the Fund's subprime investments was in crisis, the Fund began a precipitous decline in value. In late July 2007, State Street's internal advisory groups recommended to their clients that they withdraw from those funds while State Street continued encouraging others to stay invested and to continue to invest.

26. In late July 2007, three of State Street's internal advisory groups that oversaw client investments in actively-managed bond funds, decided that their clients should redeem their investments in the Fund and the related funds. One of the advisory group clients that redeemed was State Street Corporation's Defined Benefit Plan. The advisory groups decided to redeem based on their awareness of exposure to subprime investments and other problems with the Fund that had not been fully disclosed to other investors, such as State Street's need to sell a significant percentage of the Fund's subprime investments in an illiquid market in order to meet anticipated investor redemptions.

27. State Street's internal advisory groups were aware of the Fund's subprime concentration and other problems with the Fund that had not been disclosed to other investors because: 1) employees of two of the advisory groups were voting members on State Street's confidential Investment Committee that, under the direction of Flannery, issued directives to portfolio managers concerning subprime investments; 2) the advisory groups had regular access to the Fixed Income trading desk and portfolio managers (indeed, one of the advisory groups reported to Flannery); and 3) the advisory groups received Hopkins' internal use only subprime alerts, including an alert Hopkins sent on July 2 describing the Fund's June underperformance.

28. The clients in State Street's three advisory groups were invested in the Fund and 14 of the related funds. As of July 25, 2007, the clients in these internal advisory groups held approximately 20 percent of the shares in these funds. By early August 2007, because of State Street's actions, virtually all of the advisory groups' clients had redeemed out of the Fund and the related funds.

29. By at least July 27, Flannery was aware that the two largest advisory groups had decided to redeem or recommend redemption of the Fund. First, on July 26 or 27, a representative of one of the advisory groups called Flannery to tell him that the advisory group had decided to recommend that its clients redeem from the Fund effective August 1. Flannery responded that the advisory groups' clients could redeem for cash before August 1. Second, Flannery led a confidential discussion about subprime at an SSgA Investment Committee meeting on the morning of July 25. At the beginning of the discussion, the head of one of the advisory groups, who reported directly to Flannery, left the meeting after stating that, as the manager of funds that were invested in the Fund, he wanted to avoid any appearance of bias or impropriety. (A representative of the other advisory group that contacted Flannery on July 26 or 27 about its recommendation to redeem stayed at the meeting and listened to the subprime discussion led by Flannery.) After the Investment Committee meeting, the manager of this advisory group went to Flannery to discuss his decision to redeem. Flannery instructed the manager not to discuss his decision with him because he wanted to make sure the manager acted independently. A few days later, on August 1, Flannery received a document called "Frequently Asked Questions Sub-Prime/Active Fixed Income Issues" with a question and answer explicitly stating that the advisory group that reported to Flannery was "recommending a move to passive fixed income."

30. Between July 26 and August 1, as a result of the directions from the July 25 Investment Committee meeting, State Street raised almost $700 million in cash to meet anticipated investor redemption demands. Approximately 75 percent of this cash came from the sale of almost all of the Fund's highest rated AAA bonds, even though the Fund's AAA bonds were only 20 percent of the Fund's net asset value at the time of the July 25 Investment Committee meeting. During this same period, the Fund experienced significant redemptions, including redemptions from clients of State Street's internal advisory groups. Therefore, after State Street met the redemption demands of the Fund's more informed clients, average credit quality of the Fund's bonds decreased.

Mid-2007 Communications About The Fund

31. At the same time that State Street was preparing to redeem its internal advisory group clients' investments in the Fund and the related funds, State Street began sending a series of letters to all other investors in the Fund and the related funds that continued to mislead these investors by omitting material information about the Fund and the related funds, including information State Street had disclosed to its internal advisory groups. Hopkins and Flannery played an instrumental role in the misrepresentations in these letters, which had the effect of causing the misled investors to continue to purchase or continue to hold their investments in the Fund and the related funds. As Flannery observed in his Commission testimony: "when you hold illiquid positions in an illiquid market, it is generally not advantageous to telegraph that holdings, that view. I don't think most investment managers would be specific about that exposure."

