JULY 2013
FOIA FILE

104
TOTAL DOCUMENTS

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 **July 2013**, 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.

Elisse B. Walter, served as SEC Chairman
December 14, 2012 to April 10, 2013*

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

ELISSE B. WALTER, CHAIRMAN

LUIS A. AGUILAR, COMMISSIONER

TROY A. PAREDES, COMMISSIONER

DANIEL M. GALLAGHER, COMMISSIONER

(2 Documents)

*Elisse B. Walter preceded Mary Jo White as SEC Chairman;
Chair White's term began April 10, 2013 - Present

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

July 18, 2013

In the Matter of **American Technologies Group, Inc., Bonanza Oil & Gas, Inc., and Gulf Coast Oil & Gas, Inc.,** **File No. 500-1**	**ORDER OF SUSPENSION OF TRADING**

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

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

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

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on July 18, 2013, through 11:59 p.m. EDT on July 31, 2013.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITI... ANGE ACT OF 1934
Release N... uly 18, 2013

ADMI... E PROCEEDING
File ...

...nologies Group, Inc., ... Gas, Inc., and ... & Gas, Inc., ...nts.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

...e Securities and Exchange Commission ("Commission") deems it necessary and ...priate for the protection of investors that public administrative proceedings be, and hereby ..., instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against the Respondents named in the caption.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. American Technologies Group, Inc. ("ATGR") [1] (CIK No. 878547) is a revoked Nevada corporation located in Fort Worth, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ATGR 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, 2010, which reported a net loss of $98,634 for the prior nine months. As of July 15, 2013, the common stock of ATGR was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. Bonanza Oil & Gas, Inc. ("BGOI") (CIK No. 1214605) is a revoked Nevada corporation located in Houston, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). BGOI is delinquent in its periodic filings with the

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

2 of 2

Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended June 30, 2010, which reported a net loss of $7,816,477 for the prior six months. As of July 15, 2013, the common stock of BGOI was quoted on OTC Link, had eight market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. Gulf Coast Oil & Gas, Inc. ("GCOG") (CIK No. 1108943) is a revoked Nevada corporation located in Houston, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GCOG is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended June 30, 2008, which reported a net loss of $322,224 for the prior six months. As of July 15, 2013, the common stock of GCOG was quoted on OTC Link, had eight market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

4. 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.

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

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

III.

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

A. Whether the allegations contained in Section II 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

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 **July 2013**, 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.

Mary Jo White, SEC Chair
April 10, 2013 to Present

Elisse B. Walter, served as SEC Chairman
December 14, 2012 to April 10, 2013

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

MARY JO WHITE, CHAIR

ELISSE B. WALTER, COMMISSIONER

LUIS A. AGUILAR, COMMISSIONER

TROY A. PAREDES, COMMISSIONER

DANIEL M. GALLAGHER, COMMISSIONER

(102 Documents)

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

March 31, 2011

In the Matter of **Corestream Energy, Inc.** **(f/k/a Zealous, Inc.),** **File No. 500-1**	**ORDER OF SUSPENSION OF TRADING**

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Corestream Energy, Inc. ("Corestream") (f/k/a Zealous, Inc.) because it has failed to file certain periodic reports with the Commission and because of questions regarding the accuracy and adequacy of statements made by Corestream in press releases concerning, among other things, the acquisition of certain oil wells. Corestream is quoted on OTC Link (previously the Pink Sheets) operated by OTC Markets Group, Inc. under the ticker symbol "ZLUS."

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 March 31, 2011, through 11:59 p.m. EDT on April 13, 2011.

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. 3312 / November 9, 2011

INVESTMENT COMPANY ACT OF 1940
Release No. 29858 / November 9, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-11393

In the Matter of **MASSACHUSETTS FINANCIAL SERVICES COMPANY, JOHN W. BALLEN AND KEVIN R. PARKE** **Respondents.**	**ORDER MODIFYING ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO 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, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER AS TO MASSACHUSETTS FINANCIAL SERVICES COMPANY**

I.

On February 5, 2004, the United States Securities and Exchange Commission (the "Commission") instituted administrative and cease-and desist proceedings pursuant to Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act"), Making Findings and Imposing Remedial Sanctions and Cease-and Desist Order (the "2004 Order") against Massachusetts Financial Services Co. ("MFS" or "Respondent"), John W. Ballen and Kevin R. Parke.[1]

II.

[1] See Advisers Act Rel. No. IA-2213, February 5, 2004, Admin. Proc. File No. 3-11393.

In anticipation of the institution of these proceedings, MFS consented to the 2004 Order. Among other things, the 2004 Order required MFS to cease and desist from further violations of the federal securities laws, directed MFS to pay disgorgement and civil money penalties, and directed MFS to comply with various undertakings.

III.

MFS has submitted an Amended Offer of Settlement (the "Offer") proposing to relieve it of the obligations to continue to: (1) use its best efforts to cause each MFS retail mutual fund to hold a meeting of shareholders at least every 5th calendar year to elect trustees in accordance with paragraph III.31.c of the 2004 Order; (2) use its best efforts to cause each MFS retail fund to designate an independent compliance officer in accordance with paragraph III.31.d of the 2004 Order; (3) maintain an Internal Compliance Controls Committee in accordance with paragraph IV.B.1.b. of the 2004 Order; (4) undergo a third-party biennial compliance review in accordance with paragraph IV.F of the 2004 Order. Solely for purposes of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, MFS consents to the entry of this Order Modifying Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to 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, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

IV.

The Commission deems it appropriate and in the public interest to modify the 2004 Order as agreed to in MFS's Offer.

Accordingly, IT IS HEREBY ORDERED that:

A. Paragraph III.31.c of the 2004 Order is modified as follows:

c. In 2005 and 2010, each MFS Retail Fund will hold a meeting of shareholders at which the board of trustees will be elected.

B. Paragraph III.31.d of the 2004 Order is modified as follows:

d. Until at least September 30, 2011, each MFS Retail Fund will designate an independent compliance officer reporting to its board of trustees as being responsible for assisting the board of trustees and any of its committees in monitoring compliance by MFS with the federal securities laws, MFS's fiduciary duties to fund shareholders and its Code of Ethics in all matters relevant to the operation of the MFS Retail Funds. The duties of this person will include reviewing all compliance reports furnished to the board of trustees or its committees by MFS, attending meetings of MFS's Internal Compliance Controls Committee to be established pursuant to MFS's undertakings set forth in paragraph IV.B.1.b below, serving as liaison between the board of trustees and its committees and the chief compliance officer of MFS, making such recommendations to the board of trustees regarding MFS's compliance procedures as may appear advisable from time to time, and promptly reporting to the board of trustees any material breach of fiduciary duty, breach of the Code of Ethics and/or violation of the federal securities laws of which he or she becomes aware in the course of carrying out his or her duties.

C. Paragraph IV.B.1.b of the 2004 Order is modified as follows:

b. Until at least September 30, 2011, MFS shall establish an Internal Compliance Controls Committee to be chaired by MFS's chief compliance officer, which Committee shall have as its members senior executives of MFS's operating businesses. Notice of all meetings of the Internal Compliance Controls Committee shall be given to the independent compliance officer of the trustees of the MFS Retail Funds, who shall be invited to attend and participate in such meetings provided that the involvement of the independent compliance officer shall be limited to compliance issues relating to the MFS Retail Funds. The Internal Compliance Controls Committee shall review compliance issues throughout the business of MFS, endeavor to develop solutions to those issues as they may arise from time to time, and oversee implementation of those solutions. The Internal Compliance Controls Committee shall provide reports on internal compliance matters to the Compliance or Audit Committee of the trustees of the MFS Retail Funds with such frequency as the independent trustees of such funds may instruct, and in any event at least quarterly. MFS shall also provide to the Risk Review or Audit Committee of Sun Life Financial Inc. the same reports of the Code of Ethics Oversight Committee and the Internal Compliance Controls Committee that it provides to the Compliance or Audit Committee of the MFS Retail Funds.

D. Paragraph IV.F of the 2004 Order is modified as follows:

F. Periodic Compliance Review. Commencing in 2006, and at least once every other year thereafter through 2010, MFS shall undergo a compliance review by a third party, who is not an interested person, as defined in the Investment Company Act, of MFS. At the conclusion of the review, the third party shall issue a report of its findings and recommendations concerning MFS's supervisory, compliance, and other policies and procedures designed to prevent and detect breaches of fiduciary duty, breaches of the Code of Ethics and federal securities law violations by MFS and its employees in connection with their duties and activities on behalf of and related to the MFS Retail Funds. Each such report shall be promptly delivered to MFS's Internal Compliance Controls Committee and to the Compliance or Audit Committee of the board of trustees of each MFS Retail Fund.

E. All other provisions of the 2004 Order remain in effect.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

December 1, 2011

IN THE MATTER OF ZipGlobal Holdings, Inc. Symbollon Pharmaceuticals, Inc. Microholdings US, Inc. ComCam International, Inc. Outfront Companies Augrid Global Holdings Corp. 1st Global Financial, Corp. File No. 500-1	ORDER OF SUSPENSION OF TRADING

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of the issuers listed below. As set forth below for each issuer, questions have arisen regarding the accuracy and adequacy of publicly available information about the issuers.

1. ZipGlobal Holdings, Inc. is a Delaware corporation with its principal place of business in Massachusetts. Questions have arisen concerning the adequacy and accuracy of its public filings concerning the company's issuance of shares in company stock and its financial statements.

2. Symbollon Pharmaceuticals, Inc. (f/k/a Symbollon Corp.) is a Delaware corporation with its principal place of business in Massachusetts. Questions have arisen concerning the adequacy and accuracy of publicly available information about the company concerning the company's issuance of shares in company stock. Questions have

also arisen concerning the adequacy and accuracy of publicly available information about the company because it has not filed any periodic reports since the period ended March 31, 2011.

3. Microholdings US, Inc. is an Oklahoma corporation with its principal place of business in Washington. Questions have arisen concerning the adequacy and accuracy of publicly available information about the company concerning the company's issuance of shares in company stock.

4. ComCam International, Inc. is a Delaware company with its principal place of business in Pennsylvania. Questions have arisen concerning the adequacy and accuracy of publicly available information about the company.

5. Outfront Companies has its principal place of business in Florida. Questions have arisen concerning the adequacy and accuracy of publicly available information about the company.

6. Augrid Global Holdings Corp. has its principal place of business Texas. Questions have arisen concerning the adequacy and accuracy of publicly available information about the company.

7. 1st Global Financial, Corp. has its principal place of business in Nevada. Questions have arisen concerning the adequacy and accuracy of publicly available information about the company.

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

THEREFORE, IT IS ORDERED, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 12 noon EST, on December 1, 2011 through 11:59 p.m. EST on December 14, 2011.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

February 16, 2012

IN THE MATTER OF NIKRON TECHNOLOGIES, INC. File No. 500-1	ORDER OF SUSPENSION OF TRADING

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Nikron Technologies, Inc. ("Nikron") because of possible manipulative conduct occurring in the market for the company's stock. Nikron is quoted on OTC Link operated by OTC Markets Group, Inc. under the ticker symbol "NKRN."

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

THEREFORE, IT IS ORDERED, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed company is suspended for the period from 9:30 a.m. EST, on February 16, 2012 through 11:59 p.m. EST, on March 1, 2012.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

February 16, 2012

IN THE MATTER OF	:	
C$ cMoney, Inc.	:	ORDER OF SUSPENSION OF TRADING
File No. 500-1	:	

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of C$ cMoney, Inc. ("cMoney") because of questions regarding the accuracy of assertions by cMoney, and by others, in press releases to investors and other public statements concerning, among other things, the identity of persons controlling the operations, management and securities of the company, the purported engagement of an independent auditor and the status of the company's audit.

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

THEREFORE, IT IS ORDERED, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed company is suspended for the period from 9:30 a.m. EST, on February 16, 2012 through 11:59 p.m. EST, on March 1, 2012.

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. 67112 / June 5, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14904

In the Matter of TRUE PRODUCT ID, INC., Respondent.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

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

II.

After an investigation, the Division of Enforcement alleges that:

RESPONDENT

1. True Product ID, Inc. ("Respondent") is a Delaware corporation with is principal executive offices in Wayne, Pennsylvania, with a class of equity securities registered with the Commission pursuant to Section 12(g) of the Exchange Act. The Respondent's common stock (ticker "TPID") is quoted on the OTC Link operated by OTC Markets Group, Inc.

DELINQUENT FILINGS

2. Section 13(a) of the Exchange Act and the rules promulgated thereunder require issuers with classes of securities registered pursuant to Section 12 of the Exchange Act to file with the Commission current and accurate information in periodic reports. Specifically, Rule 13a-1 requires issuers to file annual reports and Rule 13a-13 requires issuers to file quarterly reports.

3. The Respondent filed its last Form 10-K for the year ended June 30, 2008 on October 15, 2008, and its last Form 10-Q for the quarter ended March 31, 2009 on May 20, 2009. Since then, the Respondent has not filed its required periodic reports.

4. As discussed above, the Respondent is delinquent in its periodic filings with the Commission. The following periodic filings are delinquent.

Form	Period Ended	Due on or about
10-K	June 30, 2009	September 30, 2009
10-K	June 30, 2010	September 30, 2011
10-K	June 30, 2011	September 30, 2012
10-Q	September 30, 2009	November 15, 2009
10-Q	December 31, 2009	March 15, 2010
10-Q	March 31, 2010	May 15, 2010
10-Q	September 30, 2010	November 15, 2010
10-Q	December 31, 2010	March 15, 2011
10-Q	March 31, 2011	May 15, 2011
10-Q	September 30, 2011	November 15, 2011
10-Q	December 31, 2011	March 15, 2012
10-Q	March 31, 2012	May 15, 2012

5. As a result of the conduct described above, the Respondent 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 to institute public administrative proceedings to determine:

A. Whether the allegations set forth in Section II are true and, in connection therewith, to afford Respondent an opportunity to establish any defenses to such allegations; and,

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

IV.

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

IT IS FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220 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 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 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

June 5, 2012

In the Matter of	:	
True Product ID, Inc.,	:	ORDER OF SUSPENSION OF TRADING
File No. 500-1	:	

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of True Product ID, Inc. ("True Product") because it has not filed a periodic report since it filed its Form 10-Q for the period ending March 31, 2009, filed on May 20, 2009.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of True Product. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of True Product is suspended for the period from 9:30 a.m. EDT on June 5, 2012, through 11:59 p.m. EDT on June 18, 2012.

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. 67114 / June 5, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14905

In the Matter of **OPTIMIZED TRANSPORTATION MANAGEMENT, INC.,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

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

II.

After an investigation, the Division of Enforcement alleges that:

RESPONDENT

1. Optimized Transportation Management, Inc. ("Respondent") is a Delaware corporation formerly headquartered in Springville, Utah and now headquartered in San Antonio, Texas. Respondent has a class of equity securities registered with the Commission pursuant to Section 12(g) of the Exchange Act. The Respondent's common stock (ticker "OPTZ") is quoted on the OTC Link operated by OTC Markets Group, Inc.

DELINQUENT FILINGS

2. Section 13(a) of the Exchange Act and the rules promulgated thereunder require issuers with classes of securities registered pursuant to Section 12 of the Exchange Act to file with

the Commission current and accurate information in periodic reports. Specifically, Rule 13a-1 requires issuers to file annual reports and Rule 13a-13 requires issuers to file quarterly reports.

3. The Respondent filed its last Form 10-K for the year ended December 31, 2009 on March 31, 2010, and its last Form 10-Q for the quarter ended September 30, 2010 on November 22, 2010. Since then, the Respondent has not filed its required periodic reports.

4. As discussed above, the Respondent is delinquent in its periodic filings with the Commission. The following periodic filings are delinquent.

Form	Period Ended	Due on or about
10-K	December 31, 2010	March 31, 2011
10-K	December 31, 2011	March 31, 2012
10-Q	March 31, 2011	May 15, 2011
10-Q	June 30, 2011	August 14, 2011
10-Q	September 30, 2011	November 14, 2011

5. As a result of the conduct described above, the Respondent 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 to institute public administrative proceedings to determine:

A. Whether the allegations set forth in Section II are true and, in connection therewith, to afford Respondent an opportunity to establish any defenses to such allegations; and,

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

IV.

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

IT IS FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220 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 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 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

June 5, 2012

In the Matter of	:	
Optimized Transportation Management, Inc.	:	**ORDER OF SUSPENSION OF TRADING**
File No. 500-1	:	

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Optimized Transportation Management, Inc. ("Optimized Transportation Management") because it has not filed a periodic report since it filed its Form 10-Q for the period ending September 30, 2010, filed on November 22, 2010.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of Optimized Transportation Management. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of Optimized Transportation Management is suspended for the period from 9:30 a.m. EDT on June 5, 2012, through 11:59 p.m. EDT on June 18, 2012.

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

October 5, 2012

IN THE MATTER OF	:	
Liberty Silver Corp.	:	**ORDER OF SUSPENSION OF TRADING**
File No. 500-1	:	

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Liberty Silver Corp. ("Liberty Silver") because of questions concerning publicly available information about Liberty Silver, the control of its stock, its market price, and trading in the stock. Liberty Silver is a Nevada corporation based in Toronto, Ontario, Canada; it is quoted on the OTCBB under the symbol LBSV.

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 October 5, 2012 through 11:59 p.m. EDT, on October 18, 2012.

By the Commission.

Kevin M. O'Neill

Kevin M. O'Neill
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

October 25, 2012

IN THE MATTER OF Chimera Energy Corporation File No. 500-1	: : : : : :	**ORDER OF SUSPENSION OF TRADING**

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Chimera Energy Corporation ("Chimera") because of questions regarding the accuracy of statements by Chimera in press releases to investors concerning, among other things, the company's business prospects and agreements.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of Chimera.

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 October 25, 2012 through 11:59 p.m. EST, on November 7, 2012.

By the Commission.

Elizabeth M. Murphy
Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

March 1, 2013

In the Matter of **Southern USA Resources, Inc.,** **File No. 500-1**	**ORDER OF SUSPENSION OF TRADING**

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Southern USA Resources, Inc. ("Southern USA") because of questions regarding the accuracy of publicly-disseminated information concerning, among other things: (1) the company's operations; and (2) the company's outstanding shares. Southern USA's securities are quoted on the OTC Link, operated by OTC Markets Group Inc., under the ticker symbol "SUSA."

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

THEREFORE, IT IS ORDERED, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed company is suspended for the period from 9:30 a.m. EST, on March 1, 2013 through 11:59 p.m. EDT, on March 14, 2013.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Paredes
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

June 10, 2013

IN THE MATTER OF **Polar Petroleum Corp.** **File No. 500-1**	**ORDER OF SUSPENSION OF TRADING**

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Polar Petroleum Corp. ("Polar") because of questions regarding the adequacy and accuracy of assertions by Polar, and by others, to investors in press releases and promotional material concerning, among other things, the company's assets, operations, and financial condition. Polar is a Nevada corporation based in Anchorage, Alaska; it is dually quoted on the OTCBB and OTC Link under the symbol POLR.

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 June 10, 2013 through 11:59 p.m. EDT on June 21, 2013.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Walter,
Commissioner Gallagher
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 69895 / July 1, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15367

In the Matter of Fuqi International, Inc., Respondent.	ORDER INSTITUTING PROCEEDINGS, MAKING FINDINGS AND REVOKING REGISTRATION OF SECURITIES PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

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

II.

In anticipation of the institution of these proceedings, Fuqi has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Fuqi consents to the entry of this Order Instituting Proceedings, Making Findings, and Revoking Registration of Securities Pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Order"), and to the findings as set forth below.

III.

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

1. Fuqi (CIK No. 0001382696) is a Delaware corporation headquartered in Shenzhen, People's Republic of China ("China"). Fuqi's common stock is registered with the SEC pursuant to Section 12(g) of the Exchange Act and was traded on the NASDAQ Global Market, until it was delisted on March 29, 2011. As of June 13, 2013, Fuqi stock was quoted at

$1.43 per share on OTC Link (formerly "Pink Sheets") operated by OTC Markets Group Inc. ("OTC Link"), had 17 market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. Fuqi has failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder because it has not filed any periodic reports with the Commission since the period ended September 30, 2009.

IV.