32. On July 2, 2007, Hopkins circulated an internal communication to State Street's client service personnel describing how the subprime market situation had caused recent underperformance of the Fund's portfolio and stating that the cause of substantial underperformance in the month of June was exposure to the ABX subprime investment described above. By July 11, 2007, Hopkins and others were revising the internal communication into an investor letter. However, the letter was not finalized until July 26, 2007, and the final form of the letter was much less detailed than the internal alert.

33. State Street's July 26 five-paragraph letter to investors disclosed little more than the fact that recent events in the subprime market "are impacting performance in some of our active fixed income portfolios in which you are invested directly or indirectly." The letter omitted that: the Fund was concentrated in subprime bonds; the Fund's performance had been and could continue to be adversely affected because it was leveraged through other subprime investments; and State Street was planning to sell the Fund's highest rated assets to meet investor redemptions. The purpose of the letter was to update investors on how the subprime market was affecting their investments, and these facts were essential to that message. As for State Street's view of the subprime situation and what it would do in response to the situation, the letter stated:

> We believe that what has occurred in June, and thus far in July, has been more driven by liquidity and leverage issues than long term fundamentals... We have been seeking to reduce risk in those portfolios where we believe it is appropriate by taking advantage of liquidity in the market when it exists, and will continue to do so, while seeking to avoid putting undue pressure on asset valuations.

34. As described above, at the time State Street made this statement, it was selling the Fund's highest rated bonds to meet investor redemptions, resulting in a Fund that held bonds of lower average credit quality for investors who remained in the Fund after the anticipated redemptions. At a State Street Investment Committee meeting on July 25, where Flannery led a confidential discussion about subprime investments and the Fund, the committee voted unanimously to direct the portfolio managers of the Fund to sell assets to meet anticipated investor redemptions of 25-50% by month end. State Street sold the vast majority of the Fund's AAA rated securities on July 26. Then, to meet the early redemption demands of the more informed investors, including State Street's internal advisory group clients, State Street depleted the cash it raised from the sale of the AAA bonds at a much faster rate than it sold the Fund's lower rated bonds. Indeed, from the beginning, the purpose of the AAA bond sale on July 26 was to raise cash to meet the anticipated investor redemptions described by Flannery at the July 25 Investment Committee meeting. For example, an internal State Street chronology about the Fund prepared by the Fund's portfolio managers and circulated to Flannery and Hopkins on August 2 stated: "[The Fund's] sale in late July of approximately $1.6 billion on short AAA securities (to meet anticipated demands for liquidity) was done at an average spread ..."

35. Hopkins knew or was reckless in not knowing that the July 26 letter omitted the material information that the Fund was concentrated in subprime. According to Hopkins, he knew by at least July 18 that the Fund was concentrated in AA and AAA rated subprime investments that were materially underperforming. Hopkins was also aware by this time that at least some investors and client service personnel believed that the Fund's only subprime exposure was the relatively small BBB rated subprime derivative investment that Hopkins highlighted earlier in the year in two letters and various investor presentations about the Fund. Nonetheless, on July 24, Hopkins commented on a draft of the July 26 letter that omitted to state that the Fund was concentrated in subprime investments or that the Fund's concentration in higher rated subprime investments was causing material underperformance of the Fund. In his comments, Hopkins suggested that the letter highlight that "we have in fact lessened our exposure to the subprime sector in many of these portfolios and we are continuing our analysis in terms of further risk reduction." Once again, Hopkins wanted to focus on what State Street had done with respect to the BBB rated ABX investment while omitting that the Fund's other subprime investments made up more than 90% of the Fund and were causing material underperformance. In suggesting this edit, which gave rise to the risk reduction language in the final version of the July 26 letter, Hopkins knowingly misled investors because he knew the purpose of the letter was to inform investors about the material causes of the Fund's underperformance, yet he omitted what he knew was causing that underperformance (a concentration in higher rated subprime investments) and chose instead to focus on State Street's modest efforts to reduce exposure to the Fund's lower rated subprime investments that were only a small percentage of the Fund. Therefore, in suggesting this edit, Hopkins was in a unique position to understand that many investors were unaware of what was driving the Fund's risks and underperformance, but he chose to ignore the factors driving underperformance in suggesting an edit to the letter that Hopkins knew would lull investors to stay in the Fund because they would remain uninformed about the Fund's subprime investment concentration and the significant risks of continuing to invest in the Fund.