Section 12(j) of the Exchange Act provides as follows:

> The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

In view of the foregoing, the Commission deems it necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

Accordingly, it is hereby ORDERED, that pursuant to Section 12(j) of the Exchange Act, the registration of each class of Respondent's securities registered pursuant to Exchange Act Section 12 be, and hereby is, revoked.

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. 69912 / July 2, 2013

WHISTLEBLOWER AWARD PROCEEDING
File No. 2013-2

In the Matter of the Claim for Award

in connection with

Redacted

Notice of Covered Action Redacted

ORDER DETERMINING WHISTLEBLOWER AWARD CLAIM

Claimant filed a timely whistleblower award claim pursuant to section 21F of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78u-6, in connection with Notice of Covered Action Redacted . The Claims Review Staff ("CRS") issued a Preliminary Determination recommending that Claimant 's claim should be denied. Claimant now has filed a response contesting the Preliminary Determination. For the reasons set forth below, Claimant 's claim is denied.

I. Background

A. Claimant 's Tip and the Commission's Covered Action

In approximately April 2006, Claimant submitted information to the Securities and Exchange Commission (the "Commission") about suspected accounting fraud at Redacted At that time, Claimant was the company's CEO. After May 2006, Claimant did not provide any additional information to the Commission relating to the alleged fraud.

On Redacted , the Commission filed an enforcement action against Redacted for operating a financial fraud at Redacted The Commission's action alleged that Redacted violated various anti-fraud provisions of the federal securities laws, as well as registration and books and records provisions. Redacted agreed to the entry of consent judgments that included a total of $ Redacted in disgorgement, penalties, and prejudgment interest.

On Redacted , the district court entered Redacted in favor of the Commission. Among other relief, the court ordered that Redacted pay Redacted in civil penalties, $ Redacted in disgorgement, and $ Redacted in prejudgment interest.

As noted above, Claimant filed a timely whistleblower award claim based on Notice of Covered Action Redacted , which was posted on Redacted . On Redacted , the CRS made a Preliminary Determination recommending that Claimant 's claim should be denied. The Preliminary Determination concluded that Claimant 's information was not "original information" because it was not submitted after July 21, 2010, the date that Section 21F was added to the Exchange Act by the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1]

B. Claimant 's Response to the Preliminary Determination

On Redacted , Claimant submitted a response contesting the Preliminary Determination pursuant to Rule 21F-10(e)(2) under the Exchange Act. Rule 21F-10(e)(2) provides that a claimant seeking to contest a Preliminary Determination must submit a written response within 60 days that "sets forth the grounds for your objection to either the denial of an award or the proposed amount of an award." 17 C.F.R. § 240.21F-10(e)(2).

Claimant 's response argues that:

Redacted

In the response, Claimant does not claim that – provided any information to the Commission after July 21, 2010.

II. Analysis

To be considered for an award under Section 21F, a whistleblower must voluntarily

1 Pub. L. No. 111-203, § 922, 124 Stat. 1376, 1841 (2010).

2 Redacted

provide the Commission with "original information" that leads to the successful enforcement of a covered judicial or administrative action or related action. 15 U.S.C. § 78u-6(b)(1). Under Rule 21F-4(b)(1)(iv), information will be considered "original information" only if it was provided to the Commission for the first time after July 21, 2010. 17 C.F.R. § 240.21F-4(b)(1)(iv). Claimant has not provided the Commission with any information about this covered action since Redacted , and – has not claimed otherwise in – response. The information Claimant provided to the Commission therefore is not "original information" and does not provide a basis for a whistleblower award.

III. Conclusion

Accordingly, it is ORDERED that Claimant 's whistleblower award claim be, and hereby is, denied.

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. 69906 / July 2, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15368

In the Matter of **GDT Tek, Inc.,** **Gemini Explorations, Inc.,** **Genetic Vectors, Inc., and** **Global Gate Property 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 GDT Tek, Inc., Gemini Explorations, Inc., Genetic Vectors, Inc., and Global Gate Property Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. GDT Tek, Inc. (CIK No. 880584) is a Florida corporation located in Largo, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GDT Tek 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 June 30, 2010, which reported a net loss of over $5.9 million for the prior twelve months. As of June 25, 2013, the company's stock (symbol "GDTK") was quoted on OTC Link, had fourteen market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. Gemini Explorations, Inc. (CIK No. 1373693) is a Nevada corporation located in Fort Lauderdale, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Gemini Explorations 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, 2009, which reported a net loss of $309,222 for the prior three months. As of June 25, 2013, the company's stock (symbol "GMXS") was quoted on OTC Link, had nine market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. Genetic Vectors, Inc. (CIK No. 1017157) is a tax delinquent Delaware corporation located in Miami, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Genetic Vectors is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2000, which reported a net loss of over $5.2 million for the prior nine months. As of June 25, 2013, the company's stock (symbol "GVEC") was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. Global Gate Property Corp. (CIK No. 1334345) is a defaulted Nevada corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Global Gate 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, 2011, which reported a net loss of $166,568 for the prior three months. As of June 25, 2013, the company's stock (symbol "GGPC") was quoted on OTC Link, had eight market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

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

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

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

III.

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

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

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

July 2, 2013

In the Matter of **GDT Tek, Inc.,** **Gemini Explorations, Inc.,** **Genetic Vectors, Inc., and** **Global Gate Property Corp.,** **File No. 500-1**	**ORDER OF SUSPENSION OF TRADING**

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

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Gemini Explorations, Inc. because it has not filed any periodic reports since the period ended July 31, 2009.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Genetic Vectors, Inc. because it has not filed any periodic reports since the period ended September 30, 2000.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Global Gate Property Corp. because it has not filed any periodic reports since the period ended March 31, 2011.

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

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on July 2, 2013, through 11:59 p.m. EDT on July 16, 2013.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Walter not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 69917 / July 2, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-14982

In the Matter of **Wells Fargo Brokerage Services, LLC n/k/a Wells Fargo Securities, LLC and Shawn Patrick McMurtry** **Respondents.**	**ORDER APPOINTING FUND ADMINISTRATOR AND APPROVING FUND ADMINISTRATOR BOND AMOUNT**

On August 14, 2012, the Commission issued an Order Instituting Administrative and Cease-and-Desist Proceedings pursuant to Section 8A of the Securities Act of 1933, Section 15(b) of the Securities Exchange Act of 1934, and Section 9(b) of the Investment Company Act of 1940, Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order") finding that Wells Fargo Brokerage Services, LLC n/k/a Wells Fargo Securities, LLC ("Wells Fargo") and Shawn Patrick McMurtry (collectively "Respondents") willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933. (Securities Act Rel. No. 9349 (Aug. 14, 2012)). Pursuant to the Order, Wells Fargo paid disgorgement of \$65,000, prejudgment interest of \$16,571.96, and a civil money penalty of \$6,500,000, and Shawn Patrick McMurtry paid a civil money penalty in the amount of \$25,000 for a total payment of \$6,606,571.96. The Order directed that these funds be used to create a Fair Fund pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended, and required Wells Fargo to pay all reasonable costs and expenses for the distribution of the Fair Fund. The Order further required Wells Fargo to retain a Fund Administrator "not unacceptable" to

Commission staff. Wells Fargo has informed the Division of Enforcement staff that it proposes Michael J. Liccar and Company LLC ("Liccar") as the Fund Administrator.

The Division of Enforcement staff now seeks the appointment of Liccar as the Fund Administrator and the approval of a fund administrator bond in the amount of $6,606,571.96 that is equal to size of the Fair Fund. The Division of Enforcement staff evaluated Liccar's ability to serve as the Fund Administrator for the distribution of the Fair Fund and determined that Liccar was not unacceptable.

Accordingly, pursuant to Rules 1105(a) and 1105(c) of the Commission's Rules on Fair Fund and Disgorgement Plans, 17 C.F.R. § 201.1105, IT IS HEREBY ORDERED that Liccar is appointed as the Fund Administrator, and that Liccar will obtain a bond in the manner prescribed in Rule 1105(c) in the approved amount of $6,606,571.96.

By the Commission.

Elizabeth M. Murphy
Secretary

Lynn M. Powalski

By: Lynn M. Powalski
Deputy Secretary

Commissioner Aguilar
not participating

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 69922 / July 2, 2013

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3470 / July 2, 2013

Admin. Proc. File No. 3-14171

In the Matter of JAMES M. SCHNEIDER, CPA c/o W. Neil Eggleston Kirkland & Ellis LLP 655 Fifteenth Street, N.W. Washington, D.C. 20005	ORDER DENYING MOTION OR IN THE ALTERNATIVE APPLICATION TO MODIFY COMMISSION ORDER IMPOSING REMEDIAL SANCTION

James M. Schneider is a certified public accountant and the former chief financial officer of Dell, Inc. On July 22, 2010, we filed a civil injunctive action against Dell, Schneider, and other Dell executives for fraud and various reporting and recordkeeping violations.[1] Schneider subsequently agreed to be permanently enjoined by a U.S. district court from future violations of, among other things, the antifraud provisions of the federal securities laws. He also agreed to the Commission's filing a follow-on administrative proceeding against him, pursuant to which Schneider consented to our suspending him from appearing or practicing before the Commission as an accountant, with the right to apply for reinstatement after five years. Schneider now asks the Commission to clarify that suspension order "to prevent the existing order from being construed by the Staff of the Commission as barring activities that are outside the scope of [our Rule of Practice Rule 102(e)(3)(i)]."[2] In particular, Schneider asks us to clarify that our Rule

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1 *SEC v. Dell Inc.*, No. Civ. 1:10-cv-01245 (D.D.C. July 22, 2010), *available at* http://www.sec.gov/litigation/complaints/2010/comp21599.pdf.

2 Respondent's Mot. Under SEC Rule[ ] of Practice 154 or in the Alternative Appl. for Modification of Comm'n Order Imposing Remedial Sanctions Against James M. Schneider at 1 ("Respondent's Mot.") (citing 17 C.F.R. § 201.102(e)(3)(i) (providing that the Commission may suspend from practicing before it any accountant who has been "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")).

102(e) order "does not preclude Mr. Schneider from serving on the audit committee of a Commission registrant or as the CFO of a public company, so long as he does not serve as the principal accounting officer."[3] For the reasons below, we deny Schneider's motion.

I.

A. Schneider consented to a suspension from appearing or practicing before the Commission as an accountant after the Commission instituted civil proceedings against him.

On July 22, 2010, we instituted civil proceedings against Dell and certain of its executives, including Schneider, in the United States District Court for the District of Columbia. Among other violations, the complaint alleged that Dell, Schneider, and other Dell executives engaged in fraud by failing to disclose material information and using an accounting scheme to create the false appearance that the company was consistently meeting Wall Street earnings targets and reducing its operating expenses. According to the complaint, Dell had failed to disclose large "exclusivity payments" that Intel Corporation made to Dell not to use processors made by Intel's rival, Advanced Micro Devices, Inc. ("AMD"). The complaint alleged that, without these payments, Dell would have missed analysts' consensus earnings-per-share estimates for every quarter from fiscal years 2002 through 2006. Although these payments amounted to 76% of Dell's operating income by the first quarter of fiscal year 2007, "Dell did not disclose the existence, much less the magnitude, of the Intel exclusivity payments."[4]

In May 2006, Dell announced its intention to use AMD's processors in some of its products. Intel responded by cutting its exclusivity payments, and Dell subsequently reported a 36% drop in its operating income. "In dollar terms," the complaint explained, "the reduction in Intel exclusivity payments was equivalent to 75% of the decline in Dell's operating income."[5] But Schneider falsely told analysts and investors in a quarterly earnings call that the drop in the company's operating results "was attributable to Dell pricing too aggressively in the face of slowing demand and to component costs declining 'less than we anticipated.'"[6]

According to the complaint, Schneider also "engaged in a wide-ranging accounting fraud by maintaining a series of 'cookie jar' reserves that [the company] used to cover shortfalls in operating results from FY02 to FY05."[7] These manipulations, the complaint explained, "were undertaken to meet consensus earnings targets or to misstate materially important financial

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3 Respondent's Mot. ¶ 29.

4 Compl. ¶ 69.

5 *Id.* ¶ 3.

6 *Id.* ¶ 63 (quoting statements that were in a script circulated before the earnings call to certain Dell personnel).

7 *Id.* ¶ 4.

metrics."[8] This manipulation "not only materially misstated Dell's financial results, but caused material misstatements in Dell's annual and quarterly reports filed with the Commission during the period."[9] For example, in the second quarter of 2004, a Dell finance director told Schneider that Dell's Europe, Middle East, and Asia ("EMEA") unit "was having difficulty meeting its $159 million operating income target."[10] Schneider replied, "We need $175m. You need to tell me how we will get it. I suggest you not be too proud and see what [a vice president of marketing] has socked away."[11] The finance director complied with Schneider's request and released $16 million that had been put away. "The release of this cookie jar reserve," the complaint explained, "allowed the EMEA segment to report eight consecutive quarters of increasing operating income."[12] Without the reserve, "EMEA's operating income in Q1FY05 would have declined by about 12.5% from the prior quarter, rather than increased by 3.1%."[13]

The complaint concluded that, because of this misconduct, Schneider violated Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933,[14] Section 13(b)(5) of the Securities Exchange Act of 1934,[15] and Exchange Act Rules 13a-14, 13b2-1, and 13b2-2.[16] It also alleged that Schneider aided and abetted Dell's violations of Exchange Act Sections 13(a),

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8 *Id.* ¶ 84.

9 *Id.*

10 *Id.* ¶ 110.

11 *Id.*

12 *Id.* ¶ 111.

13 *Id.*

14 15 U.S.C. §§ 77q(a)(2) (prohibiting any person from "obtain[ing] money or property by means of any untrue statement of a material fact or any omission to state a material fact"), 77q(a)(3) (prohibiting any person from "engag[ing] in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser").

15 *Id.* § 78m(b)(5) (providing that "[n]o person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record or account . . .").

16 17 C.F.R. §§ 240.13a-14 (requiring CFOs to certify in periodic reports that, based on personal knowledge, the report does not contain any untrue statement of material fact or omit any material fact), 240.13b2-1 (providing, in part, that "[n]o person shall directly or indirectly, falsify or cause to be falsified, any book, record or account . . ."), 240.13b2-2 (prohibiting any officer or director of an issuer from making or causing to be made any materially false or misleading statement in connection with the preparation of reports and documents required by the Exchange Act).

13(b)(2)(A), and 13(b)(2)(B)[17] and Rules 12b-20, 13a-l, and 13a-13.[18] Without admitting or denying the allegations, Schneider consented to a permanent injunction, disgorgement, and civil penalties.[19]

On December 22, 2010, Schneider consented to our initiating administrative follow-on proceedings against him pursuant to our Rule of Practice 102(e)(3)(i).[20] In connection with an order instituting and settling those proceedings, Schneider consented to being "suspended from appearing or practicing before the Commission as an accountant" with a right to reapply after five years.[21]

B. Schneider continued to serve as a member of a public company's audit committee after the Commission imposed a bar.

At the time we instituted the civil injunctive proceedings, Schneider was serving as a director and audit committee member at three publicly held companies. Schneider subsequently resigned from two of those companies, but he continued to serve as an audit committee member at General Communications, Inc. ("GCI"), an Alaska-based communications provider listed on NASDAQ. According to GCI's proxy statement filed with the Commission on May 12, 2011, Schneider was chair of GCI's audit committee and was designated as an audit committee financial expert.[22] Schneider's name, as chair of the audit committee, also appeared on GCI's audit committee report, which the company included in its proxy statement.[23] In its filing, GCI stated that the company's audit committee reviewed GCI' s financial statements, discussed the financial statements and the accounting principles applied in those financial statements with

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17 15 U.S.C. §§ 78m(a) (requiring issuers to file periodic reports in accordance with Commission rules), 78m(b)(2)(A) (requiring issuers to make and keep books, records, and accounts that, in reasonable detail, accurately and fairly reflect their transactions and dispositions of assets), 78m(b)(2)(B) (requiring issuers to devise and maintain internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with Generally Accepted Accounting Principles and to maintain accountability for assets).

18 17 C.F.R. §§ 240.12b-20 (requiring issuers to provide any additional material information necessary to make required statements, in the light of the circumstances under which they are made, not misleading), 240.13a-l (requiring issuers to file annual reports), 240.13a-13 (requiring issuers to file quarterly reports).

19 *SEC v. Dell*, No. Civ. 1:10-cv-01245 (D.D.C. Oct. 13, 2010) (imposing final judgment as to Schneider).

20 *James M. Schneider, CPA*, Securities Exchange Act Release No. 63600, 2010 SEC LEXIS 4422, at *6 (Dec. 22, 2010).

21 *Id.* In consenting to the suspension, Schneider neither admitted nor denied our findings, except as to the Commission's jurisdiction over him, the subject matter of the proceedings, the Commission's having filed a complaint against him, and the district court's having permanently enjoined him from violating certain securities laws.

22 Gen. Commc'ns, Inc., Definitive Proxy Statement (Form Def 14A) 23–24 (May 12, 2011); *see* Regulation S-K, Item 407, 17 C.F.R. § 229.407(d)(5) (defining "audit committee financial expert").

23 Gen. Commc'ns, Inc., Definitive Proxy Statement 75.

GCI's auditor, and recommended to GCI's board that the financial statements be filed with the Commission.

On August 5, 2011, Commission staff notified GCI and Schneider's counsel that Schneider was violating the terms of the Commission's Rule 102(e) order by serving on GCI's audit committee. Schneider resigned from GCI's audit committee and then filed the present motion seeking clarification of our Rule 102(e) order.

II.

A. Schneider seeks a ruling that our Rule 102(e) order does not preclude Schneider from serving in certain positions, such as a CFO or audit committee member.

Schneider asks us to "issue an order clarifying that the Rule 102(e) Order does not prohibit him from accepting non-accountant positions, such as positions on an audit committee or as a non-accountant CFO."[24] He argues that the reason for such a clarification is "to prevent the existing order from being construed by the Staff of the Commission as barring activities outside the scope of [Rule 102(e)]."[25] In support, Schneider argues that the staff has already once exceeded its authority under our order by demanding that he resign from GCI's audit committee.[26]

Schneider contends that Commission staff has not cited any authority, nor is he aware of any, that "would have given [him] notice that," by agreeing to the Rule 102(e) order, he would be prohibited from "serv[ing] on an audit committee or as the CFO of a public company so long as he did not act as the principal accounting officer."[27] Schneider concedes that he "theoretically could attempt to accept such a position and require the Staff to bring an enforcement action," but argues that "the Staff's past conduct with GCI demonstrates that any issuer that would appoint Mr. Schneider to its audit committee or as its CFO is likely to be threatened with an enforcement action."[28] Because of this, Schneider argues, a clarification of our order is necessary.

The Division opposes Schneider's motion, arguing that Schneider had fair notice that our Rule 102(e) order would prohibit him from serving on a public company's audit committee or as a CFO. The Division contends that such a prohibition is consistent with Rule 102(e)'s remedial purpose of ensuring that accountants, "on whom the Commission relies heavily in the performance of its statutory duties, perform their tasks diligently and with a reasonable degree of

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24 Respondent's Reply to Br. of the Div. of Enforcement in Opp'n to Respondent's Mot. ("Respondent's Reply") at 3.

25 Respondent's Mot. at 1.

26 *Id.* ¶ 19.

27 *Id.* ¶ 26.

28 *Id.* ¶ 28.

competence."'[29] The Division further concludes that Schneider's request is not ripe for review "because Schneider fails to present any specific job functions for Commission review, and the staff stands ready to provide specific guidance when necessary [about any future role Schneider may wish to take]."[30]

B. Schneider's proposed clarification is inconsistent with our order and the rule on which it is based.

Schneider seeks a ruling from us that our Rule 102(e) order does not prohibit him from "accepting non-accountant positions, such as positions on an audit committee or as a non-accountant CFO."[31] We find no basis for granting this request. As explained below, the applicability of our order depends on the particular tasks and responsibilities involved with any future position that Schneider may seek to undertake. Schneider's proposed clarification, by comparison, would exempt entire job titles from our order, regardless of what tasks or responsibilities those positions entailed. Granting such a request would undermine the remedial purpose of our order and the rule on which it is based.

We barred Schneider from appearing or practicing before us as an accountant pursuant to our authority under Rule 102. That rule defines "practicing before the Commission" as including, but not limited to, "[t]ransacting any business with the Commission" and "[t]he preparation of any statement, opinion or other paper by any . . . accountant . . . filed with the Commission in any registration statement, notification, application, report or other document with the consent of such . . . accountant."[32] Determining whether a particular position fits within that definition involves a "fact-specific inquiry" into the conduct involved when serving in such a position.[33] As a U.S. district court recently explained, someone who is appearing or practicing before the Commission as an accountant includes persons who "'participate[d] in the preparation of' financial statements filed with the Commission by, for example, 'creat[ing],' 'compil[ing]' or

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29 Br. of the Div. of Enforcement in Opp'n to Respondent's Mot. at 12 (quoting *Michael C. Pattison, CPA*, Exchange Act Release No. 67900, 2012 SEC LEXIS 2973, at *16 (Sept. 20, 2012)).

30 *Id.* at 19.

31 Respondent's Reply at 3.

32 17 C.F.R. § 201.102(f). Because we barred Schneider pursuant to our authority under Rule 102, that rule's definitions apply to our order. *Cf. Charles E. Gaecke*, Investment Advisers Act Release No. 2681, 2007 SEC LEXIS 2809, at *9 (Dec. 4, 2007) (stating that, because "we issued the Bar Order pursuant to our authority under the Advisers Act . . . the definition of 'investment adviser' in the Advisers Act applies when that term is used in the Bar Order").

33 Br. of the Div. of Enforcement in Opp'n to Respondent's Mot. at 18 (quoting *SEC v. Brown*, 878 F. Supp. 2d 109, 127 (D.D.C. 2012)).

'edit[ing]' information or data incorporated into those documents and consenting to their incorporation."[34]

Nothing in this definition discusses, let alone exempts, specific job titles, such as CFO or audit committee member. This is by design. As we recognized in our release adopting the 1998 amendments to Rule 102(e), the Commission's limited resources mean that the Commission and the investing public must "rely heavily on accountants to assure corporate compliance with federal securities law and disclosure of accurate and reliable financial information."[35] Accountants play "a particularly important role . . . in preparing and certifying the accuracy of financial statements of public companies that are so heavily relied upon by the public in making investment decisions."[36] This process is impaired if incompetent or unethical accountants are permitted to participate in the preparation of financial statements certified and filed with the Commission.[37] We therefore promulgated Rule 102(e) to ensure that these professionals on whom we rely so heavily "'perform their tasks diligently and with a reasonable degree of competence.'"[38]

These remedial purposes would be undermined if we were to hold that Schneider could avoid the prohibition in our Rule 102(e) order by accepting a position based only on that position's title or on whether non-accountants could accept such a position.[39] Incompetent or

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[34] *Brown*, 878 F. Supp. 2d at 125 (quoting *Robert W. Armstrong III*, Exchange Act Release No. 51920, 2005 SEC LEXIS 1497, at *47–48 (June 24, 2005) (finding that the controller of a public company's subsidiary appeared and practiced before the Commission as an accountant)); *accord SEC v. Prince*, No. 09-1423, 2013 U.S. Dist. LEXIS 62691, at *99 (D.D.C. May 2, 2013) (quoting *Armstrong* and finding that a public company employee, serving as "Director of Mergers and Acquisitions," violated a Rule 102(e) order by appearing and practicing before the Commission as an accountant).

[35] *Amendment to Rule 102(e) of the Commission's Rules of Practice*, 63 Fed. Reg. 57,164, 57,165 (Oct. 26, 1998).

[36] *Marrie v. SEC*, 374 F.3d 1196, 1200–01 (D.C. Cir. 2004) (noting the reason for the Commission's adoption of the amendments to Rule 102(e)); *accord Amendment to Rule 102(e)*, 63 Fed. Reg. at 57,165 (stating that, because of the Commission's limited resources, it "must rely on the competence and independence of . . . the accountants who prepare . . . financial statements).

[37] *See Armstrong*, 2005 SEC LEXIS 1497, at *48 (concluding that the "disciplining [of] accountants pursuant to Rule 102(e) for effecting a fraudulent scheme by computing the figures and providing the information incorporated into Commission filings furthers the Rule's remedial purpose of protecting the integrity of the Commission's processes").

[38] *Marrie*, 374 F.3d at 1200 (quoting *Touche Ross & Co. v. SEC*, 609 F.2d 570, 582 (2d Cir. 1979)); *accord Gregory M. Dearlove, CPA*, Exchange Act Release No. 57244, 2008 SEC LEXIS 223, at *107 (Jan. 31, 2008) (noting that the Commission adopted Rule 102(e) "to ensure the Commission's 'processes continue to be protected, and that the investing public continues to have confidence in the integrity of the financial reporting process'" (quoting *Amendment to Rule 102(e)*, 63 Fed. Reg. at 57,164)), *petition denied*, 573 F.3d 801 (D.C. Cir. 2009).

[39] *Cf. Armstrong*, 2005 SEC LEXIS 1497, at *46 (finding that controller of a registrant's subsidiary was appearing or practicing before the Commission despite not signing the financial statements filed with the Commission because to find otherwise "would allow accountants to escape discipline under Rule 102(e) simply by instructing someone else to draft, sign, and file fraudulent documents").

unethical accountants pose a risk to our process regardless of what title they hold—or whether or not they are even licensed accountants. Accountants, we have explained, "often serve as corporate officers, and the integrity of the Commission's processes is threatened when they execute fraudulent schemes by providing falsified financial information just as when licensed accountants engage in this conduct."[40] This interpretation of Rule 102(e)'s remedial purpose, we have noted, also accords with cases in which we have denied the privilege of appearing or practicing before the Commission to incompetent or unethical accountants serving in a variety of positions, including the very ones that Schneider seeks to carve out of our order.[41] And a U.S. district court recently found that someone serving in a "general advisory role" with the title "Director of Mergers and Acquisitions" violated a Rule 102(e) order prohibiting him from appearing or practicing before the Commission as an accountant.[42] The court found that, even though the company established procedures designed to ensure that this person "would not be involved with the accounting department and accounting data," he violated the Rule 102(e) order by preparing financial data and determining how particular data should be treated in the company's financial statements.[43]

This breadth of ways in which accountants can threaten our processes highlights the inherent difficulty of enumerating every position that Schneider could take that would be prohibited by, or consistent with, our Rule 102(e) order, but that does not, as Schneider argues, render our order impermissibly vague.[44] As courts have explained, it is often sufficient that a

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40 *Id.* at *52.

41 *See id.* at *49 (noting that, for purposes of defining what constitutes appearing or practicing before the Commission, broadly interpreting Rule 102(e)'s remedial purpose "accords with the settled cases in which we have denied the privilege of appearing or practicing before the Commission to accountants serving as officers of privately-held subsidiaries of public companies"); *cf., e.g., Pattison*, 2012 SEC LEXIS 2973, at *51–52 (permanently disqualifying former controller of a public company from appearing or practicing before the Commission as an accountant); *Steven A. Gould, CPA*, Exchange Act Release No. 68500, 2012 SEC LEXIS 4013, at *4 (Dec. 20, 2012) (settled order) (suspending former CFO from appearing or practicing before the Commission as an accountant); *James S. Quay*, Exchange Act Release No. 68234, 2012 SEC LEXIS 3522, at *4 (Nov. 14, 2012) (settled order) (suspending respondent, who was not licensed as a certified public accountant, from appearing or practicing before the Commission as an accountant); *H. Clayton Peterson, CPA*, Exchange Act Release No. 67282, 2012 SEC LEXIS 1982, at *3 (June 27, 2012) (suspension order) (suspending former board member and audit committee chairman, whose certified public accounting license had expired, from appearing or practicing before the Commission because he had been convicted of a felony); *Lynne Norman*, Exchange Act Release No. 66352, 2012 SEC LEXIS 437, at *5 (Feb. 7, 2012) (settled order) (suspending former controller, who held no accounting licenses or certifications, from appearing or practicing before the Commission as an accountant).

42 *Prince*, 2013 U.S. Dist. LEXIS 62691, at *7–8, *110–11.

43 *Id.*

44 *See DiCola v. FDA*, 77 F.3d 504, 509 (D.C. Cir. 1996) ("The FDA chose . . . not to write the debarment order in terms more specific than those in the statute because of the difficulty inherent in defining what constitutes a sufficient nexus with the regulatory scheme under all circumstances." (internal quotation omitted)); *cf. Perez v. Hoblock*, 368 F.3d 166, 175 (2d Cir. 2004) ("Limitations inherent in the English language often prevent the drafting of statutes 'both general enough to take into account a variety of human conduct and sufficiently specific to provide

proscription "'mark out the rough area of prohibited conduct, allowing law-abiding individuals to conform their conduct by steering clear of the prohibition.'"[45] In implementing such a proscription, "[n]o more than a reasonable degree of certainty can be demanded and it is not unfair to require that one who deliberately goes perilously close to an area of proscribed conduct shall take the risk that he may cross the line."[46]

Therefore, while our order in this case may not precisely enumerate the job titles that Schneider could take and comply with our order, we find that our order nevertheless provides a sufficient standard by which Schneider can judge his ability to accept a particular position.[47] There are nearly limitless positions that Schneider could safely take that have nothing to do with preparing financial statements of public companies. Some positions, however, will involve duties that increase the likelihood that Schneider could engage in prohibited conduct, including the two that Schneider seeks to exempt from our order (audit committee member and CFO).[48] Determining whether Schneider could accept such positions will unavoidably involve a closer call. Our order reasonably places Schneider on notice that, the more a prospective position is associated with the preparation of a company's financial statements, the more Schneider's acceptance of such a position without prior approval from the Commission would be done "at his peril."[49] For these reasons, we find no basis for modifying or clarifying our order.[50]

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fair warning that certain kinds of conduct are prohibited.'" (quoting *Arnett v. Kennedy*, 416 U.S. 134, 159–60 (1974))).

45 *DiCola*, 77 F.3d at 509 (quoting *United States v. Thomas*, 864 F.2d 188, 194 (D.C. Cir. 1988)).

46 *Id.* at 508 (quoting *Throckmorton v. Nat'l Transp. Safety Bd.*, 963 F.2d 441, 445 (D.C. Cir. 1992)).

47 *See id.* at 509 (concluding that it was "fanciful for [debarred person] to say that he can only 'guess' at the meaning of the debarment order; he will usually have a pretty good idea whether a position at a firm that is not itself a drug manufacturer runs afoul of the remedial purpose for which he has been debarred from providing services to a drug house").

48 *See, e.g.*, 15 U.S.C. §§ 7203(a)(3) (defining audit committee as a committee established "for the purpose of overseeing the accounting and financial processes of the issuer and audits of the financial statements of the issuer"), 7241(a) (requiring chief financial officers, or the equivalent, to certify the issuer's periodic reports).

49 *DiCola*, 77 F.3d at 505, 509 (noting that an executive barred from "provid[ing] any type of service to a person that has an approved or pending drug product application" was "on notice that, without prior approval from the FDA, he gets close to the pharmaceutical industry at his peril"); *see also Disclosure Required by §§ 404, 406 & 407 of the Sarbanes-Oxley Act of 2002*, Exchange Act Release No. 46701, 67 Fed. Reg. 66,208, 66,212 (Oct. 22, 2002) (noting that, "[b]ecause of the significant role the audit committee plays in the filing of a public company's financial statement, . . . any accountant, while suspended or barred from practice under Rule 102(e) of the Commission's Rules of Practice, generally would not be eligible to serve as a financial expert [on an audit committee]"). Schneider interprets our comments in the immediately preceding authority about financial experts as supporting his argument that he may serve on an audit committee so long as he does not serve as a financial expert. If anything, however, these comments simply emphasize that, the greater one's involvement with a public company's financial statements, the greater the likelihood that one may violate a Rule 102(e) order.

50 The Division argues that we should also deny Schneider's motion using our more traditional analysis of bar and suspension modifications. Although Schneider titles his motion as a "modification" of our order, he expressly

In denying Schneider's motion, we express no opinion on whether our Rule 102(e) order prohibits Schneider from taking any of the hypothetical positions he posits.[51] Nor do we express any opinion on whether any of the positions Schneider held in the past, such as at CGI, violated our order, as those questions are not before us. Nor can we can find any basis, given the record before us, to conclude that Commission staff somehow misled Schneider about the scope or applicability of our Rule 102(e) order when he consented to our order's prohibitions. Schneider asserts, for example, that he lacked notice that he would be prohibited from serving on an audit committee or as a CFO because he was serving on three audit committees at the time he consented to our order. As described herein, however, we find that Rule 102 and case law interpreting that rule gave Schneider sufficient notice of what conduct our order proscribed, and nothing in the record before us provides a basis to conclude otherwise. Furthermore to the extent Schneider is uncertain about an actual position he may seek to take sometime in the future, the Division has represented its willingness to provide guidance to Schneider regarding such potential positions. It is entirely possible, therefore, that Schneider "posits an injury that may never materialize."[52]

Accordingly, IT IS ORDERED that James M. Schneider's motion and, in the alternative, application for modification of the Commission's order imposing remedial sanctions are DENIED.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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represents in his reply brief that he is not seeking a modification to our order, only a clarification. *See* Respondent's Reply at 18–19 (explaining that his motion "bears no resemblance to petitions for relief, which seek to absolve a petitioner of an obligation by which he or she is admittedly bound").

[51] *Cf. Hoblock*, 368 F.3d at 175 (stating that the evaluation of whether a regulation is vague as applied to a particular person "must be made with respect to [his] actual conduct and not with respect to hypothetical situations at the periphery of the [regulation's] scope or with respect to the conduct of other parties who might not be forewarned by the broad language").

[52] *United States v. Colasuonno*, 697 F.3d 164, 183 (2d Cir. 2012) (declining to amend a written judgment and citing *Simmonds v. INS*, 326 F.3d 351, 357 (2d Cir. 2003) (stating that ripeness requirement allows courts "to avoid becoming embroiled in adjudications that may later turn out to be unnecessary")).

Commissioner Aguilar
not participating

SECURITIES AND EXCHANGE COMMISSION
Washington D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 69923 / July 2, 2013

Admin. Proc. File No. 3-14609

In the Matter of the Application of WILLIAM J. MURPHY and CARL M. BIRKELBACH For Review of Disciplinary Action Taken by FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION -- REVIEW OF DISCIPLINARY PROCEEDINGS

Discretionary Trading Without Written Authorization

Unauthorized Trading

Unsuitable Trading

Churning

Misleading Communications

Failure to Supervise

Registered securities association found that registered representative, while associated with member firm, engaged in discretionary trading without written authorization, engaged in unauthorized trading, engaged in unsuitable and excessive trading, churned customer accounts, and caused the creation and distribution of inaccurate, unbalanced and misleading communications. The association also found that president of member firm failed to establish and maintain a supervisory system reasonably designed to achieve compliance with applicable securities laws and regulations and with association rules. *Held*, association's findings of violations and sanctions imposed are *sustained*.

APPEARANCES:

William J. Murphy, pro se.

James J. Moylan, of James J. Moylan and Associates, P.C., for Carl M. Birkelbach.

Marc Menchel, James Wrona, and *Michael J. Garawski* for Financial Industry Regulatory Authority, Inc.

Appeal filed: October 28, 2011
Last brief received: April 26, 2012

I.

William J. Murphy and Carl M. Birkelbach, formerly associated with Birkelbach Investment Securities, Inc. ("BIS"), appeal from FINRA disciplinary action.[1] FINRA found that Murphy (i) engaged in discretionary trading without written authorization in violation of NASD Rules 2510(b), 2860(b), and 2110; (ii) engaged in unauthorized trading and trading beyond approved levels in a customer's account in violation of NASD Rule 2110; (iii) engaged in unsuitable and excessive trading in violation of NASD Rules 2310, 2860, and 2110; (iv) churned customer accounts in violation of Section 10(b) of the Securities Exchange Act of 1934, Exchange Act Rule 10b-5, and NASD Rules 2120, 2310, and 2110; and (v) caused the creation and distribution of inaccurate, unbalanced and misleading communications in violation of NASD Rules 2210, 2220, and 2110. Based upon these violations, FINRA barred Murphy from associating with any member firm in any capacity and ordered him to pay $585,174.67 in disgorgement. Additionally, FINRA found that Birkelbach failed to supervise Murphy in violation of NASD Rules 3010, 2860(b), and 2110. For his supervisory failures, FINRA barred Birkelbach in all capacities. We base our findings on an independent review of the record.

II.

Applicants had long careers in the securities industry. Murphy entered the industry in 1985 and became associated with BIS in 1995. Murphy was registered as a general securities representative and general securities principal, and he eventually became the second-ranking

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1 FINRA is a private, not-for-profit, self-regulatory organization registered with, and overseen by, the Securities and Exchange Commission. It was created in July 2007 following the consolidation of the National Association of Securities Dealers, Inc. and the member regulation, enforcement, and arbitration functions of the NYSE Regulation, Inc. *[No Name in Original]*, Exchange Act Release No. 56751, 2007 WL 4302651, at *1 (Nov. 6, 2007); *Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes To Accomm. the Consol. of the Member Firm Regulatory Functions of NASD and NYSE Reg., Inc.*, Exchange Act Release No. 56145, 2007 WL 5185330, at *29 (July 26, 2007). Though this case was instituted after the consolidation, some of the conduct at issue took place before then. Accordingly, this opinion refers to those conduct rules that were in place at the time.

officer at BIS. Birkelbach founded BIS in 1983 and served as its president. Birkelbach was registered as a general securities representative and general securities principal, a municipal securities representative and municipal securities principal, an options principal, and a financial and operations principal. The conduct at issue took place between 2002 and 2007 and involved the accounts of two BIS customers: Amy Lowry and Benjamin Martinelli.

A. Murphy's management of Lowry's account

Lowry is a mother of three, a writer and illustrator of children's books, and a painter. In 1998, Lowry's father, who had been an executive at Proctor & Gamble ("P&G"), placed approximately 47,000 shares of P&G stock worth approximately $4 million in a trust for Lowry's benefit. Lowry, as trustee, deposited the shares in an account at Fidelity Investments. Lowry's father died in 1999, and Lowry divorced the same year.

In 2001, a trader friend of Lowry's, Frank DeMaria, suggested that she consider a covered call strategy of options trading as a way to generate additional income from her P&G stock.[2] A covered call strategy involves "writing" (*i.e.*, selling) covered call options and "is commonly used by investors who desire to increase the income which they derive from ownership of stock."[3] After explaining the basics of the covered call strategy to Lowry, DeMaria then helped Lowry write ten covered call options on P&G stock in her Fidelity account. DeMaria suggested that Lowry talk with Pat Jage, a registered representative at BIS, about opening an account at BIS in order to pursue a covered call strategy.

In October 2001, Lowry opened an options and margin account with Jage at BIS, where she deposited 20,000 shares of P&G stock, which at the time were valued at approximately $1.5 million. The account documentation, which included a new account form and an option

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2 With respect to Lowry's account, this case involves the trading of stock options. Options are divided into two types: calls and puts. "A call option gives the buyer the right to buy shares (usually 100) of the underlying security at the stated exercise price within a specified period of time. A put option gives the buyer the right to sell such shares at the exercise price within the specified period. The exercise price (striking price) is the fixed price per unit at which the holder of the option may purchase or sell the underlying stock." *Thomas J. Furnari*, Exchange Act Release No. 21046, 47 SEC 1074, 1984 WL 472728, at *1 n.2 (June 14, 1984). "Writing a covered call" means to sell an option while maintaining the underlying stock. Conversely, "[a] call writer selling a naked (uncovered) option does not own the underlying security." *Id.*

3 Norman S. Poser, *Options Account Fraud: Securities Churning in a New Context*, 39 Bus. Law. 571, 589 (1984). A covered call strategy has the potential to generate income because the covered call writer receives a premium from selling the call. If the price of the underlying security never exceeds the exercise price before the option expires, then the buyer of the option will not exercise the option. The call option thus expires worthless, allowing the call writer to retain the premium as profit. If, however, the price of the underlying security exceeds the exercise price before the option expires (*i.e.*, the option is "in the money"), then the call buyer will exercise the option, and the covered call writer will be required to sell the underlying security to the call buyer at a price lower than the market price. To avoid having to sell the underlying security to the call buyer, the covered call writer may buy back the identical call option at a loss (because the option now has a higher price) before the option is exercised. This is called a closing or liquidating transaction.

agreement and approval form, indicated that Lowry was a 44-year-old, self-employed, single mother with three dependents and an annual income of "$55,000+."[4] The bulk of her annual income came from dividends from her P&G stock. The new account form indicated that her "liquid net worth excluding her residence" was "$2,500,000+."[5]

The account opening documents noted that Lowry's investment objectives were "income," "long-term growth," and "income & appreciation," and her risk exposure level was "moderate."[6] Lowry's overall objective was to generate income without having to sell her P&G stock. She did not want her P&G stock to be called away (*i.e.*, sold to satisfy an obligation on a call option) because she had an emotional attachment to P&G and because she had a low tax basis in the stock. The option agreement, which was reviewed and signed by Birkelbach, approved Lowry's account only for "covered writing" and "buying" of stock options.[7] The account forms did not approve Lowry's account for discretionary trading.