36. In conjunction with the July 26 letter, State Street's Fixed Income group provided client service personnel with answers to Frequently Asked Questions (FAQs) concerning the subprime situation. On July 26, 2007, Flannery and certain other managers held a meeting with

State Street's entire client service group to discuss "our communication plan," including the July 26 letter and the "rules of the road and FAQs." Right after that meeting, State Street distributed the first set of FAQs to its client service personnel with the instruction that the FAQs were "to assist you with client/consultant questions" but were "for internal use only" and should only be used for oral discussions with investors. The FAQs were far more comprehensive than the July 26 letter, and enabled State Street's client service personnel to disclose material information to certain investors, including that the Fund was concentrated in subprime investments and that State Street's largest internal advisory group had decided to redeem out of the Fund and the related funds. Many investors who received information from the FAQs redeemed their investments shortly after receiving the information. In late July and early August, in response to requests from certain investors or their outside consultants, State Street also provided the Fund's holdings and disclosed the fact that State Street had decided to reprice some of the Fund's securities to reflect market prices that were lower than the vendor prices State Street had been using to arrive at the Fund's net asset value. All but one of these investors immediately sold their investments before the Fund experienced its most significant losses in August.

37. On August 2, 2007, State Street asked its client service personnel to send another form letter to all affected investors concerning the subprime situation and preliminary July performance returns. That letter did not disclose the information that State Street had provided to its internal advisory groups and certain other investors who requested the information. Also, in the August 2 letter, State Street again stated it had taken actions to reduce risk, including the sale of certain subprime bonds, while maintaining the Fund's average credit quality. However, State Street had sold almost all of the Fund's highest rated subprime bonds, and, upon meeting anticipated investor redemptions in late July and early August, the Fund's bonds were increasingly lower credit quality. Those investors who remained in the dark concerning the Fund's risks invested in or continued to hold their investment as the Fund became concentrated in lower-rated and largely illiquid subprime investments.

38. Flannery revised the August 2 letter to make it even more misleading concerning actions State Street had taken to reduce risk in the Fund. On August 1, Flannery revised the letter's risk reduction statements to reflect what State Street had already done (e.g., reduced exposure to certain swaps) to reduce risk as opposed to what State Street intended to do to reduce risk. When making the statement concerning what State Street had already done to reduce certain exposures (and omitting that those same actions increased the Fund's risks), Flannery was aware that these decisions were motivated to meet significant investor redemption demands, including advisory groups' clients' redemptions.

39. When he revised the August 2 letter, Flannery also knew that those investors who remained in the Fund held a fund with bonds of lower average credit quality because State Street sold the Fund's AAA rated bonds to meet redemption demands. On the morning of July 25, Flannery led a discussion at an SSgA Investment Committee meeting concerning the subprime situation. Draft minutes of the meeting reflect that Flannery stated that State Street needed to raise 30-40% liquidity in the Fund by the end of the month to meet redemptions that were estimated at 25-50% of the fund. The minutes also reflect that State Street decided to: 1) increase liquidity in the Fund by month end; 2) reduce AA exposure by 5% by the end of the week; and 3) seek to sell securities pro-rata to meet withdrawals. The Fund's portfolio manager attended the July 25 Investment Committee meeting and understood that the committee was directing him to sell

virtually all of the Fund's AAA rated bonds. The portfolio manager worked with State Street's head trader on July 26 to carry out the AAA sale, which many involved in the sale considered it to be one of the biggest bond sales State Street had ever done. As soon as the sale was complete, the head trader informed Flannery of that fact. Flannery's involvement in the Investment Committee's discussion, his awareness of the Fund's holdings, and his expertise concerning the market conditions for the Fund's assets put him in a unique position to understand that the Investment Committee's decision put investors who remained in the Fund at greater risk after the anticipated redemptions were satisfied.