Although she previously had accounts that held securities, Lowry had no prior experience with securities trading other than once trading some Ben & Jerry's stock and the P&G options transactions she had executed with DeMaria's help.[8] Lowry's testimony demonstrates that, while she had a rudimentary understanding of the covered call strategy, she lacked a sophisticated understanding of options trading.

Jage handled Lowry's account until July 2002, when he abruptly left BIS due to illness. During the time he managed the account, Jage wrote only covered calls, and when he left BIS, Lowry's account was valued at approximately $1.7 million and had no margin debt. Following Jage's departure, Birkelbach transferred Lowry's account to Murphy. Around the time Murphy

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4 Exs. JX-15, JX-16.

5 Ex. JX-15. The option agreement indicated that she had "cash" of "$2,500,000+," "marketable securities" of "$2,500,000+," "real estate (exclusive of family residence)" worth $350,000, and a "total net worth" of "2,500,000+." Ex. JX-16. But Lowry testified that, contrary to what the option agreement reflected, she kept a cash balance of only about $20,000 to $30,000.

6 Ex. JX-15.

7 Ex. JX-16. Lowry signed the original option agreement again on November 1, 2004. *See* Ex. JX-17. Lowry testified that she believed she was simply re-signing the agreement so that her account paperwork would reflect a name change (she had stopped using her first husband's last name). At some point, however, the agreement was altered to indicate that the account was approved for both "uncovered writing" and "spreading" (an options strategy that involves buying and selling equal numbers of options of the same type on the same underlying security but with different strike prices or expiration dates). The parties stipulated that in November 2004 Birkelbach approved the account for uncovered options writing, but Lowry testified that neither Birkelbach nor Murphy informed her that her account was being approved for uncovered writing and spreading.

8 Despite this fact, the new account form indicated that she had ten years of investment experience, and the option agreement indicated that she had 25 years of investment experience with stocks and bonds and one year of experience with options. Lowry testified that Jage knew she had no trading experience but he told her that inflating her investment experience on the opening documentation was "a common thing to do" and would "facilitate the opening of the account" and allow her to pursue the covered call strategy. Transcript of Hearing ("Tr.") at 120.

took over the account, Lowry expressed concerns to him about trading losses and commissions during the time Jage handled the account. Murphy apologized and told Lowry that he would lower the commissions and that the account would make money going forward. Lowry told Murphy to continue to pursue the covered call strategy and reiterated that she did not want her P&G stock called away. Lowry testified that she trusted Murphy and gave him oral permission to execute trades in her account without prior approval from her. But Lowry never provided written authorization for Murphy to exercise trading discretion in her account.

After Murphy was assigned to Lowry's account, trading in the account increased dramatically. Between July 2002 and February 2006, Murphy made 2,594 options trades involving more than 67,000 P&G option contracts. Murphy frequently traded options in Lowry's account several times a week—sometimes multiple times on a single day. At the peak of his trading in the account, between November 2004 and January 2006, Murphy traded between 4,000 and 8,000 option contracts per month. Murphy's trading involved numerous "round-trip" trades, meaning that he would repeatedly sell and buy back the same series of option contracts. For example, between August 5, 2004, and January 5, 2005, Murphy effected 11 round-trip trades of P&G call options with a January 2005 expiration and a $55 exercise price, which resulted in a loss of $74,162, including $34,142 in commissions. Murphy's trading activity ultimately generated over one million dollars in commissions during the approximately three-and-a-half years he was assigned to the account. During this time, the account also incurred substantial trading losses and a large margin debit balance. Between October 2003 and February 2006, Lowry's account consistently ran a margin debit balance, with the month-end margin debit balance reaching as high as $1.16 million (on July 31, 2005). Lowry ultimately paid $125,034 in margin interest. For the period Murphy was assigned to the account, the annualized cost-to-equity ratio—the amount the account would have to appreciate to break even—was 25.59%.[9] The cost-to-equity ratios for 2004 and 2005 were even higher, at 31.25% and 48.56%, respectively.

In addition to the high volume of trading in the account, Murphy also engaged in a substantial number of transactions that were not part of a covered call strategy and that went beyond the type of trades orally agreed to by Lowry and authorized by her BIS option agreement. Although Jage had confined his trading in Lowry's account to pursuing the covered call strategy, Murphy almost immediately upon being assigned to the account began trading that was not part of a covered call strategy: he wrote uncovered calls, uncovered puts, and combinations.[10] Such trading was frequent, with Lowry's account holding option positions that were not covered calls at the end of every month between July 2002 and October 2004.

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9 Without taking margin interest into account, the annualized cost-to-equity ratio during the same time period was 22.75%.

10 "A combination is any strategy involving the purchase or sale of both puts and calls." *Furnari*, 1984 WL 472728, at *1 n.2.

Murphy spoke with Lowry on the phone approximately once a month at the start of his management of her account and more frequently near the end. But Murphy did not consult with Lowry before executing each trade, and he never told her that he was pursuing options trading beyond a covered call strategy. Lowry received account statements, but she did not regularly review them and did not understand them when she did—a fact that Lowry told Murphy.

Moreover, many of the statements that Murphy caused to be created and sent to Lowry contained errors and inconsistencies. For example, at Murphy's direction, profit and loss reports were sent to Lowry that purported to show the options transactions that occurred during the period covered by the report and the resulting profits and losses by option series and in total. Twelve of the sixteen profit and loss reports sent to Lowry included overstatements of the account's total profits, with errors in the total profit figures ranging from a few hundred dollars to over $38,000.[11] In addition, a report sent to Lowry some time after 2005, purporting to show the change in Lowry's account balance over several years, calculated the change in the account's value in an inconsistent manner, which resulted in the report providing inaccurate information for multiple years.

Lowry raised concerns to Murphy about the handling of her account on a few occasions, but Murphy downplayed her concerns and told her not to worry because her account was profitable. For example, in late 2003, after receiving an activity letter from George Langlois, the BIS compliance officer, indicating that year-to-date commissions in her account were $251,781, Lowry called Murphy to express her concern. Murphy told Lowry that the commissions "didn't matter" because "the account was profitable" and she "was making money."[12] Murphy also misled Langlois by telling him that Lowry was approving each of the trades in the account. Then in early 2005, Lowry's accountant, Mark Pesavento, was preparing her tax returns and informed Lowry that she had incurred a substantial loss in her BIS account exceeding $300,000, and she learned that her margin debit balance had "grown huge."[13] "[A]larmed and upset," Lowry called Murphy to ask what had happened.[14] Murphy tried to reassure her by explaining that the margin debit balance "wasn't a true indication" of the margin in her account—an explanation that Lowry did not understand.[15] Around April 2005, Lowry began to meet with Murphy, Pesavento, and Karen DeRose, a financial planner Lowry had engaged at the suggestion of Birkelbach. At one such meeting, Lowry told Murphy to "be conservative and stop the bleeding" in her account.[16] Lowry also for the first time authorized Murphy to let her P&G stock get called away to bring down the margin balance. In May 2005, BIS began to send duplicate copies of Lowry's account statements to Pesavento and DeRose.

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[11] On occasion, the statements also understated the account's profits.

[12] Tr. at 148.

[13] *Id.* at 152-53.

[14] *Id.* at 153.

[15] *Id.*

[16] *Id.* at 156.

In December 2005, Lowry learned from Pesavento that Murphy had continued to trade heavily in her account. Around this time, FINRA contacted Lowry about Murphy's handling of her account in connection with an investigation into Murphy's conduct. In January 2006, Lowry sent a letter to Murphy instructing him to cease options trading in her account. Lowry closed her BIS account in April 2006, after transferring the assets in the account to Fidelity. Murphy's options trading in Lowry's account ultimately generated trading losses totaling $871,301.95 and commissions totaling $1,002,100.[17] From the third quarter of 2002 through the end of 2005, Murphy's trading in Lowry's account accounted for 59% of Murphy's overall commissions and 18% of BIS's total revenues. After closing her BIS account, Lowry brought an arbitration claim against BIS, which was eventually settled for $150,000.

B. Murphy's management of Martinelli's account

In May 1999, while he was a college student in Chicago, Illinois, Martinelli opened an account with George Langlois at BIS. Under Langlois's management, Martinelli's account grew from the $2,500 he deposited between 1999 and 2001 to over $18,000 in March 2007, mainly through investments in low-priced securities. In April 2007, Langlois left BIS, and Birkelbach assigned Martinelli's account to Murphy. At this time, Martinelli was an active member of the United States military and stationed in Germany. Shortly after learning of the account transfer, Martinelli called Murphy to discuss his account. Murphy told Martinelli that he wanted to handle the account differently than had Langlois. Specifically, he proposed to use a "little more conservative approach" and "not deal with penny stocks."[18] Martinelli told Murphy that this approach sounded reasonable but that he wanted to think about it and would get back to Murphy. At no point did Martinelli provide written authorization for Murphy to exercise discretion in his account.

Because of a delay in receiving his mail overseas, Martinelli did not receive his April 2007 account statement from BIS until late May or early June 2007. When he received the statement, he was surprised to see that Murphy had actively traded in his account, even though he had not given Murphy permission to do so. Murphy's trading in Martinelli's account in April included dozens of transactions, including the liquidation of four of the five stocks in the account and several in-and-out trades. The trading resulted in costs of $2,132 and caused the value of Martinelli's account to drop to $15,387.34—a 17% drop in a single month. Upon receiving the April statement, Martinelli called Murphy to ask why he had been trading in the account at all. Martinelli also complained that the commissions were significantly higher than he had paid with Langlois. According to Martinelli, Murphy responded by suggesting that there had been a misunderstanding and by offering to refund $3,000 in commissions. Murphy also told Martinelli

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17 Because the value of Lowry's P&G stock increased considerably during the time she maintained an account at BIS, her net loss during the time her account was open at BIS was approximately $93,821, when accounting for options trading losses, the marked-to-market value of her P&G stock, dividends received, mutual fund distributions, commissions paid, and margin interest.

18 Tr. at 55.

that his account was worth about $13,000. Martinelli told Murphy that he wanted to transfer his account to Langlois, who was now at a different firm, and that he wanted Murphy to stop trading in his account.

When Martinelli eventually received his May 2007 account statement he discovered that matters were worse than Murphy had led him to believe. Throughout May 2007, Murphy had continued to actively trade in the account, including several in-and-out trades over a short time period. By the end of May 2007, around the time of Martinelli's phone conversation with Murphy, the account value had plummeted to $10,134.46—a 45% decline in only two months. Account costs for May 2007 were $3,257. In July 2007, after he received the May 2007 statement, Martinelli called both Murphy and Birkelbach to complain. The same month, Martinelli closed his BIS account and transferred his assets to Langlois's new firm. During the three months Murphy managed Martinelli's account, Murphy's trading (which had never been authorized by Martinelli) involved 26 trades in 14 different stocks, resulting in approximately $5,395 in commissions and $5,703 in losses. The annualized turnover ratio—the number of times per year the securities in an account are replaced by new securities—was 22.62, and annualized cost-to-equity ratio was 169%.

On July 12, 2007, Martinelli sent a formal letter of complaint to FINRA and the Illinois Securities Department, with a copy to Birkelbach. In January 2008, Martinelli agreed to settle his dispute with BIS regarding Murphy's handling of his account for $4,758.05.

C. Birkelbach's supervision of Murphy

During the time Murphy managed Lowry's account, Birkelbach had ultimate supervisory responsibilities regarding Murphy's options trading because he was the Senior Registered Options Principal and Compliance Registered Options Principal. All options trades required his approval, and he reviewed the options trades daily to ensure that they were suitable. Birkelbach testified that to trade uncovered options a customer's investment objective would have to be "speculative or high risk."[19] In addition to reviewing and approving Murphy's options trading, Birkelbach also had responsibility for reviewing profit and loss reports and correspondence sent by Murphy to Lowry.

As Murphy's boss at BIS since 1995, Birkelbach knew before he assigned Lowry's account to Murphy that Murphy had a disciplinary history related to options trading as well as a history of customer complaints and arbitrations. For example, in 1999, the Commission sustained findings by the Chicago Board Options Exchange, Inc., that Murphy had traded without prior authorization from a customer and had exercised discretion without prior written authorization from a customer and written approval from his broker-dealer. Murphy was

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19 Ex. JX-202, at 57.

censured, barred from associating with any exchange member firm for two months, and fined $10,000.[20]

Langlois, who served as the compliance officer during the time Murphy handled Lowry's account, frequently raised concerns to Birkelbach about Murphy's very active trading in Lowry's account, including the high level of commissions. Birkelbach agreed with requests by Langlois to send activity letters to Lowry, which noted a "high level of activity" in her account and sought the assurance that she was "financially able to assume the risk associated with active trading."[21] Birkelbach, however, never followed up personally with Lowry about the activity letters or the nature and level of trading in her account more generally.[22] Moreover, Birkelbach never disapproved any trades made by Murphy in Lowry's account.

Birkelbach was also responsible for supervising Murphy's handling of Martinelli's account. Long before he assigned Martinelli's account to Murphy, Birkelbach knew that FINRA was investigating Murphy for misconduct related to Lowry's account. In November 2005, FINRA had asked Birkelbach to put Murphy on heightened supervision. There is no evidence that Birkelbach changed his supervisory approach to Murphy in any way. Although Birkelbach reviewed Murphy's trading in Martinelli's account, which included short-term, in-and-out trading, he never disapproved any trades made by Murphy in the account.

D. Procedural history

After a routine examination of BIS in which FINRA examiners reviewed trading in Lowry's account, FINRA launched a formal investigation in November 2005 that led to this proceeding. On July 30, 2008, FINRA's Department of Enforcement issued a nine-count complaint against Murphy, Birkelbach, and BIS. After a four-day hearing, a FINRA hearing panel issued a decision on May 6, 2011, finding violations on all but two counts in the complaint. In reaching its findings, the hearing panel made express determinations that Murphy was not a credible witness and that Martinelli was a "very credible" witness.[23] Based on the finding of violations, the hearing panel barred Murphy from associating with any member firm and ordered him to pay $591,933.67 in disgorgement; suspended Birkelbach for six months as a general securities principal and options principal and fined him $25,000; and fined BIS $2,500.

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[20] *William J. Murphy*, Exchange Act Release No. 41804, 54 SEC 303, 1999 WL 668560, at *5 (Aug. 27, 1999).

[21] Exs. JX-80 through JX-87.

[22] Lowry testified that when she asked Murphy about the activity letters, he suggested they were a formality and she should simply sign and return them.

[23] *Dep't of Enforcement v. Murphy*, Complaint No. 2005003610701, 2010 WL 5129558, at *6 n.10, *7 n.12 (OHO May 6, 2010). The hearing panel made no further express credibility determinations but, in making its findings, relied on aspects of Lowry's testimony as well as on some of the testimony of Langlois, Pesavento, DeRose, Julie Murphy (a FINRA investigator), and Marc Allair (FINRA's expert witness). The hearing panel did not rely on any of Birkelbach's testimony except for statements he made against his own interest.

Murphy, Birkelbach, and BIS appealed the hearing panel's decision to FINRA's National Adjudicatory Council. On October 20, 2011, the NAC issued a decision affirming all of the hearing panel's findings of violations.[24] With regard to sanctions, the NAC affirmed the bar against Murphy but decreased the disgorgement amount by $6,759 to reflect a $5,000 fine Murphy had paid to the Illinois Securities Department for his misconduct in connection with Martinelli's account and $1,759 in commissions for which Martinelli had been reimbursed. The NAC increased Birkelbach's sanction to a bar in all capacities and affirmed the $2,500 fine imposed on BIS.[25] In support of its decision to increase Birkelbach's sanction, the NAC found that the hearing panel's sanction was "wholly insufficient to remedy his failure to supervise" and that his "conduct reflect[ed] a shocking disregard for FINRA rules designed to protect customers."[26]

III.

Section 19(e) of the Exchange Act provides that, in reviewing a disciplinary proceeding by a self-regulatory organization, we shall determine whether the associated person engaged in the conduct found by the SRO, whether the conduct violated the SRO rules at issue, and whether those rules were applied in a manner consistent with the purposes of the Exchange Act.[27] In conducting our *de novo* review, we apply a preponderance of the evidence standard to determine whether the record supports FINRA's findings that Murphy and Birkelbach violated its rules.[28] Based on our independent review of the record, we find that a preponderance of the evidence supports FINRA's findings of violations.

A. Murphy engaged in discretionary trading without written authorization.

FINRA found that Murphy engaged in discretionary trading without written authorization in violation of NASD Rules 2510(b), 2860(b), and 2110.[29] Rule 2510(b) provides that "[n]o . . . registered representative shall exercise any discretionary power in a customer's account unless such customer has given prior written authorization" and that the account must be approved for

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[24] *Dep't of Enforcement v. Murphy*, Complaint No. 2005003610701, 2011 WL 5056463 (NAC Oct. 20, 2011).

[25] FINRA found that BIS violated NASD Rule 2110 by including an improper confidentiality provision in a settlement agreement with a client that had the potential to impede the investigation of this case. Before the Commission, BIS has voluntarily withdrawn its appeal of this finding, and it has paid the associated $2,500 fine.

[26] *Murphy*, 2011 WL 5056463, at *35, *37.

[27] 15 U.S.C. § 78s(e).

[28] *See, e.g.*, *Richard G. Cody*, Exchange Act Release No. 64565, 2011 WL 2098202, at *9 (May 27, 2011), *aff'd*, 693 F.3d 251 (1st Cir. 2012).

[29] NASD Rule 2110 provides that "[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." According to "our long-standing and judicially-recognized policy . . . a violation of another Commission or NASD rule or regulation . . . constitutes a violation of [NASD] Rule 2110." *Stephen J. Gluckman*, Exchange Act Release No. 41628, 54 SEC 175, 1999 WL 507864, at *6, (July 20, 1999).

discretionary trading in writing by the member firm. With regard to options trading, Rule 2860(b)(18)(A) further provides that a representative may not exercise discretionary authority in a customer's account unless the trading complies with Rule 2510, the customer's written authorization for discretionary trading "specifically authorize[s] options trading in the account," and the account is accepted in writing for discretionary trading by a Registered Options Principal.

As we recognized in an earlier disciplinary proceeding involving Murphy, "[d]iscretionary trading in a customer's account is a practice that is inherently susceptible to abuse."[30] In light of this potential for abuse, FINRA's rules require that the authorization for the exercise of discretionary power in a customer's account be in writing. It is undisputed that neither Lowry nor Martinelli gave Murphy prior written authorization for any discretionary trading in their accounts. Lowry gave Murphy oral permission to make trades in her account without her prior authorization. While Murphy contends that he understood Martinelli to have given him oral permission to pursue the strategy they discussed, we do not believe that to be the case.[31] In any event, oral permission is insufficient to exercise discretionary power in a customer's account under Rule 2510. Likewise, neither account was approved in writing for discretionary trading by BIS. And Lowry's account was not approved for discretionary options trading by a Registered Options Principal. Despite the lack of written authorization, Murphy exercised discretionary power in both Lowry's and Martinelli's accounts by executing numerous trades for which neither customer gave prior approval. The record thus amply supports a finding that Murphy violated FINRA's rules on discretionary trading.

Murphy argues[32] that his trading in Lowry's account fell within the "time and price discretion" exception to Rule 2510, as it existed prior to January 31, 2005.[33] The exception permits a registered representative to "exercise discretion as to the price at which or the time when an order by a customer for the purchase or sale of a definite amount of a security shall be executed." But the time and price discretion exception does not excuse Murphy's discretionary trading here. For the exception to apply, Lowry would have had to direct Murphy to buy or sell

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30 *Murphy*, 1999 WL 668560, at *3.

31 Murphy testified that he understood Martinelli to give him authority to trade without talking to him first, but the hearing panel generally found Murphy to be not credible. On the other hand, Martinelli, whom the hearing panel described as "very credible," testified that he "hadn't given [Murphy] the authorization to trade." Tr. at 56. On cross-examination, Martinelli testified that when he told Murphy that the proposed investment approach "sounded reasonable" he was not authorizing Murphy to realign the portfolio, but he acknowledged that, if Murphy "really wanted to take it that way," it was possible that Murphy could have misunderstood. *Id.* at 77.

32 Upon notice from Murphy that he would represent himself *pro se* before the Commission, the Commission granted his request to consider his prior pleadings in support of his application for review. Accordingly, in our *de novo* review of the alleged violations by and sanctions imposed on Murphy, we have considered the arguments Murphy raised before the hearing panel and the NAC as if raised before the Commission.

33 On January 31, 2005, the exception was amended to state that "time and price discretion will be considered to be in effect only until the end of the business day on which the customer granted such discretion, absent a specific, written contrary indication signed and dated by the customer."

a definite amount of a security, but there is no evidence that she ever gave Murphy any such direction. Put another way, Murphy's trading did not involve the exercise of discretion only over the timing and prices related to the options transactions in Lowry's account, but also over the type and quantity of options transacted. The record demonstrates that Murphy exercised complete discretion over what specific option series to buy or sell and at what quantities, in addition to exercising discretion with regard to time and price. And, contrary to Murphy's suggestion, the fact that Lowry approved the covered call strategy does not mean that Murphy's trading—which involved exercising discretion over the type and quantity of options traded—would come within the time and price discretion exception.[34] Furthermore, Murphy's argument does not excuse the discretionary trading that took place in Lowry's account after January 2005 and in Martinelli's account for the entire time Murphy managed it. Murphy apparently concedes that this trading could not fall within the amended time and price discretion exception, which limits the exercise of such discretion to one business day.

For all of these reasons, we sustain FINRA's finding that Murphy violated Rules 2510(b), 2860(b), and 2110 by engaging in discretionary trading without proper authorization.

B. Murphy engaged in unauthorized trading in Lowry's account.

FINRA also found that Murphy violated NASD Rule 2110 by engaging in trading that was not authorized by Lowry and that went beyond the level approved by BIS for her account. "An associated person is 'responsible for obtaining his [or her] customer's consent prior to purchasing a security for the customer's account.'"[35] We have recognized that "[u]nauthorized trades are a serious breach of the duty," set forth in Rule 2110, "to observe high standards of commercial honor and just and equitable principals of trade."[36] Unauthorized trading "goes 'to the heart of the trustworthiness of a securities professional,' and 'is a fundamental betrayal of the duty owed by a sales[person] to his [or her] customers.'"[37]

Lowry directed Murphy to pursue a covered call strategy and Murphy told Lowry he would pursue that strategy. There is no evidence that Murphy ever received authorization from Lowry to pursue trading beyond the covered call strategy. Nevertheless, Murphy frequently

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34 Even if we were to accept Murphy's contention that Lowry's approval of the covered call strategy granted Murphy some degree of discretion, it would not authorize his trading because, as discussed more fully below, Murphy deviated significantly from the covered call strategy agreed to by Lowry.

35 *Wanda P. Sears*, Exchange Act Release No. 58075, 2008 WL 2597567, at *2 (July 1, 2008) (quoting *Carlton Wade Fleming, Jr.*, Exchange Act Release No. 36215, 52 SEC 409, 1995 WL 539462, at *3 (Sept. 11, 1995)).

36 *Janet Gurley Katz*, Exchange Act Release No. 61449, 2010 WL 358737, at *22 (Feb. 1, 2010) (quoting *Sears*, 2008 WL 2597567, at*2); *see also Gregory W. Gray, Jr.*, Exchange Act Release No. 60361, 2009 WL 2176836, at *7 (July 22, 2009) (recognizing that unauthorized trading is inconsistent with just and equitable principles of trade); *Michael G. Keselica*, Exchange Act Release No. 34929, 52 SEC 33, 1994 WL 615112, at *3 (Nov. 3, 1994) (same).

37 *Katz*, 2010 WL 358737, at *22 (quoting *Adam Stuart Levine*, Exchange Act Release No. 32214, 51 SEC 395, 1993 WL 138530, at *2 (Apr. 26, 1993) and *Sears*, 2008 WL 2597567, at *2).

engaged in options trades that were not part of the covered call strategy agreed to by Lowry. He wrote uncovered calls, uncovered puts, and combinations—trades that Murphy's own expert witnesses agreed were not part of a covered call strategy. Because he conducted numerous trades that were clearly outside the strategy agreed to by Lowry, we sustain FINRA's finding that Murphy engaged in unauthorized trading in violation of Rule 2110.

We also sustain FINRA's finding that, in the circumstances of this case, Murphy violated Rule 2110 by pursuing trading in Lowry's account not approved by BIS. Prior to November 2004, Lowry's option agreement authorized only "covered writing" and "buying of stock options"—the box on the agreement authorizing uncovered writing was left unchecked. Yet, during this time, Murphy did not limit his trading to the categories authorized in the option agreement but instead wrote numerous uncovered options.

While acknowledging that some trades "were technically outside" the approved types of transactions on the option agreement, Murphy argues that his unauthorized trading should be excused because "a portion of the uncovered positions were caused by Lowry" who used some of her P&G stock as collateral to obtain a $500,000 bridge loan.[38] In 2004, Lowry bought a new residence and pledged some of her P&G stock as collateral in order to secure a bridge loan necessary to finance the purchase. But even if some of the uncovered positions can be attributed to Lowry's pledging a portion of her P&G shares to secure the loan, this does not explain or excuse the numerous uncovered calls Murphy wrote before June 2004, when Lowry used her stock to secure the loan.

Murphy also contends that "Lowry approved and insisted upon the strategy employed by Mr. Murphy during the time he handled her account."[39] But there is no evidence that Lowry agreed to or insisted upon a strategy involving uncovered option writing. Lowry asked for and agreed to only a covered call strategy. Lowry further testified that she believed throughout the time Murphy handled her account that he was pursuing only that strategy. Lowry could not have approved and insisted upon a strategy that she was not even aware Murphy was pursuing.

To the extent Murphy is arguing that an alleged demand by Lowry for $10,000 per month in income justified the type of options trades he transacted in her account, this argument fails for several reasons. First, as discussed more fully below, there is a lack of credible evidence to support the assertion that Lowry made such a demand.[40] Second, even if she did make the demand, Murphy has completely failed to show why his uncovered options trades were necessary to meet such a demand. Finally, Lowry's alleged demand for a particular investment outcome does not mean that Murphy was permitted to pursue unauthorized trades in pursuit of that goal. As the NAC decision concluded, "[i]f Murphy was unable to meet any purported

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38 NAC Appeal Br. of Appellants-Resp'ts at 18.

39 *Id.*

40 *See infra* at 19-20.

income demands employing only covered calls, that did not give him the authorization—either from [Lowry] or [BIS]—to effect uncovered options trades."[41]

Murphy further argues that, despite "frequent contact" with him, "Lowry never expressed a concern about the type of options transactions effected" in her account.[42] But the fact that Lowry did not complain about the uncovered option positions in her account does not mean that Murphy's trading was authorized. Lowry believed that Murphy was pursuing only a covered call strategy, and she lacked the sophistication to understand that Murphy was, in fact, significantly deviating from that strategy. Moreover, even if Lowry's apparent acquiescence were viewed as ratification of Murphy's uncovered options trades, "we have held repeatedly that after-the-fact 'acceptance' of an unauthorized trade does not transform that transaction into an authorized trade."[43] And, as FINRA recognized, given Lowry's lack of investment experience and Murphy's repeated false assurances that her account was profitable, any absence or delay in complaints from Lowry was most likely "a consequence of misplaced trust" in Murphy, "rather than approval of his actions."[44]

C. Murphy's conduct involved unsuitable recommendations, excessive trading, and churning.

NASD Rule 2310, known as the suitability rule, requires that "[i]n recommending to a customer the purchase, sale, or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." A registered representative can violate the suitability rule if he or she "inadequately assesses whether the recommendation is suitable for the 'specific investor to whom the recommendation is directed'" (customer-specific unsuitability), or if "the level of trading recommended by the representative is excessive in light of the customer's investment needs and objectives" (quantitative unsuitability).[45] FINRA found that Murphy violated customer-specific suitability requirements by his options trading in Lowry's account and violated quantitative suitability requirements by engaging in excessive trading in both Lowry's and Martinelli's accounts. In addition, FINRA found that Murphy churned Lowry's and Martinelli's

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41 *Murphy*, 2011 WL 5056463, at *11.

42 NAC Appeal Br. of Appellants-Resp'ts at 17-18.

43 *Sandra K. Simpson*, Exchange Act Release No. 45923, 55 SEC 766, 2002 WL 987555, at *13 (May 14, 2002); *see also Edgar B. Alacan*, Exchange Act Release No. 49970, 57 SEC 715, 2004 WL 1496843, at *6 n.27 (July 6, 2004); *Katz*, 2010 WL 358737, at *22 ("[R]atification of a transaction after the fact does not establish that trades were authorized before being executed.").

44 *See Alacan*, 2004 WL 1496843, at *6 n.27.

45 *Cody*, 2011 WL 2098202, at *9 (quoting *F.J. Kaufman & Co. of Va.*, Exchange Act Release No. 27535, 50 SEC 164, 1989 WL 259961, at *3 (Dec. 13, 1989)).

accounts in violation of FINRA rules[46] and antifraud provisions of the securities laws.[47] We sustain FINRA's findings on each of these violations.

1. Murphy's options trading in Lowry's account violated customer-specific suitability requirements.

We have held that "[i]nvestment recommendations must be suitable for the investor when evaluated in terms of the investor's financial situation, tolerance for risk, and investment objectives."[48] Because options trading involves heightened risk, before recommending "an opening transaction in any option contract" a registered representative must have "a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he [or she] may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract."[49]

Lowry was an unsophisticated investor with a limited understanding of options. When opening her account, she indicated that her tolerance for risk was moderate and that her primary objectives were income and long-term growth. Lowry had considerable assets—notably her shares of P&G stock—but she was also dependent on her P&G stock as her primary source of income. Upon a recommendation from a friend, she asked Jage, and later Murphy, to pursue a covered call strategy as a way to supplement the income she received from P&G dividends. Although a covered call strategy is considered a relatively conservative options strategy,[50] it is not clear from her testimony that Lowry properly understood what that strategy entailed or the attendant risks. In addition to having only a basic understanding of options, it appears that Lowry did not understand that her insistence that her P&G stock not get called away had the

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46 FINRA found that, in addition to violating NASD Rule 2310, which prohibits excessive trading as a violation of suitability obligations, Murphy violated NASD Rule 2120, which prohibits registered representatives from "effect[ing] any transaction in, or induc[ing] the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance."

47 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

48 *Simpson*, 2002 WL 987555, at *14; *see also Katz*, 2010 WL 358737, at *20 ("A registered representative is obligated to make 'a customer-specific determination of suitability and to tailor his recommendations to the customer's financial profile and investment objectives.'" (quoting *F.J. Kaufman & Co. of Va.*, 1989 WL 259961, at *3)).

49 NASD Rule 2860(b)(19)(B). Additionally, before recommending any options transaction, a registered representative must conduct a "reasonable inquiry . . . concerning the customer's investment objectives, financial situation and needs." NASD Rule 2860(b)(19)(A).

50 *Michael E. Tennenbaum*, Exchange Act Release No. 18429, 47 SEC 703, 1982 WL 31984, at *2 n.6 (Jan. 19, 1982) ("Covered writing involves the sale of options against stock already owned, and is considered a relatively conservative strategy."); Poser, *supra* note 3, at 589 ("Covered call writing is generally considered to be a conservative strategy.").

potential to undermine her goal of income generation, because the need to buy back options could lead, in the words of FINRA's expert witness, to a "severe cash drain."[51]

Because Murphy's trading strayed considerably from a covered call strategy, in order to find that Murphy violated customer-specific suitability requirements, we, like the NAC, need not reach the question whether a covered call strategy combined with Lowry's direction to preserve her P&G stock was *per se* unsuitable. Even if the strategy was not *per se* unsuitable under the circumstances, and even if Lowry had understood and was financially able to bear the risks associated with the covered call strategy she requested, Murphy did not limit his trading to this strategy. Instead, Murphy's trading in Lowry's account included writing numerous uncovered or naked calls as well as uncovered puts. Unlike writing covered calls, where the potential for loss is limited by the fact that the option writer holds the underlying security necessary to satisfy the option obligation, the sale of uncovered calls entails substantial risks because it "may theoretically involve unlimited losses."[52] Likewise, writing uncovered puts is extremely risky because the writer may be obligated to buy a security at an exercise price that is far greater than the security is worth.[53] In addition to uncovered options, Murphy's trading involved complex option combinations, which involve buying or selling both puts and calls and are by their nature more complex than other options transactions. Trading in uncovered options and combinations was highly risky and was unsuitable for Lowry, an investor with only moderate risk tolerance and limited understanding of and experience with options.[54]

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[51] Ex. CX-37, at 4.

[52] *Ronald L. Brownlow*, Exchange Act Release No. 18257, 47 SEC 662, 1981 WL 28137, at *2 n.2 (Nov. 16, 1981) (citing U.S. Securities and Exchange Commission, 96th Cong., 1st Sess., Report of the Special Study of the Options Markets, 114 (Comm. Print 1978) [hereinafter Special Study]); *see also id.* at *2 ("[N]aked call options . . . are highly speculative investments" because a "customer might have to purchase (1) the underlying securities covered by the option at a price greater than the premium received and the exercise price, or, in order to protect himself, (2) an option similar to the one sold for more than the premium he obtained."); *Clyde J. Bruff*, Exchange Act Release No. 31141, 50 SEC 1266, 1992 WL 224091, at * 4 & n.19 (Sept. 3, 1992) ("Since the writer does not own the underlying security represented by a 'naked' option, he is subject to high degree of loss."); *Thomas P. Garrity*, Exchange Act Release No. 25115, 48 SEC 880, 1987 WL 755334, at *1 & n.3 (Nov. 12, 1987) (noting that "writ[ing] uncovered or 'naked' call options" is "a very risky strategy" because "uncovered call writing may result in very substantial losses if the market price of the stock underlying the call continues to rise above the exercise price of the call").

[53] *See* Special Study, *supra* note 53, at 114 (the writer of an uncovered put faces a potential "loss which is limited only by the exercise price").

[54] *See Frank DeRose*, Exchange Act Release No. 32812, 51 SEC 652, 1993 WL 328418, at *5-6 (Aug. 26, 1993) (broker's options trading was unsuitable for his customers who expressed a low tolerance for risk and "were unsophisticated investors with little experience in financial matters and even less knowledge of options"); *Patrick G. Keel*, Exchange Act Release No. 31716, 51 SEC 282, 1993 WL 12348, at *2 (Jan. 11, 1993) (registered representative's recommendation of risky options trading was unsuitable for an unsophisticated investor who sought long-term growth and desired to retain her principal); *Ivan M. Kobey*, Exchange Act Release No. 31630, 51 SEC 204, 1992 WL 394557, at *7 (Dec. 22, 1992) (trading "in risky option strategies, including taking positions in naked options" was "entirely unsuitable" for customers "with conservative, growth-oriented objectives" and very limited investment experience); *Bruff*, 1992 WL 224091, at *3-4 (registered representative's recommendations for "highly aggressive options trading" that "involved a high degree of financial risk and complexity" were unsuitable for

(continued...)

Furthermore, Murphy's extensive trading on margin in Lowry's account (with the margin debit balance reaching as high as $1.16 million on July 31, 2005) made his risky options trading even riskier and, therefore, even less suitable for Lowry. We have frequently held that trading on margin increases the risk of loss to a customer.[55] Not only does the use of margin mean that a customer is "at risk to lose more than the amount invested if the value of the securities depreciates sufficiently," but "[t]he customer is also required to pay interest on the margin loan, adding to the investor's cost of maintaining the account and increasing the amount by which his or her investment must appreciate before the customer realizes a net gain."[56] The large margin debit balance in Lowry's account exacerbated the unsuitability of Murphy's already risky trading.[57]

Murphy suggests that, if his trading were unsuitable, others who received information about the account, such as Pesavento and DeRose, would have expressed concerns. This argument is without merit. DeRose raised concerns to Birkelbach, saying that she thought the activity in Lowry's account was unusually high. Furthermore, because neither Pesavento nor DeRose had the responsibility to assess the suitability of Murphy's trading and neither had expertise in options trading, there is no reasonable basis for Murphy to have expected them to raise concerns about the trades' suitability. Moreover, as we have held previously, "applicants cannot shift to others the responsibility for their own compliance with applicable rules."[58]

Given Lowry's lack of investment knowledge and experience and her moderate tolerance for risk, Murphy's trading in Lowry's account, which involved highly risky options transactions and extensive trading on margin, was wholly unsuitable for his customer. Accordingly, we sustain FINRA's finding that Murphy violated customer-specific suitability requirements with regard to his trading in Lowry's account.

(...continued)
customers who, *inter alia*, lacked experience with and understanding of options trading); *see also* Poser, *supra* note 3, at 593 ("[T]he complexity of the options strategy used in a customer's account is a factor in ascertaining whether or not the trading in the account was consistent with the customer's investment objectives and financial needs. A strategy that is incomprehensible to an investor can hardly be regarded as suitable for him. As the literature of the options exchanges states, 'a complexity not well understood is, in itself, a risk factor.'" (quoting American Stock Exchange, Inc., et al., *Understanding the Risks and Uses of Listed Options* 30 (1982))).

55 *See, e.g., Luis Miguel Cespedes*, Exchange Act Release No. 59404, 2009 WL 367026, at *7 (Feb. 13, 2009).

56 *Id.*; *see also Alacan*, 2004 WL 1496843, at *9 & n.54 (noting that margin trading increased the risks to customers).

57 *James B. Chase*, Exchange Act Release No. 47476, 56 SEC 149, 2003 WL 917974, at *4 (Mar. 10, 2003) (finding that trading on margin increased the unsuitability of already risky trading); *Jack H. Stein*, Exchange Act Release No. 47335, 56 SEC 108, 2003 WL 431870, at *3 & n.15 (Feb. 10, 2003) (same); *David A. Gingras*, Exchange Act Release No. 31206, 50 SEC 1286, 1992 WL 280780, at *3 (Sept. 21, 1992) (same).

58 *John Edwards Mullins*, Exchange Act Release No. 66373, 2012 WL 423413, at *13 (Feb. 10, 2012).

2. Murphy engaged in excessive trading in Lowry's and Martinelli's accounts.

Murphy also violated suitability requirements by engaging in excessive trading.[59] "Excessive trading occurs when a registered representative has control over the trading in an account and the level of trading in that account is inconsistent with the customer's objectives and financial situation."[60] A registered representative's control over an account "may be established when the customer relies on the representative such that the representative controls the volume and frequency of transactions."[61] Thus, a registered representative's exercise of *de facto* discretionary control over a client's account (even if the exercise of discretion is not properly authorized) satisfies the element of control for the purpose of demonstrating excessive trading.[62] As we previously found, Murphy exercised discretionary control in both Lowry's and Martinelli's accounts, and thus had the requisite control over the trading in these accounts to establish an excessive trading violation.