40. On August 14, 2007, Flannery signed a letter concerning the subprime situation that State Street sent to investors in the Fund and the related funds. This letter represented that State Street believed investors should not redeem from the Fund and the related funds: "While we will continue to liquidate assets for our clients when they demand it, we believe that many judicious investors will hold the positions in anticipation of greater liquidity in the months to come." However, while advising investors to continue to hold their investments in the Fund and related funds, the letter omitted the information that the advisory groups and certain other investors who had decided to redeem had already learned, including the illiquid nature of the remaining investments in the Fund and that the Fund's exposure to subprime investments was actually magnified through the use of credit default swaps, total return swaps, and reverse repurchases tied to subprime investments. Just as this information was important for the advisory groups and certain other investors to make an informed investment decision, this information was necessary for the investors who were still invested in the Fund to decide whether to continue to hold their positions. Furthermore, the letter's statement that State Street believed judicious investors would continue to hold their investments omitted that, as Flannery was aware, State Street, through its internal advisory groups, had already recommended, that certain clients exit the funds. Therefore, Flannery misled investors by making a statement that State Street believed many judicious investors would hold their positions in the Fund while omitting that State Street's advisory groups, one of which even reported directly to Flannery, had decided not to hold their positions. This was misleading because the statement purported to convey State Street's view about whether a judicious investor should hold the Fund when the view of all of State Street's advisory groups directly contradicted that view. In addition, the August 14 letter omitted that State Street had already sold the Fund's most liquid investments and used the cash from those sales to meet investor redemptions. Therefore, even to the extent that Flannery or others at State Street believed on August 14 that judicious investors should hold their positions in the Fund and related funds, it was misleading to omit the basis for this belief that the Fund was now concentrated in only illiquid subprime investments because a judicious investor (i.e., investors in State Street's advisory groups) may have wanted to redeem from the Fund when the Fund still had cash from the AAA bond sales, but may no longer want to redeem when State Street would have to sell the Fund's illiquid holdings to meet the redemption request.

41. On August 7, a State Street attorney revised the quoted sentence from the August 14 letter from Flannery's initial draft of "our advice is to hold..." to "we believe that many judicious investors will hold..." Flannery never discussed with the attorney whether this sentence was appropriate in light of the decisions to redeem made by State Street's advisory groups. Instead, the attorney explained to Flannery that he suggested the edit because State Street was not normally in the position of giving investors advice when to buy or sell a State Street fund.

E. VIOLATIONS

42. As a result of the conduct described above, Hopkins and Flannery willfully violated Section 17(a)(2) and Section 17(a)(3) of the Securities Act in that, in the offer and sale of securities and by the use of the means and instruments of transportation or communication in interstate commerce or by use of the mails, Hopkins and Flannery directly or indirectly have obtained money or property by making untrue statements of material fact and/or by omitting to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. In addition, in violation of Section 17(a)(3) of the Securities Act, Hopkins and Flannery engaged in the transactions, practices, or courses of business described above that operated or would operate as a fraud or deceit upon the purchasers of such securities.

43. As a result of the conduct described above, other than the allegations described in paragraphs 40 and 41 concerning an August 14, 2007 letter to State Street's investors signed by Flannery, Hopkins and Flannery willfully violated Section 17(a)(1) of the Securities Act in that, in the offer and sale of securities and by the use of the means and instruments of transportation or communication in interstate commerce or by use of the mails, Hopkins and Flannery directly or indirectly employed devices, schemes and artifices to defraud.

44. As a result of the conduct described above, other than the allegations described in paragraphs 40 and 41 concerning an August 14, 2007 letter to State Street's investors signed by Flannery, Hopkins and Flannery 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 and in the public interest that administrative and cease-and-desist proceedings be instituted pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, Section 203(f) of the Advisers Act and Section 9(b) of the Investment Company Act to determine:

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

B. Whether, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Respondents should be ordered to cease and desist from committing or causing violations of and any future violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder;

C. Whether, pursuant to Section 8A of the Securities Act, Section 21B(a) of the Exchange Act, Section 203(i) of the Adviser Act, and Section 9(d) of the Investment Company Act, to impose civil penalties as a result of Respondents' willful violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; and

D. What, if any, remedial action is appropriate in the public interest against Respondents pursuant to Section 203(f) of the Advisers Act and Section 9(b) of the Investment Company Act.

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that Respondents shall each 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 either of the Respondents fail to file the directed answer, or fails to appear at a hearing after being duly notified, that Respondent may be deemed in default and the proceedings may be determined against 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 Respondents personally or by certified mail.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 300 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

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

By the Commission.

Elizabeth M. Murphy
Secretary

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

Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 63019 / September 30, 2010

INVESTMENT ADVISERS ACT OF 1940
Release No. 3095 / September 30, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14082

In the Matter of

FreedomTree Mutual Funds and Asset Management, LLC, d/b/a FreedomTree Asset Management, LLC; Spence-Lingo & Company, Ltd. d/b/a FreedomTree Transfer Agency; and Jermaine Ezekiel Spence

Respondents.