Murphy's trading in Lowry's account was excessive. Almost immediately after taking over the management of Lowry's account from Jage, Murphy began frequently trading large volumes of option contracts. For the three-and-a-half years he managed Lowry's account, Murphy engaged in over 2,500 options transactions involving more than 67,000 option contracts. This trading reached its peak between November 2004 and January 2006, when Murphy traded between 4,000 and 8,000 option contracts per month. Because Murphy traded almost exclusively option contracts in Lowry's account, a relevant gauge of excessive trading is the cost-to-equity ratio, *i.e.*, the percentage the account would have to appreciate just to break even.[63] Although "our assessment of whether trading is excessive does not rest on any magical per

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59 *See Harry Gliksman*, Exchange Act Release No. 42255, 54 SEC 471, 1999 WL 1211765, at *2 (Dec. 20, 1999) ("[R]ecommendations may be unsuitable if the trading is excessive based on the customer's objectives and financial situation."), *aff'd*, 24 F. App'x 702 (9th Cir. 2001) (unpublished); *John M. Reynolds*, Exchange Act Release No. 30036, 50 SEC 805, 1991 WL 288500, at *2 (Dec. 4, 1991) ("Excessive trading may be thought of as quantitative unsuitability.").

60 *Cody*, 2011 WL 2098202, at *12 (citing *Gliksman*, 1999 WL 1211765, at *2).

61 *Id.* (citing *Clyde J. Bruff*, Exchange Act Release No. 40583, 53 SEC 880, 1998 WL 730586, at *2 (Oct. 21, 1998), *Stephen Thorlief Rangen*, Exchange Act Release No. 38486, 52 SEC 1304, 1997 WL 163991, at *4 (Apr. 8, 1997), and *Reynolds*, 1991 WL 288500, at *2).

62 *See Frederick C. Heller*, Exchange Act Release No. 31696, 51 SEC 275, 1993 WL 8588, at *2 & n.7 (Jan. 7, 1993) (finding "control" when a registered representative "exercised *de facto* discretionary control" over customers' account, as evidenced by the fact that customers "were not consulted, nor typically even made aware of, the particular trades executed in their account until well after the fact.").

63 *See* Special Study, *supra* note 53, at 451-55 (noting that conventional turnover rate formulas do not adequately measure "the impact of options trading on the activity in customer accounts since they completely ignore the effect of the sale of options contracts" and that a cost-to-equity ratio is a "logical solution to the need for a standard formula to measure trading activity in customer accounts which include options"); *cf. Eugene J. Erdos*, Exchange Act Release No. 20376, 47 SEC 985, 1983 WL 33908, at *4 n.14 (1983) (citing the Special Study in rejecting the use of the turnover rate for measuring excessive trading in an options account).

annum percentage,"[64] we have held that "a cost-to-equity ratio in excess of 20% generally indicates that excessive trading has occurred."[65] During Murphy's management of the account, the annualized cost-to-equity ratio was 25.59% (22.75% excluding margin interest). And looking separately at 2004 and 2005, the cost-to-equity ratios were even higher—31.25% for 2004 and 48.56% for 2005.[66] Another indication of excessive trading is the fact that Murphy's trading frequently involved multiple round-trip transactions for the same option series, meaning that Murphy sold and bought back the same option series repeatedly.[67] Under the circumstances, we agree with FINRA that Murphy's trading in Lowry's account was excessive.

Murphy contends the amount of trading in Lowry's account was "necessitated" by Lowry's demand that the account generate $10,000 per month in income.[68] To meet this demand, Murphy suggests that he had to engage in heavy and frequent trading. But there is a lack of credible evidence that Lowry directed Murphy to generate $10,000 per month in income. Murphy testified to this effect, but the hearing panel found that Murphy generally was not credible.[69] For her part, Lowry testified before the hearing panel that she never made such a demand. Murphy argues that the hearing panel did not give sufficient weight to a document prepared for Lowry by her financial planner Karen DeRose, which Murphy asserts impeaches Lowry's testimony. But the document is not persuasive impeachment evidence. Prepared by DeRose in April 2004, the document summarizes a discussion between DeRose and Lowry concerning the latter's financial plans. Under the heading "Retirement Planning," the document states: "You want to be financially independent with annual income of 120,000, adjusting for

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64 *Cody*, 2011 WL 2098202, at *14 (quoting *Gerald E. Donnelly*, Exchange Act Release No. 36690, 52 SEC 600, 1996 WL 20843, at *2 (Jan. 5, 1996)) (internal quotation marks omitted); *see also Stein*, 2003 WL 431870, at *4 (noting that "there is no single test for making an excessive trading determination").

65 *Daniel Richard Howard*, Exchange Act Release No. 46269, 55 SEC 1096, 2002 WL 1729157, at *3 (July 26, 2002); *see also Rafael Pinchas*, Exchange Act Release No. 41816, 54 SEC 331, 1999 WL 680044, at *5 (Sept. 1, 1999) ("We have previously found that a cost-to-equity ratio in excess of 20% indicates excessive trading."); *Gliksman*, 1999 WL 1211765, at *3-4 (finding excessive trading in the account of a conservative corporate investor with an annualized cost-to-equity ratio of 18%); *Peter C. Bucchieri*, Exchange Act Release No. 37218, 52 SEC 800, 1996 WL 254677, at *2-4 (May 14, 1996) (finding excessive trading in account with cost-to-equity ratios of 21% to 30%).

66 Excluding margin interest, the cost-to-equity ratios were 27.78% in 2004 and 39.32% in 2005.

67 *Cf. Bruff*, 1992 WL 224091, at *4 (finding options trading unsuitable that was "highly aggressive" and included, *inter alia*, "frequent transactions where positions were opened and closed within short periods of time").

68 NAC Appeal Br. of Appellants-Resp'ts at 14, 16.

69 We have frequently held that "'the credibility determination of the initial decisionmaker is entitled to considerable weight and deference, since it is based on hearing the witnesses' testimony and observing their demeanor'" and that "'without substantial evidence in the record to the contrary, we cannot depart from the fact finder's determination of credibility.'" *Sears*, 2008 WL 2597567, at *2 (quoting *Jon R. Butzen*, Exchange Act Release No. 36512, 52 SEC 512, 1995 WL 699189, at *2 n.7 (Nov. 27, 1995) and *Fu-Sung Peter Wu*, Exchange Act Release No. 45694, 55 SEC 737, 2002 WL 507009, at *5 n.22 (Apr. 4, 2002)). We find no basis to disturb the hearing panel's credibility determination here.

inflation until age 95."[70] Contrary to Murphy's contention, the fact that Lowry told DeRose that the goal for her future retirement was to have $120,000 in income per year does not mean that Lowry demanded $10,000 per month from Murphy during the time he managed her account. The weight of the relevant evidence does not support Murphy's contention that Lowry made such a demand.

Moreover, even if Lowry had insisted that Murphy generate $10,000 in monthly income, Murphy has not adequately explained how his excessive options trading was likely to further that objective. Notably, Murphy's options trading, rather than generating income, consistently lost money for Lowry. And although Murphy points to the testimony of his two expert witnesses to argue for the "difficulties" of the task he faced,[71] no coherent explanation of his excessive trading can be found in either expert's testimony. Indeed, Murphy's trading frequently resulted in option positions that defied any rational explanation. As FINRA's expert testified concerning one set of positions in Lowry's account, "if this looks like spaghetti . . . it's because it is."[72] Murphy himself was unable to explain to the hearing panel how similar positions held in Lowry's account in late 2002 would lead to profits. But even if Murphy could explain how his trading was intended to meet Lowry's alleged demand for income—which he has not done—Murphy offers no explanation for how his aggressive trading of highly risky options was compatible with Lowry's moderate risk tolerance. A request from Lowry for $10,000 in monthly income would not permit Murphy to pursue trading that was wholly unsuitable in light of his customer's financial profile.[73]

Murphy also argues that FINRA's excessive trading and suitability analysis does not account for the increased value of Lowry's P&G stock, which "mitigated" the account's losses.[74] But the fact that Murphy's excessive options trading did not result in as great a loss to Lowry as it could have does not mean that it was suitable for her.[75] Indeed, it is only because the value of Lowry's P&G stock appreciated significantly (something over which Murphy had no control) that the cost-to-equity ratio in the account was not significantly higher. Regardless of the

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70 Ex. RX-58.

71 NAC Appeal Br. of Appellants-Resp'ts at 15.

72 Tr. at 625.

73 *See Pinchas*, 1999 WL 680044, at *6 ("[E]ven if [his customer] desired Pinchas to double her money, that desire would not have relieved Pinchas from his duty to recommend only those trades suitable to her situation.").

74 NAC Appeal Br. of Appellants-Resp'ts at 15; *see also id.* at 2.

75 *See Stein*, 2003 WL 431870, at *4 n.21 ("Unsuitable recommendations . . . do not become suitable because they result in a profit."); *cf. also Michael T. Studer*, Exchange Act Release No. 50543A, 57 SEC 1011, 2004 WL 2735433, at *5 (Nov. 30, 2004) ("The existence of churning does not turn on whether the customer lost money. The effect of churning is to reduce the customer's return on her investment by increasing the commissions generated by the account. An account may be churned even if the customer shows a profit on the excessive trading. To maintain otherwise would mean that 'securities brokers would be free to churn their customers' accounts with impunity so long as the net value of the account did not fall below the amount originally invested.'" (footnotes omitted) (quoting *Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206, 1218 (8th Cir. 1990)), *aff'd*, 148 F. App'x 58 (2d Cir. 2005)).

appreciation in the value of Lowry's P&G stock, we find that Murphy's options trading in Lowry's account was excessive and unsuitable.

Murphy's trading in Martinelli's account was also excessive. Martinelli was an investor of modest means who, during the time Langlois managed his account, had seen significant account appreciation from investments primarily in low-priced securities. When Murphy took over the account from Langlois, Murphy told Martinelli that he would like to pursue a "more conservative" approach.[76] Despite the fact that Martinelli never authorized him to trade, Murphy almost immediately began actively trading, increasing the volume of trading in the account dramatically. In the three months he managed the account, Murphy liquidated nearly all of Martinelli's holdings and made numerous trades in a variety of stocks, including several instances of in-and-out trading. This trading resulted in an annualized turnover rate of 22.62[77] and an annualized cost-to-equity ratio of 169%. These calculations represent a level of trading substantially above that found to support excessive trading in other cases.[78] Even if it could be argued that Martinelli had a reasonably high tolerance for risk,[79] the extremely high turnover rate and cost-to-equity ratio tend to show a level of trading that is unsuitable in the circumstances.[80] In addition, the multiple in-and-out trades effected by Murphy in the account in a short period of time are a "hallmark of excessive trading."[81]

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[76] Tr. at 55.

[77] FINRA calculated the turnover rate using the modified Looper formula, which involves dividing the total cost of purchases by average monthly investment or equity, and then annualizing the result. *See Stein*, 2003 WL 431870, at *4 n.26.

[78] *See Howard*, 2002 WL 1729157, at *3 ("While there is no definitive turnover rate or cost-to-equity ratio that establishes excessive trading, a turnover rate of 6 or a cost-to-equity ratio in excessive of 20% generally indicates that excessive trading has occurred."); *Gliksman*, 1999 WL 1211765, at *4 (noting that a turnover "rate in excess of 6 is generally presumed to reflect excessive trading" and finding that annualized turnover rate of 12.28 and cost-to-equity ratio of 18% demonstrated excessive trading for a conservative investor); *Pinchas*, 1999 WL 680044, at *5 (finding excessive trading in accounts with annualized turnover rates of 16.63 and 21.04 and cost-to-equity ratios of 110% and 61%); *Al Rizek*, Exchange Act Release No. 41725, 54 SEC 261, 1999 WL 600427, at *5 (Aug. 11, 1999) (noting that a turnover "rate in excess of 6 is generally presumed to reflect excessive trading" and finding that turnover rates ranging from 13.6 to 19.8 and cost-to-equity ratios ranging from 33% to 52% demonstrated excessive trading for accounts with conservative investment objectives); *Bucchieri*, 1996 WL 254677, at *4 (finding excessive trading in accounts with annualized turnover rates of 7.2 to 13.6 and cost-to-equity ratios of 21% to 30%).

[79] Martinelli's new account documentation from 1999 indicated a risk exposure level of "speculation," but it is unclear whether that was the case when Murphy took over the account in 2007. There is no indication that Murphy made any inquiry regarding Martinelli's risk tolerance. As FINRA points out, likely the best gauge for Martinelli's risk tolerance at the time Murphy took over the account was Martinelli's statement that he thought a "more conservative" approach made sense.

[80] *Cf. Henry James Faragalli, Jr.*, Exchange Act Release No. 37991, 52 SEC 1132, 1996 WL 683707, at *6 (Nov. 26, 1996) (finding excessive trading in an account with an annualized turnover rate of 15.4 and cost-to-equity ratio of 42.9% where customer sought 10% to 15% annual returns and was "willing to accept a reasonable degree of risk").

[81] *Cody*, 2011 WL 2098202, at *13 (quoting *Howard*, 2002 WL 1729157, at *3).

Murphy argues that FINRA's use of a 169% cost-to-equity ratio is unfair because it includes costs associated with Murphy's initial reallocation of Martinelli's portfolio. But, like FINRA, we see no basis to exclude these costs, particularly because Martinelli never authorized Murphy to reallocate his portfolio. And as FINRA states, even if the commissions from Murphy's reallocation in April 2007 were excluded, the annualized cost-to-equity ratio would still be 102%—more than sufficient to support a finding of excessive trading.

Murphy also contends that the amount of time he managed the account was too short to obtain meaningful annualized measures of his trading activity. We disagree. We have often evaluated relatively short periods of time in the life of accounts to determine whether excessive trading has occurred.[82] In this context, we have noted that "the period to use to determine whether an account has been excessively traded" is simply "the period during which the allegedly excessive trading occurred."[83] While there may be limitations on the usefulness of annualized turnover rates and cost-to-equity ratios to evaluate trading for particularly short time periods, we agree with FINRA that the three months of trading here does not qualify as "particularly short" and that the turnover rate and cost-to-equity ratio are so high that they support a finding of excessive trading for the time period at issue.[84] For these reasons, we sustain FINRA's finding that Murphy's trading in Martinelli's account was quantitatively unsuitable.

3. Murphy churned Lowry's and Martinelli's accounts.

We also sustain FINRA's finding that Murphy churned Lowry's and Martinelli's accounts. "'Churning occurs when a securities broker enters into transactions and manages a client's account for the purpose of generating commissions and in disregard of his client's interests.'"[85] In addition to the two elements that are necessary to find excessive trading—control and trading that is excessive in light of the customer's investment objectives—churning requires a third element of scienter on the part of the broker.[86] Scienter "is established either by evidence of intent to defraud or by evidence of willful and reckless disregard of the customer's interests."[87]

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[82] *See, e.g., Simpson*, 2002 WL 987555, at *14 n.45 (rejecting argument that measuring account activity for six months resulted in artificially high value for the annualized turnover rate and cost-to-equity ratio); *Laurie Jones Canady*, Exchange Act Release No. 41250, 54 SEC 65, 1999 WL 183600, at *6 (Apr. 5, 1999) (rejecting argument that measuring account activity for nine months was too short a period of time to support a finding of excessive trading); *Bucchieri*, 1996 WL 254677, at *2-4 (finding excessive trading based on a review period of eight months).

[83] *Simpson*, 2002 WL 987555, at *14 n.45.

[84] *See Dep't of Enforcement v. O'Hare*, Complaint No. C9B030045, 2005 WL 1002949, at *4 (NAC Apr. 20, 2005) (finding excessive trading based on a three-month period of trading with an annualized cost-to-equity ratio of 140% and an annualized turnover rate of 21.358).

[85] *Studer*, 2004 WL 2735433, at *4 (quoting *Donald A. Roche*, Exchange Act Release No. 38742, 53 SEC 16, 1997 WL 328870, at *4 (June 17, 1997)); *see also Rizek*, 1999 WL 600427, at *5 ("Churning occurs 'when a securities broker buys and sells securities for a customer's account, without regard to the customer's investment interests, for the purpose of generating commissions.'" (quoting *Olson v. E.F. Hutton & Co.*, 957 F.2d 622, 628 (8th Cir. 1992))).

[86] *Roche*, 1997 WL 328870, at *4 ("Scienter . . . is what separates 'churning' from 'excessive trading.'").

(continued...)

FINRA found that the evidence in the record demonstrated that Murphy's trading in Lowry's account was for the purpose of generating commissions and was carried out with reckless disregard of Lowry's interests. We agree. During the time Murphy managed Lowry's account, Murphy's trading generated over $1 million in commissions, with a majority of those commissions going directly to Murphy. From the third quarter of 2002 through the end of 2005, Murphy's trading in Lowry's account was responsible for 59% of his total commissions. Given the very high level of commissions and the resulting high cost-to-equity ratio in the account, the evidence in the record supports the finding that Murphy's overriding goal was generating commissions.[88] The volume and frequency of Murphy's options trading—including repeated round-trip trades—is difficult to explain except as Murphy's seeking to maximize his own commissions in disregard of Lowry's interests.[89] And although Lowry had only a moderate tolerance for risk and limited experience with and knowledge of options trading, Murphy abused the trust she had placed in him and engaged in excessive options trading inconsistent with her interests.[90] As FINRA's expert concluded in his report, Murphy's "trading was inappropriate, unnecessarily frequent, of a speculative nature and the only beneficiary was the recipient of the all too high transaction fees."[91]

Further evidence of scienter comes from Murphy's attempts to mislead Lowry about his trading.[92] On more than one occasion, Lowry raised concerns with Murphy about the trading losses and the level of commissions in her account only to be misled by Murphy's false assurances that she was "making money" and that commissions "didn't matter."[93]

Murphy argues that it would have been illogical to send duplicate account statements to Lowry's accountants and financial planner if he had intended to defraud her. But duplicate account statements were not sent to Lowry's accountants and financial planner during one of the most active periods in the account—between April 2003 and April 2005. And the fact that

(...continued)
Although the terms "churning" and "excessive trading" have sometimes been used interchangeably, "churning" is "the violation's normal designation in a fraud context." *Id.* "'Excessive trading,' without more, is a type of violation of broad 'suitability' rules promulgated by self-regulatory organizations, which are not antifraud provisions." *Id.*

87 *Rizek*, 1999 WL 600427, at *5; *see also Studer*, 2004 WL 2735433, at *4-5; *Roche*, 1997 WL 328870, at *4.

88 *See Studer*, 2004 WL 2725433, at *5 ("The generation of commissions as a goal overriding the client's interests evidences scienter in churning.").

89 *See Roche*, 1997 WL 328870, at *4 (the motivation to maximize a broker's remuneration in disregard of the interests of the customer "creates the element of scienter necessary for a violation of the antifraud provisions of the securities laws").

90 *See Rizek*, 1999 WL 600427, at *6 (pursuing a riskier strategy than appropriate for a customer can be evidence of scienter).

91 Ex. CX-37, at 14.

92 *See, e.g., Phillip J. Milligan*, Exchange Act Release No. 61790, 2010 WL 1143088, at *5 (Mar. 26, 2010) ("[A]ttempts to conceal misconduct indicate scienter.").

93 Tr. at 148.

others received account statements does not preclude a finding of scienter. There is no evidence that Lowry's accountants and financial planner were tasked with monitoring the account or that Lowry told Murphy that they were. Even if Murphy believed there was an increased risk that Pesavento or DeRose might raise objections about the level of his trading, this is not inconsistent with the finding that he acted with scienter.

We also agree with FINRA that Murphy acted with scienter in excessively trading Martinelli's account. Given the 169% cost-to-equity ratio and turnover rate of 22, Murphy must have known that his trading was wholly inconsistent with his customer's interests. Murphy's so-called "conservative approach" resulted in Martinelli's account value decreasing by more than 45% in just two months. The approximately $5,400 in commissions Murphy generated in Martinelli's account in the three months he managed it represented 42% of Martinelli's average equity and nearly 17% of Martinelli's annual salary. These facts support the finding that Murphy was acting with the purpose of generating commissions and in reckless disregard of Martinelli's interest.

In light of the above, we find that Murphy acted with scienter and churned both Lowry's and Martinelli's accounts.

D. Murphy distributed misleading communications to Lowry.

FINRA found that Murphy caused the creation and distribution to Lowry of inaccurate, misleading, and unbalanced written communications, in violation of NASD Rules 2210, 2220, and 2110. Rule 2210(d)(1) provides, in relevant part, as follows:

> (A) All member communications with the public shall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. No member may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading.
>
> (B) No member may make any false, exaggerated, unwarranted or misleading statement or claim in any communication with the public. No member may publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.