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 15(b), 17A, AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, AND SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS 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)(6), 17A and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), and Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act").

81 of 82

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Jermaine Ezekiel Spence ("Spence"), age 29, is a resident of Atlanta, Georgia. Spence owns and controls both FreedomTree Mutual Funds and Asset Management, LLC, and Spence-Lingo & Company, Ltd.

2. FreedomTree Mutual Funds and Asset Management, LLC, d/b/a FreedomTree Asset Management, LLC ("FreedomTree") is a Georgia limited liability company formed on April 7, 2008. FreedomTree is solely owned and controlled by Spence, its chief executive officer and chief compliance officer. On November 14, 2008, FreedomTree registered with the Commission as an investment adviser under the name "FreedomTree Asset Management." In November 2008, FreedomTree filed applications with FINRA and the Commission to register as a broker-dealer. The applications are still pending.

3. Spence-Lingo & Company, Ltd., d/b/a FreedomTree Transfer Agency ("Spence-Lingo") is a Georgia for-profit corporation formed on June 1, 2007. Spence-Lingo is indirectly owned and controlled by Spence, its chief executive officer and majority shareholder. Spence-Lingo voluntarily registered its common stock with the Commission pursuant to Section 12(g) of the Exchange Act in June 2008, and separately registered with the Commission as a transfer agent on August 22, 2008, under the name "FreedomTree Transfer Agency." Spence-Lingo is purportedly operated from the same address as FreedomTree. Spence-Lingo is also a licensed insurance agency in Georgia.

B. FALSE DISCLOSURES CONTAINED IN FREEDOMTREE'S FORMS ADV

4. FreedomTree registered with the Commission as an investment adviser on August 19, 2008. Despite having no clients and no assets under management, FreedomTree invoked Rule 203A-2(d) under the Advisers Act, a registration prohibition exemption, thereby effectively representing that it reasonably expected to have $25 million in assets under management within 120 days.

5. In its initial Form ADV filed on August 19, 2008, FreedomTree claimed to provide financial planning, portfolio management, and pension consulting services to individuals, high-net worth individuals, investment companies, charitable organizations, corporations and state or municipal government entities. The firm further claimed to have $7 million in assets under management in three discretionary accounts.

6. On May 12, 2009, FreedomTree filed an amended Form ADV in which the company claimed that it was eligible to remain registered with the Commission because it had exactly $25 million in assets under management in three discretionary accounts.

7. On November 30, 2009, FreedomTree filed a second amendment to its Form ADV, claiming to have $235 million in assets under management in two discretionary accounts.

8. The disclosures described in paragraphs 4 to 7 were false. FreedomTree had no advisory clients, revenues, or any assets under management that would qualify FreedomTree for registration with the Commission as an investment adviser.

C. <u>MISREPRESENTATIONS ON FREEDOMTREE'S WEBSITE</u>

9. On its website, which was operational at least throughout November 2009, FreedomTree sought prospective clients willing to invest a minimum of $100,000 in the firm's "prestigious money management platform" under a "competitively priced fee-based" arrangement.

10. FreedomTree's website further represented that FreedomTree had "27+ years of unparalleled leadership" (Spence's age at the time) and emphasized that, as an investment adviser, the firm was subject to the regulatory oversight of the Commission. These representatations were false. FreedomTree had no advisory clients, revenues, or assets that would qualify FreedomTree for registration with the Commission as an investment adviser. Additionally, FreedomTree, which checked off that it was a "newly formed adviser" when it filed its initial Form ADV in August 2008, did not have a 27-year operational history.

D. <u>SPENCE-LINGO'S REGISTRATION AS A TRANSFER AGENT</u>

11. FreedomTree's website also represented that the firm was part of a larger "financial group," which included a transfer agent "providing clearing services to corporate and government issuers." Spence-Lingo registered as a transfer agent with the Commission on August 22, 2008. According to its Commission filings as a transfer agent, Spence-Lingo operated from the same address as FreedomTree. Spence served as the company's chief executive officer. However, Spence-Lingo provided no "clearing services" as represented on FreedomTree's website. Spence-Lingo remains registered with the Commission as a transfer agent.