Similarly, Rule 2220(d)(1), governing content standards for communications with the public concerning options, provides that

> [n]o member . . . or person associated with a member shall utilize any advertisement, educational material, sales literature or other communications to

> any customer or member of the public concerning options which . . . contains any untrue statement or omission of a material fact or is otherwise false or misleading.

FINRA identified three types of written communications that Murphy caused to be created and sent to Lowry in violation of these rules: profit-and-loss reports (periodic reports detailing the realized profits and losses from the options trading in the account), the change-in-account-value report (purporting to show overall change in the value of Lowry's account between 2002 and 2005), and a document titled, "Safe Option Strategies that can be employed" (a one-page document describing potential option strategies).

Murphy testified that these communications were created under his direction and sent to Lowry at his request. Each type of communication contained untrue statements of material fact or was otherwise false or misleading. Specifically, the profit-and-loss statements sent to Lowry were filled with errors concerning the profits in Lowry's account. Twelve of the sixteen statements overstated the account's total profits—one by over $38,000—and the reports contained multiple errors on a line-by-line basis that contributed to the errors in the profit totals. Similarly, the change-in-account-value report, which purported to show the change in the value of the account for each year between 2001 and 2005, contained numerous errors. Because it calculated the changes in the account's value in an inconsistent manner, the report significantly misstated the change in the value of the account for the years 2003 to 2005. The resulting errors were sizable: for 2003, the report indicated the account value increased $276,316, when in fact it decreased $7,738; for 2004, the report indicated the account value decreased $384,465, when in fact it decreased $1,136,736; and for 2005, the report indicated the account value increased by $256,031, when in fact it increased by $537,502.

These errors were material, as reasonable investors would consider information concerning the profits, losses, and value of their accounts important in making investment decisions.[94] Murphy testified that he reviewed the profit-and-loss statements and the change-in-account-value report before they were sent to Lowry. Under the circumstances, given the size and frequency of the errors in these communications, we agree with FINRA that Murphy knew or had reason to know they contained material misstatements.

The "Safe Option Strategies" document was also materially misleading and unbalanced because it failed to identify the substantial risks associated with the option strategies it described and inaccurately described such strategies as "safe." Specifically, the document identified a "collar option" and a "short straddle" as safe strategies and highlighted their objectives and upsides. But the document failed to mention that the strategies described involved the risk of substantial losses should the value of the underlying security change significantly. As someone

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[94] *See Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (materiality depends upon whether there is a substantial likelihood that a reasonable investor would have considered the misstated or omitted fact important in making an investment decision).

with experience in options, Murphy knew or had reason to know that the document was misleading.

Murphy does not dispute that the identified communications sent to Lowry contained untrue statements of material fact or that they were misleading and unbalanced. Instead, he argues these communications did not violate FINRA rules because they were not "sales literature." Murphy argues that information sent to a single customer does not qualify as "sales literature" pursuant to NASD Rule 2210. But the rules FINRA found Murphy to have violated are not limited to "sales literature." Rule 2210(d)(1) applies to "[a]ll member communications with the public," including "correspondence."[95] "Correspondence," in turn, was defined prior to November 2003 to include "any written or electronic communication prepared for delivery to a single current or prospective customer," and after November 2003 to include "any written letter or electronic mail message distributed by a member to . . . one or more of its existing retail customers."[96] The relevant communications sent to Lowry qualify as "correspondence" under either definition. Similarly, Rule 2220(d)(1) applies to "any advertisement, educational material, sales literature *or other communications to any customer* or member of the public concerning options" (emphasis added). Thus, contrary to Murphy's suggestion, all of the communications identified above come within the scope of Rules 2210(d) and 2220(d)(1).

Accordingly, we sustain FINRA's finding that Murphy violated NASD Rules 2210, 2220, and 2110 by causing inaccurate, misleading and unbalanced communications to be sent to Lowry.

E. Birkelbach failed to reasonably supervise Murphy.

NASD Rule 3010(a) requires that a member "establish and maintain" a supervisory system "that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with [NASD Rules]." In addition, NASD Rule 2860(b)(20) requires that members provide for the "diligent supervision" of options trading in customer accounts and implement procedures providing for "frequent supervisory review" of "customer accounts maintaining uncovered short option positions." Whether a supervisor's actions constitute "reasonable" supervision "'is determined based on the particular circumstances of each case.'"[97] We have held that "'[t]he duty of supervision includes the responsibility to investigate "red flags" that suggest that misconduct may be occurring and to act upon the results of such investigation.'"[98] "'Once indications of irregularity arise, supervisors must respond

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95 *See* NASD Rule 2210(a)(3).

96 *Compare* NASD Rule 2210(a)(3) (2002) *with* NASD Rules 2210(a)(3) (2006 NASD Manual) *and* 2211(a)(1)(A) (2006 NASD Manual).

97 *Ronald Pellegrino*, Exchange Act Release No. 59125, 2008 WL 5328765, at *10 (Dec. 19, 2008) (quoting *John A. Chepak*, Exchange Act Release No. 42356, 54 SEC 502, 2000 WL 49226, at *6 n.27 (Jan. 24, 2000)).

98 *Id.* (quoting *Studer*, 2004 WL 2725433, at *6).

appropriately.'"[99] "'[R]ed flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review. When indications of impropriety reach the attention of those in authority, they must act decisively to detect and prevent violations of the securities laws.'"[100]

As the Senior Registered Options Principal, Birkelbach had supervisory responsibilities over Murphy's options trading during the time Murphy managed Lowry's account. Birkelbach was familiar with Lowry's account—he approved the opening of Lowry's option account as well as the subsequent changes to the option agreement allowing uncovered writing and spreading. He was also familiar with the trading that occurred in the account because he reviewed all options trades and reviewed accounts to see if options trading was within approved levels.

From this vantage point, Birkelbach was presented with numerous red flags associated with Murphy's trading in Lowry's account. To begin with, Birkelbach should have been concerned with the dramatic increase in trading activity that occurred when Murphy took over the account from Jage. Murphy's heavy trading continued unabated for several years as commissions, trading losses, and margin debt grew. Birkelbach admitted during the hearing that he knew there was "a lot of activity" in Lowry's account and that the increase in commissions was "obvious."[101] Birkelbach should also have been concerned that Murphy's trading—involving uncovered options and complex combinations—was highly risky and exceeded the levels approved for the account. The parties stipulated that Birkelbach knew that Murphy effected uncovered options transactions from August 2002 through October 2004 in Lowry's account. And Birkelbach should have known that such trading was unsuitable for a customer like Lowry, who was an unsophisticated investor with only moderate tolerance for risk. Indeed, he conceded as much to FINRA investigators by stating that an investor's objectives should be "speculative or high risk" to trade uncovered options.[102]

In the face of these red flags, Birkelbach failed to exercise appropriate supervision over Murphy's handling of Lowry's account. Under the circumstances, an appropriate supervisory response at a minimum would have included a further investigation into Murphy's trading in Lowry's account and, when violations were detected, corrective actions to prevent future misconduct. Instead, Birkelbach allowed Murphy to churn Lowry's account for years while he took no meaningful action—never disapproving any trade made in Lowry's account and never questioning Murphy about the amount of trading.

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99 *Id.* (quoting *La Jolla Capital Corp.*, Exchange Act Release No. 41755, 54 SEC 275, 1999 WL 624046, at *6 (Aug. 18, 1999)).

100 *John B. Busacca, III*, Exchange Act Release No. 63312, 2010 WL 5092726, at *10 (Nov. 12, 2010) (quoting *Edwin Kantor*, Exchange Act Release No. 32341, 51 SEC 440, 1993 WL 167840, at *5 (May 20, 1993)), *aff'd*, 449 F. App'x 886 (11th Cir. 2011).

101 Tr. at 1104.

102 Ex. JX-202, at 57.

Birkelbach insists that he did not "do nothing" and he points to the fact that he "reviewed trade sheets, order tickets and trade blotters, including Lowry's transactions[,] daily."[103] But despite the fact that this review should have made Birkelbach aware that Murphy was involved in frequent and heavy trading that was inconsistent with Lowry's investor profile, Birkelbach failed to follow up to ensure that Murphy's trading was authorized, suitable, and not excessive.[104] Although Birkelbach contends that he would drop by Murphy's office with some frequency and they would talk about Lowry's account, these conversations did not involve any serious scrutiny by Birkelbach of Murphy's trading. Birkelbach testified that he readily accepted Murphy's explanations about his trading, but at the same time he admitted that he did not even discuss with Murphy the options trading strategy employed in Lowry's account. Even a cursory review of the trading in the account—which Birkelbach insists he was conducting—should have alerted him to numerous potential concerns that he should have raised with Murphy. Despite frequent contact with Murphy, however, Birkelbach failed to take any reasonable steps to limit Murphy's violations.

Birkelbach claims that he believed Lowry was approving every trade because Murphy was frequently talking with Lowry on the phone when Birkelbach would come by his office. But, as FINRA points out, Birkelbach did nothing to verify this assumption, such as speaking with Lowry.[105] Birkelbach argues that he met with Lowry on a few occasions, but the record shows that these face-to-face meetings were either social in nature or simply involved the brief exchange of pleasantries. There is no evidence that Birkelbach used these meetings to obtain any meaningful information from Lowry about whether she understood and approved of Murphy's trading.

Birkelbach also knew from frequent conversations with Langlois, BIS's compliance officer, that Langlois had concerns about Murphy's trading in Lowry's account, including concerns about the volume of trading, losses in the account, and the lack of written discretionary authority. Birkelbach was aware that Langlois sent multiple activity letters to Lowry because of Langlois's concerns over the level of activity in the account. Between September 2002 and April

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[103] Birkelbach's Reply Br. in Supp. of Appl. for Review at 5, 8.

[104] *See Pellegrino*, 2008 WL 5328765, at *10 (finding unreasonable supervision where supervisor was aware that registered representatives were recommending riskier investments than suitable for investors but took no steps to address the problem); *Paul C. Kettler*, Exchange Act Release No. 31354, 51 SEC 30, 1992 WL 320802, at *2 (Oct. 26, 1992) (finding supervisory violations related to an options account where supervisor ignored red flags, such as "heavy trading and severe losses in speculative options trades," and "did not even take the minimal step of questioning [the broker] or [customer] in regard to that activity"); *Tennenbaum*, 1982 WL 31984, at *6 (finding failure to supervise where, despite warnings that employee might be engaging in excessive options trading, supervisor "failed to take or recommend any action to investigate [his] activities" and instead "engaged in 'foot-dragging'").

[105] Birkelbach faults FINRA for suggesting that he should have investigated phone records to verify this assumption, arguing that the phone calls between Murphy and Lowry were "local calls," and suggesting therefore that such calls would not appear on BIS's phone bill. *See* Birkelbach's Reply Br. in Supp. of Appl. for Review at 7. But it would not have taken an extensive investigation for Birkelbach to have a candid conversation with Lowry about whether she was giving approval to Murphy prior to every trade.

2005, Langlois sent eight activity letters to Lowry, each mentioning a "high level of activity" or "active" trading in the account.[106] One activity letter, sent in November 2003, indicated that Lowry had paid year-to-date commissions totaling $251,781. As FINRA notes, this "by itself should have caused a high level of concern."[107] But Birkelbach squandered the opportunity to provide appropriate supervision of Murphy's trading in Lowry's account in relation to the activity letters sent by Langlois. Birkelbach never followed up with Lowry about the letters, and there is no evidence that he followed up with Murphy.

Birkelbach argues that "if highlighting $250,000 in commissions d[id] not raise an eyebrow" from Lowry, he could safely "conclude that Lowry was in accord with the activity in the account."[108] But, as we have noted specifically in the context of customers not complaining following the receipt of activity letters, "'[s]upervisory personnel cannot rely solely upon complaints from customers to bring misconduct of employees to their attention, particularly where customers . . . may fail to realize that they have been mistreated.'"[109] In this case, Lowry was exactly the type of customer who was likely to fail to detect Murphy's violations, because she was an unsophisticated investor, who did not understand her account statements and other documents sent to her by BIS, and who placed significant trust in Murphy. For this reason, Birkelbach's attempt to make Lowry responsible for his own supervisory failures is inappropriate.[110] Moreover, Lowry did, in fact, raise concerns to Murphy about the almost $250,000 in commissions after receiving the letter in question, only to receive false assurances from Murphy that the commissions "didn't matter" because "the account was profitable."[111] If Birkelbach had followed up with Lowry (or Murphy) about the activity letters, he may have discovered that Lowry did have concerns, and he could have taken reasonable steps to address them.[112] In the circumstances, doing nothing more than allowing the activity letters to be sent to

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106 Ex. RX-40.

107 *Murphy*, 2011 WL 5056463, at *27.

108 Birkelbach's Reply Br. in Supp. of Appl. for Review at 6.

109 *Quest Capital Strategies, Inc.*, Exchange Act Release No. 44935, 55 SEC 362, 2001 WL 1230619, at *6 (Oct. 15, 2001) (quoting *Reynolds & Co.*, Exchange Act Release No. 6273, 39 SEC 902, 1960 WL 56264, at *10 (May 25, 1960)); *see also Albert Vincent O'Neal*, Exchange Act Release No. 34116, 51 SEC 1128, 1994 WL 234316, at *4 (May 26, 1994) (finding deficient supervision when supervisor failed to follow up with customers after sending activity letters).

110 Similarly, Birkelbach recycles the argument that it was Lowry's desire for $10,000 per month that excuses his conduct in this case because her request would mean that excessive activity in the account was not a red flag. But, for many of the same reasons discussed *supra*, Birkelbach's argument is unavailing. The record does not support the claim that Lowry made a demand for $10,000 monthly. And even if she had, Murphy's trading still should have raised red flags because it was far too risky for a customer like Lowry. Moreover, Applicants have failed to provide an adequate explanation of how Murphy's trading was designed to meet the alleged demand.

111 Tr. at 148. In addition, when Lowry questioned Murphy earlier about the purpose of the activity letters, he told her they were routine and to simply sign and return them.

112 Lowry also raised concerns to Murphy about the trading losses in her account and the large margin debt in early 2005, but Murphy again tried to downplay her concerns by telling her that the margin debit balance "wasn't a true indication" of the margin in her account.

Lowry was "wholly inadequate" supervision, particularly when Lowry had been lulled by Murphy's false assurances.[113]

Birkelbach also was aware that Murphy was being investigated by FINRA in relation to the activity in Lowry's account. Murphy testified that by November 2004, FINRA had notified BIS that it was looking into the trading in Lowry's account. By November 2005, FINRA had specifically asked Birkelbach to place Murphy under heightened supervision. Birkelbach also knew of Murphy's relevant disciplinary history, namely, a 1999 disciplinary action brought by the Chicago Board Options Exchange—and sustained by the Commission—finding that Murphy had traded without prior authorization from a customer and had exercised discretion without prior written authorization. In addition to formal disciplinary action, Birkelbach knew that Murphy was the subject of arbitrations and numerous customer complaints, all of which should have prompted Birkelbach to heighten his supervision of Murphy.[114] Indeed, because Murphy had been disciplined for conduct very similar to that at issue in this case, Birkelbach should have been particularly vigilant to investigate the red flags suggesting unauthorized trading. But there is no indication in the record that Birkelbach took steps to supervise Murphy "with the vigilance called for by his disciplinary record."[115]

Birkelbach argues that his supervision was adequate because he "brought in" DeRose to "look over Birkelbach's shoulder" and because Lowry's accountants received duplicate account statements.[116] Birkelbach contends that because none of these individuals said anything to him about the trading in Lowry's account, he was left "to conclude that the activity in Lowry's account was acceptable."[117] But this argument is flawed in several respects. First, the evidence in the record does not support Birkelbach's contention that DeRose was recommended to Lowry as part of "an enhanced supervisory procedure."[118] DeRose, who was not associated with BIS, testified that she was never asked to review Murphy's options trading in Lowry's account; instead, she was hired to make a financial plan for Lowry, and she received Lowry's account statements to help her fulfill that task. Birkelbach's argument is further flawed because the record shows that DeRose did raise concerns to Birkelbach about the "unusually high" level of

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113 *Quest Capital Strategies, Inc.*, 2001 WL 1230619, at *6 (rejecting the argument that a lack of customer complaints following activity letters was justification for failing to question customers about registered representative, particularly where the representative had "lulled his customers into a false sense of security").

114 *See Robert J. Prager*, Exchange Act Release No. 51974, 58 SEC 634, 2005 WL 1584983, at *11 (July 6, 2005) (emphasizing that when an individual "has known regulatory problems or customer complaints" there is a "need for heightened supervision"); *Consol. Inv. Servs., Inc.*, Exchange Act Release No. 36687, 52 SEC 582, 1996 WL 20829, at *4 (Jan. 5, 1996) ("Having undertaken to hire and retain such a registered representative [*i.e.*, one with a disciplinary history], Applicants had an obligation to insure that procedures were in place to supervise him properly.").

115 *Prager*, 2005 WL 1584983, at *11.

116 Birkelbach's Br. in Supp. of Appl. for Review at 9.

117 *Id.* at 8.

118 *Id.* at 7.

activity and commissions in the account, but Birkelbach dismissed these concerns with the assurance that Lowry "is getting really good advice" from Murphy.[119] And Lowry's accountants, who also were not associated with BIS, were never tasked with reviewing the trading in her account. In addition, neither DeRose nor Lowry's accountants had options trading expertise. More fundamentally, Birkelbach—not DeRose or Lowry's accountants—was responsible for supervising Murphy's trading.[120] But instead of accepting and fulfilling his responsibility, Birkelbach abdicated his responsibility and insists that his failures should be excused because of what others might have done.

Birkelbach also failed to provide adequate supervision of Murphy with regard to Martinelli's account. Birkelbach had direct supervisory responsibility over Murphy's trading in Martinelli's account. Although Birkelbach knew that FINRA was investigating Murphy's trading and had requested that Birkelbach heighten his supervision of Murphy, Birkelbach did not change his supervisory approach.[121] His review of the daily tickets and activity report for the account should have alerted Birkelbach to the excessive trading, including several in-and-out trades, but he failed to take any steps to investigate and allowed Murphy to churn Martinelli's account.[122] When Martinelli telephoned Birkelbach in June 2007 to complain about Murphy's trading, Birkelbach failed to verify that Martinelli had given Murphy authority to make trades—even though Birkelbach had admitted to FINRA investigators in May 2006 that he knew that Murphy may have placed trades in Lowry's account without discussing the trades with her beforehand. And even after Martinelli complained, Birkelbach allowed Murphy to continue handling Martinelli's account until the account was closed.

Birkelbach argues that he "discharged his supervisory responsibilities as to Martinelli and treated him in a fair manner" because he "investigated" and "settled with Martinelli."[123] But the evidence in the record does not support Birkelbach's assertion that he made an adequate investigation. As FINRA points out, it was not until the Illinois Securities Department issued a temporary order of prohibition against Murphy on August 31, 2007—over a month after Martinelli closed his account—that Birkelbach heightened in any way his supervision of

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119 Ex. JX-202, at 115-16.

120 *Prager*, 2005 WL 1584983, at *11 & n.45 ("We have long maintained that '[f]inal responsibility for supervision of a trading activities at a member firm . . . rests with the firm's president, unless the president reasonably delegates the duties to someone else and has no reason to know that person is not properly performing the delegated duties.'" (quoting *Studer*, 2004 WL 2725433, at *6)). There is no evidence that Birkelbach reasonably delegated his supervisory duties related to Lowry's account to anyone—and he could not delegate those duties to individuals not associated with the member firm.

121 *Id.* at *11 (holding that the failure to heighten supervision in the face of a relevant disciplinary history is a supervisory violation).

122 *See Tennenbaum*, 1982 WL 31984, at *6 (finding a failure to supervise where supervisor had "specific warnings that [representative] might be engaging in excessive trading" but "failed to take or recommend any action to investigate [his] activities" and "never sought to place any meaningful restraints on [representative]").

123 Birkelbach's Reply Br. in Supp. of Appl. for Review at 9.

Murphy, and even after the temporary order of prohibition was issued, Birkelbach had still not asked Martinelli if he had authorized Murphy's trading. Moreover, the fact that BIS eventually settled with Martinelli is of no relevance to whether Birkelbach's supervision of Murphy was adequate.

For all of the above reasons, we sustain FINRA's finding that Birkelbach failed to adequately supervise Murphy in violation of NASD Rules 3010, 2860(b)(20), and 2110.

IV.

Applicants argue that FINRA's disciplinary action against them is barred by the statute of limitations in 28 U.S.C. § 2462, which provides that a "proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued." As support for their position, Applicants point to *Johnson v. SEC*, 87 F.3d 484 (D.C. Cir. 1996), which held that § 2462 applied to an administrative enforcement proceeding initiated by the Commission. But § 2462 does not apply to FINRA disciplinary proceedings because FINRA is not a government entity.[124] Indeed, we have repeatedly held that "the disciplinary authority of private self-regulatory organizations ('SROs') such as [FINRA] is not subject to any statute of limitation."[125]

Applicants argue that SROs act as the Commission's "surrogates" and therefore *Johnson*'s reasoning should apply to disciplinary proceedings brought by an SRO. This argument misconstrues the Commission's role in SRO disciplinary proceedings. As we have stated:

> SRO proceedings are not initiated by a government agency, nor does their initiation require our approval. We do not participate in the disciplinary proceeding before the SRO, and we do not control when the SRO begins or concludes its determination. Our sole responsibility in this context arises when an SRO imposes a final disciplinary sanction on a person who seeks review of the SRO's determination from this Commission. Moreover, enforcement of the

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124 *See Faragalli*, 1996 WL 683707, at *10 n.36 (holding that "*Johnson* is inapplicable to SRO proceedings" because "SROs are private organizations"); *see also Larry Ira Klein*, Exchange Act Release No. 37835, 52 SEC 1030, 1996 WL 597776, at *6 (Oct. 17, 1996) ("We do not believe that [§2462] applies to disciplinary proceedings brought by a self-regulatory organization ('SRO')."); *United States v. Inc. Village of Island Park*, 791 F. Supp. 354, 367 (E.D.N.Y. 1992) ("Section 2462 applies *only* to actions brought by the United States." (emphasis in original)); *Erie Basin Metal Prods., Inc. v. United States*, 150 F. Supp. 561, 566 (Ct. Cl. 1957) ("The limitation of section 2462 applies only to actions instituted by the Government.").

125 *Gluckman*, 1999 WL 507864, at *6; *see also William D. Hirsh*, Exchange Act Release No. 43691, 54 SEC 1068, 2000 WL 1800614, at *5 (Dec. 8, 2000) ("We have consistently held that no statute of limitations applies to the disciplinary actions of the Exchange or other self-regulatory organizations ('SROs')."); *Faragalli*, 1996 WL 683707, at *10 ("[I]t is well established that no statute of limitations applies to the disciplinary actions of the Exchange or other self-regulatory organizations ('SROs').").

> sanctions imposed will be the direct responsibility of the SRO, and any fine will be payable to the SRO, not the United States Treasury.[126]

Furthermore, courts and the Commission have held that SROs are generally not subject to the requirements and duties applicable to government agencies.[127]

Moreover, even if § 2462 were to apply, it would not bar FINRA's action here because the vast majority of the violative conduct in this case occurred within five years of FINRA's filing its complaint, and all of the violations culminated within that period.[128] Indeed, conduct by Applicants sufficient to sustain each of the violations under review continued until well after July 30, 2003—the date five years before FINRA issued its complaint. For all of the above reasons, we conclude that § 2462 does not bar FINRA's disciplinary proceeding against Applicants.

V.

Section 19(e) of the Exchange Act directs us to sustain FINRA's sanctions unless we find, having due regard for the public interest and the protections of investors, that the sanctions are excessive or oppressive or impose an unnecessary or inappropriate burden on competition.[129] Although we are not bound by FINRA's Sanction Guidelines, "we use them as a benchmark in conducting our review under Exchange Act Section 19(e)(2)."[130]

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126 *Klein*, 1996 WL 597776, at *6.

127 *See, e.g., Shultz v. SEC*, 614 F.2d 561, 569 (7th Cir. 1980) (holding that the Administrative Procedure Act did not apply to a disciplinary proceeding of the Chicago Board Options Exchange, Inc., because "[t]he Exchange is a Delaware non-stock corporation and not an authority of the Government"); *United States v. Solomon*, 509 F.2d 863, 868-69 (2d Cir. 1975) (holding that privilege against self-incrimination does not apply in investigation by the New York Stock Exchange and rejecting the argument that "interrogation by NYSE must be deemed the equivalent of interrogation by the United States because the Exchange has become in effect the arm of the Government in administering portions of the Securities Exchange Act") (Friendly, J.); *Daniel Turov*, Exchange Act Release No. 31649, 51 SEC 235, 1992 WL 394575, at *3 (Dec. 23, 1992) (NYSE disciplinary action not subject to challenge under various constitutional provisions because "the Exchange is not the government"). *But cf. D'Alessio v. N.Y. Stock Exch., Inc.*, 258 F.3d 93, 104 (2d Cir. 2001) (holding that NYSE is immune from liability for claims arising out of the discharge of its duties under the Exchange Act).

128 *Faragalli*, 1996 WL 683707, at *10 n.36 ("In any event, much of the conduct at issue in this case occurred within five years of the institution of proceedings, and all of the violations culminated within that period. Thus, these proceedings would not be barred by Section 2462 even if that section were deemed to apply."); *cf. Nat'l Parks Conservation Ass'n, Inc. v. Tenn. Valley Auth.*, 480 F.3d 410, 416 (6th Cir. 2007) (holding that an action is timely under § 2462 so long as it identifies "a wrongful act that took place within five years" of filing suit).

129 15 U.S.C. § 78s(e)(2). Applicants do not claim, nor does the record show, that FINRA's actions imposed an unnecessary or inappropriate burden on competition.

130 *PAZ Sec., Inc.*, Exchange Act Release No. 57556, 2008 WL 1697153, at *3 (Apr. 11, 2008).

A. The remedial sanctions FINRA imposed on Murphy are not excessive or oppressive.

For all of his violations, except misleading communications, FINRA barred Murphy in all capacities and ordered him to pay $585,174.67 in disgorgement.[131] FINRA's Sanction Guidelines recommend up to a bar for egregious cases of churning, excessive trading, unsuitable recommendations, and unauthorized trading.[132] We agree with FINRA that there are several aggravating factors that support its finding that Murphy's violations were egregious and warrant a bar.

Murphy is a recidivist with a history of discipline related to his sales practices. Murphy's prior Commission-sustained discipline by the Chicago Board Options Exchange—for unauthorized trading and discretionary trading without proper authorization—involved conduct similar to the conduct at issue here, supporting the conclusion that the investing public should be protected from the potential of similar violations in the future.[133] In addition, Murphy's misconduct in this case involved multiple violations occurring over a period of several years.[134] Murphy's misconduct also benefitted himself while injuring his customers.[135] He earned over a

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[131] FINRA considered all of the violations except misleading communications as part of the same course of conduct, and in light of the bar imposed for these violations, did not impose a separate sanction for Murphy's use of misleading communications.

[132] *See* FINRA Sanction Guidelines at 82, 99, 103. For exercising discretion without written authorization, the Guidelines recommend in egregious cases a suspension from 10 to 30 business days. *Id.* at 90.

[133] *Midas Sec., LLC*, Exchange Act Release No. 66200, 2012 WL 169138, at *16 (Jan. 20, 2012) ("'We have long recognized that prior disciplinary history . . . provides evidence of whether an applicant's misconduct is isolated, the sincerity of the applicant's assurance that he will not commit future violations and/or the egregiousness of the applicant's misconduct.'" (quoting *Consol. Inv. Servs.*, 1996 WL 20829, at *6)); Sanction Guidelines at 2 ("Disciplinary sanctions should be more severe for recidivists"—particularly in cases where "past misconduct [is] similar to that at issue" or "evidences a disregard for regulatory requirements, investor protection, or commercial integrity.").

[134] *See* Sanction Guidelines at 6 (providing that "[w]hether the respondent engaged in numerous acts and/or a pattern of misconduct" and "[w]hether the respondent engaged in the misconduct over an extended period of time" are principal considerations in determining sanctions). In connection with his argument that FINRA's "sanctions are not appropriate given the surrounding circumstances," Murphy noted before the NAC in 2010 that his alleged misconduct related to Lowry "began almost 7 years ago, and for Martinelli, 3 years have passed." NAC Appeal Br. of Appellants-Resp'ts at 22. But this ignores the fact that Murphy's mishandling of Lowry's account continued for over three years until she decided to close her account in early 2006. And in any event, we do not believe the amount of time that has passed since Murphy's violative conduct is mitigating under the circumstances. *Cf. James Gerard O'Callaghan*, Exchange Act Release No. 61134, 2009 WL 4731651, at *5 (Dec. 10, 2009) (rejecting the argument "that the 'mere passage of time' . . . without engaging in similar conduct is mitigating" in determining whether a suspension was excessive or oppressive); *Gregory O. Trautman*, Exchange Act Release No. 61167A, 2009 WL 6761741, at *21 (Dec. 15, 2009) (finding that conduct over six years before the issuance of the Commission's opinion was "relatively recent" and supportive of a cease-and-desist order).

[135] *See id.* (providing that "whether the respondent's misconduct resulted directly or indirectly in injury" is a principal consideration in determining sanctions).

half million dollars in commissions churning Lowry's and Martinelli's accounts, while Lowry lost $871,301.95 and Martinelli lost $5,703.59 from his trading.[136]

We also agree with FINRA that Murphy acted with intent.[137] Murphy's excessive trading evidenced scienter because Murphy placed his own interest in earning commissions above the interest of his customers. And given his disciplinary history, Murphy knew or was reckless in not knowing that he could not exercise discretionary authority in either Lowry's or Martinelli's accounts without their written consent.[138] Similarly, Murphy must have known that his risky options trading in Lowry's account was neither authorized by Lowry nor appropriate for an unsophisticated investor with a moderate tolerance for risk.

Murphy also attempted to conceal his misconduct from Lowry and from BIS.[139] Murphy gave false assurances to Lowry about the profitability of her account, never disclosed to her the risks involved in the options trading he was pursuing or that he was deviating from a covered call strategy, told her the activity letters sent to her by Langlois were only a formality, and sent her misleading profit-and-loss statements that frequently overstated the profits in her account. And Murphy misled Langlois, BIS's compliance officer, by telling him that Lowry had authorized every trade. In addition, Murphy attempts to minimize his wrongdoing and shift blame to others, such as Lowry, Pesavento, and DeRose.[140] In light of these significant aggravating factors, we

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136 The net loss to Lowry of approximately $93,821 from Murphy's management of her account was considerably less than the options trading losses, primarily given the appreciation in the value of her P&G stock—a fact that FINRA took into account when fashioning its sanctions. But, as FINRA points out, the options trading losses are also highly relevant to the sanctions analysis, because Lowry's account would be worth much more had Murphy not engaged in excessive and unsuitable options trading. *See Bucchieri,* 1996 WL 254677, at *5 (noting that, even for customers who had not suffered a net loss, "the effect that [broker's] trading had in reducing . . . customers' profits" was relevant in the sanctions analysis). Indeed, as suggested previously, without the significant appreciation of Lowry's P&G stock (something for which Murphy can take no credit) the net loss to Lowry would have been substantially greater.

137 *See* Sanction Guidelines at 7 (providing that "[w]hether the respondent's misconduct was the result of an intentional act" is a principal consideration in determining sanctions).

138 Although Lowry gave Murphy oral permission to conduct trades without her prior authorization and Murphy contends that he understood Martinelli to give him oral permission to pursue the strategy they discussed, we agree with FINRA that, under the circumstances, this is not mitigating evidence. *See* Sanction Guidelines at 90 (providing that "[w]hether customer's grant of discretion was express or implied" is a principal consideration in determining sanctions for violations of the rule against discretionary trading without authorization). First, Murphy exceeded the permission granted to him by Lowry by pursuing risky options trades not part of the covered call strategy she had requested. Second, Martinelli provided credible testimony that he did not give Murphy permission to trade.

139 *See* Sanction Guidelines at 6 (providing that "[w]hether the respondent attempted to conceal his or her misconduct or to lull inactivity, mislead, deceive or intimidate a customer . . . or . . . the member firm with which he or she is/was associated" is a principal consideration in determining sanctions).

140 *See id.* (providing that "[w]hether an individual . . . accepted responsibility for and acknowledged the misconduct" is a principal consideration in determining sanctions).

believe that a bar is neither excessive nor oppressive and is appropriate to protect investors from further misconduct by Murphy.[141]

The disgorgement order also serves the remedial purpose of depriving Murphy of the benefit of his misconduct.[142] The Sanction Guidelines provide that payment of disgorgement should be required in all sales practice cases in which "the respondent has retained substantial ill-gotten gains."[143] FINRA found that Murphy's churning of Lowry's and Martinelli's accounts resulted in commissions to him personally of $591,933.67.[144] In reaching a disgorgement amount, FINRA deducted $5,000 for the fine Murphy paid to the Illinois Securities Department and $1,759 for commission reimbursements that Martinelli acknowledged receiving. The resulting $585,174.67 is a reasonable approximation of the ill-gotten gains Murphy retained from his violative conduct, and we thus sustain FINRA's disgorgement order.[145]

Murphy's arguments against the sanctions imposed by FINRA are unpersuasive. Murphy argues that the settlements reached with Lowry and Martinelli support a lesser sanction. Although the Sanction Guidelines recognize that a voluntary and reasonable attempt, "prior to detection and intervention, to pay restitution or otherwise remedy the misconduct" may be mitigating,[146] the settlements reached with both Lowry and Martinelli came about only after the customers lodged formal complaints and FINRA had begun its investigation.[147] And Murphy's

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[141] *See, e.g., Clyde J. Bruff*, 1998 WL 730586, at *4-5(1998) (finding that bar was neither excessive or oppressive in churning case in which representative had a relevant disciplinary history, attempted to shift blame to customer, and customer was an unsophisticated investor).

[142] *See Michael David Sweeney*, Exchange Act Release No. 29884, 50 SEC 761, 1991 WL 716756, at *5 (Oct. 30, 1991) ("[D]isgorgement is intended to force wrongdoers to give up the amount by which they were unjustly enriched.").

[143] Sanction Guidelines at 10.

[144] From July 2002 through December 2003, Murphy earned 60% of gross commissions in Lowry's account, and from January 2004 through February 2006 he earned 58%. This resulted in $588,804.12 in personal commissions from trading in Lowry's account. FINRA assumed that his payout remained at 58% during the time he managed Martinelli's account, which means he personally earned $3,129.55 from trading in Martinelli's account. These calculations were not challenged before FINRA and are not challenged before the Commission.

[145] *See Roche*, 1997 WL 328870, at *6 (finding that total commissions represented a reasonable approximation of ill-gotten gains retained from churning); *Canady*, 1999 WL 183600, at *10 n.35 (noting that "courts have held that '[t]he amount of disgorgement ordered need only be a reasonable approximation of profits causally connected to the violation [and that] any risk of uncertainty [in calculating disgorgement] should fall on the wrongdoer whose illegal conduct created that uncertainty'" (quoting *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1475 (2d Cir. 1996) (alterations in original and internal quotation marks omitted)); *Sweeney*, 1991 WL 716756, at *5 (sustaining the disgorgement of all commissions in a case of excessive trading and noting that "courts have approved action like that taken by the NASD here in civil actions involving excessive trading, basing their determinations on the difficulty of specifying a 'correct' level of trading and the conclusion that the burden of this problem should be borne by the broker who caused it" (citing *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1374 (7th Cir. 1983) and *Carras v. Burns*, 516 F.2d 251, 259 (4th Cir. 1975))).

[146] Sanction Guidelines at 6.

[147] *See Cody*, 2011 WL 2098202, at *21 (rejecting argument that settlements with customers were mitigating

(continued...)

offer during a telephone call with Martinelli to refund some commissions was not a reasonable attempt to remedy the misconduct, because Murphy continued to mislead Martinelli regarding the trading activity and the true amount of losses in his account. Moreover, we agree with FINRA that Murphy failed to demonstrate that the customers' settlements with BIS provide a basis to decrease the disgorgement amount. Although Murphy's counsel, at the hearing before the NAC, made a vague assertion that Murphy was responsible for the "lion's share" of the settlement with Lowry, Murphy failed to show his contribution to the settlements.[148] Under the circumstances, we agree with FINRA that Murphy has not met his burden of demonstrating why and by how much the disgorgement amount should be reduced as a result of the settlements with Lowry and Martinelli.

Murphy also attacks the fairness of FINRA's sanctions given that he was disciplined by the Illinois Securities Department for conduct related to his handling of Martinelli's account. Following a complaint by Martinelli, the Illinois Securities Department pursued a disciplinary action that resulted in Murphy's agreeing to an order finding that he traded Martinelli's securities without written authorization and for the purpose of generating commissions in violation of Section 8.E(1)(b) of the Illinois Securities Law of 1953. The consent order fined Murphy $5,000, required the reimbursement of some commissions to Martinelli, and prohibited Murphy from acting as a supervisor or taking on new clients for two months. Beyond the NAC's decision to reduce the disgorgement ordered by the amount of the fine paid by Murphy to the Illinois Securities Department, we agree with FINRA that there is no basis to reduce its sanctions because Murphy entered into a consent order with state regulators regarding some of the same conduct at issue here. There is nothing unfair about FINRA's pursuing a disciplinary action for violations of its own rules and the Exchange Act while a state regulator pursues parallel disciplinary action under state law for some of the same conduct.[149] We agree with FINRA that the fact that Murphy was disciplined in Illinois for a portion of the misconduct at issue in this proceeding does not mean that Murphy is any less a threat to the investing public or that he has retained any less in ill-gotten gains than FINRA ultimately ordered disgorged.[150]

(...continued)
when the settlements were entered into after customers complained and the registered representative's firm had investigated).

148 As part of his Statement of Financial Condition submitted to FINRA in support of his claim of inability to pay the disgorgement amount, Murphy included a promissory note to BIS for $100,000. Because there is no evidence in the record linking the promissory note to the Lowry settlement, however, we cannot determine its relevance.

149 *Cf. Kirk A. Knapp*, Exchange Act Release No. 31556, 51 SEC 115, 1992 WL 365568, at *11 (Dec. 3, 1992) (rejecting the argument that NASD was precluded from pursuing an action against a respondent for conduct that was already the subject of an SEC administrative action and noting that "NASD has an independent statutory mandate to enforce the provisions of the Exchange Act, as well as its own rules").

150 Murphy also argues that his sanctions are "not warranted by the evidence" because "the Martinelli account had a life-span of three months with Murphy" and "Lowry directed Mr. Murphy to generate premium income for her of $10,000 per month." NAC Appeal Br. of Appellants-Resp'ts at 23. We have already considered and rejected these arguments in the context of Murphy's violations, *see supra* notes 82-84 and accompanying text; *supra* at 19-20, and for the same reasons, we believe that they do not serve to mitigate Murphy's misconduct in the context of our review of the sanctions imposed by FINRA.

Before the NAC, Murphy argued for the first time that he was unable to pay the monetary sanctions. Murphy submitted evidence to support his claim, but the NAC ultimately concluded that the materials Murphy submitted were unreliable and found that Murphy failed to demonstrate an inability to pay the disgorgement order. Although we have recognized that "a *bona fide* inability to pay a judgment is an important consideration in determining whether [a] sanction . . . is excessive or oppressive,"[151] "[i]t is well settled that a respondent bears the burden of demonstrating an inability to pay, and that [FINRA] is entitled to make a searching inquiry into any such claim."[152]

We agree with FINRA that Murphy has failed to meet that burden here. Murphy failed to submit some financial information requested by FINRA, and the information he did submit was often incomplete, inconsistent, and unreliable. For example, FINRA's Statement of Financial Condition required Murphy to submit federal and state tax returns filed during the prior two years, but Murphy submitted only his 2009 income tax returns. The statement also required Murphy to submit pay stubs for the previous eight pay periods, but he provided only a spreadsheet of unknown origin purporting to list payments to him in 2010. Murphy claimed in the Statement of Financial Condition that he has no bank account, but as FINRA points out, this seems questionable given that he received substantial monthly income and that he apparently pays at least one of his credit cards from a "funding account." Likewise, Murphy's claim that he owns only one car (a 1982 Toyota he values at $5,700) appears inconsistent with his