E. <u>FREEDOMTREE'S APPLICATIONS FOR REGISTRATION AS A BROKER-DEALER</u>

12. In November 2008, FreedomTree filed applications with FINRA and the Commission to register as a broker-dealer. The applications are still pending.

F. FREEDOMTREE AND SPENCE-LINGO FAILED TO RESPOND TO REQUESTS FOR RECORDS AND EXAMINATIONS

13. In November 2009, Commission staff from the Office of Compliance, Inspections, and Examinations ("OCIE") attempted to conduct routine investment adviser and transfer agent examinations of FreedomTree and Spence-Lingo respectively. Spence failed to appear for a scheduled meeting with the staff, failed to produce documents requested by the staff, failed to respond to two resulting exam deficiency letters, and failed to produce documents in response to a related request for documents and information from staff from the Enforcement Division. In a brief phone interview with OCIE staff in November 2009, Spence conceded that FreedomTree had no advisory clients and no revenue.

G. VIOLATIONS

14. As a result of the conduct described above, FreedomTree and Spence willfully violated Sections 206(1) and 206(2) of the Advisers Act, which make it unlawful for an investment adviser to employ any device, scheme or artifice to defraud clients or to engage in any transaction, practice or course of business that defrauds clients or prospective clients.

15. As a result of the conduct described above, FreedomTree willfully violated, and Spence willfully aided and abetted, and/or caused violations of Section 203A of the Advisers Act, which generally prohibits an adviser that is regulated or required to be regulated in the state in which it has its principal office and place of business from registering with the Commission, unless it has assets under management in excess of $25 million or advises a registered investment company.

16. As a result of the conduct described above, FreedomTree willfully violated, and Spence willfully aided and abetted, and/or caused violations of Section 204(a) of the Advisers Act. Section 204(a) of the Advisers Act requires every registered investment adviser to furnish to the Commission in connection with compliance examinations true, accurate, and current books and records relating to its investment advisory business.

17. As a result of the conduct described above, FreedomTree willfully violated, and Spence willfully aided and abetted and/or caused violations of Section 206(4) and Rule 206(4)-1. Section 206(4) of the Advisers Act prohibits an investment adviser from engaging "in any act, practice, or course of business which is fraudulent, deceptive or manipulative." Section 206(4) also authorizes the Commission to define, by rule, what acts, practices, or courses of business constitute fraudulent conduct. Rule 206(4)-1(a)(5) prohibits investment advisers from publishing, circulating, or distributing "any advertisement ... which contains any untrue statement of a material fact, or which is otherwise false or misleading." Further, Rule 206(4)-1 provides that "the term 'advertisement' shall include any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers (1) any analysis, report, or publication concerning

securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (2) any graph, chart, formula, or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (3) any other investment advisory service with regard to securities."

18. As a result of the conduct described above, FreedomTree and Spence willfully violated Section 207 of the Advisers Act, which makes it unlawful "for any person willfully to make any untrue statements of material fact in any registration application or report filed with the Commission under Section 203 or 204, or willfully to omit to state in any such application or report any material fact which is required to be stated therein."

19. As a result of the conduct described above, Spence-Lingo willfully violated, and Spence willfully aided and abetted and/or caused violations of Sections 17(b)(1) and 17A(d)(1) of the Exchange Act and Rule 17Ad-6 thereunder. Under Section 17(b)(1), all transfer agents are subject to periodic examinations by the Commission. Section17A(d)(1) of the Exchange Act prohibits registered transfer agents from engaging in any activities that contravene certain regulations promulgated by the Commission. Rule 17Ad-6 requires registered transfer agents to maintain and keep current records of the firm's business.

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 Respondents an opportunity to establish any defenses to such allegations;

B. What, if any, remedial action is appropriate in the public interest against Spence pursuant to Sections 15(b) and 17A of the Exchange Act and Section 203(f) of the Advisers Act including, but not limited to, disgorgement and civil penalties pursuant to Section 21B of the Exchange Act and 203(i) of the Advisers Act;

C. What, if any, remedial action is appropriate in the public interest against Spence-Lingo pursuant to Section 17A of the Exchange Act including, but not limited to, disgorgement and civil penalties pursuant to Section 21B of the Exchange Act;

D. What, if any, remedial action is appropriate in the public interest against FreedomTree pursuant to Section 203(e) of the Advisers Act including, but not limited to, civil penalties pursuant to Section 203(i) of the Advisers Act;

E. Whether, pursuant to Section 203(k) of the Advisers Act, FreedomTree should be ordered to cease and desist from committing or causing violations of and any future violations of Sections 203A, 204(a), 206(1), 206(2), 206(4) and 207 of the Advisers Act and Rule 206(4)-1 thereunder, and whether FreedomTree should be ordered to pay disgorgement pursuant to Section 203(k)(5) of the Advisers Act;

F. Whether, pursuant to Section 203(k) of the Advisers Act, Spence should be ordered to cease and desist from committing or causing violations of and any future violations of Sections 203A, 204(a), 206(1), 206(2), 206(4), and 207 of the Advisers Act and Rule 206(4)-1 thereunder, and whether Spence should be ordered to pay disgorgement pursuant to Section 203(k)(5) of the Advisers Act;

G. Whether pursuant to Section 21C of the Exchange Act, Spence should be ordered to cease and desist from committing or causing violations of and any future violations of Sections 17(b)(1) and 17A(d)(1) of the Exchange Act and Rule 17Ad-6 thereunder, and whether Spence should be ordered to pay disgorgement pursuant to Section 21C(e) of the Exchange Act; and

H. Whether, pursuant to Section 21C of the Exchange Act, Spence-Lingo should be ordered to cease and desist from committing or causing violations of and any future violations of Sections 17(b)(1) and 17A(d)(1) of the Exchange Act and Rule 17Ad-6 thereunder, and whether Spence-Lingo 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 Respondents shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

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

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

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 300 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

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

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 63020 / September 30, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-14083

In the Matter of **SPENCE-LINGO & COMPANY, LTD.** **Respondent.**	**ORDER INSTITUTING PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

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

II.

After an investigation, the Division of Enforcement alleges that:

A. Spence-Lingo (CIK No. 0001437765) is a Georgia for-profit corporation. Spence-Lingo's common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act. Spence-Lingo is required to file reports pursuant to Section 13(a) of the Exchange Act.

B. Section 13(a) of the Exchange Act and the rules promulgated thereunder require issuers of securities registered pursuant to Section 12 of the Exchange Act to file with the Commission current and accurate information in current and periodic reports, even if the

82 of 82

registration under Section 12(g) is voluntary. Specifically, Rule 13a-1 requires issuers to file annual reports (Forms 10-K or 10-KSB) and Rule 13a-13 requires issuers to file quarterly reports (Forms 10-Q or 10-QSB).

C. Spence-Lingo is delinquent in its periodic filings with the Commission.

D. Since registering with the Commission, Respondent has failed to file any quarterly reports.

E. Spence-Lingo filed its original registration statement with the Commission under Section 12(b) on June 23, 2008. On June 27, 2008, the Division of Corporation Finance sent Spence-Lingo a comment letter ("June 27, 2008 comment letter"), which identified material deficiencies in Spence-Lingo's registration statement, and indicated that the registration should have been filed pursuant to Section 12(g).

F. Spence-Lingo failed to heed the June 27, 2008 comment letter.

G. On August 4, 2008, the Division of Corporation Finance sent Spence-Lingo a comment letter ("August 4, 2008 comment letter") indicating that the Commission Finance would consider Spence-Lingo's registration as having been filed under Section 12(g), and that the registration would become effective on August 22, 2008 in a deficient manner unless Spence-Lingo corrected the material deficiencies identified in the June 27, 2008 comment letter.

H. Spence-Lingo failed to heed the August 4, 2008 comment letter.

I. Spence Lingo's registration became effective on August 22, 2008.

J. Both Spence-Lingo's initial registration statement (filed on June 23, 2008) and its first untimely annual report (filed on January 8, 2010) lacked an auditor's report as well as audited financial statements as required by Regulation S-X.

K. As a result of the foregoing, Spence-Lingo has failed to comply with Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted pursuant to Section 12(j) of the Exchange Act to determine:

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

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months or to revoke the registration of each class of securities of the Respondent identified in Section II hereof 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, as provided by Rule 200 of the Commission's Rules of Practice, 17 C.F.R. § 201.200, 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 the Respondent shall file an Answer to the allegations contained in this Order Instituting Proceedings 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 the Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against the Respondent upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

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

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

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

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary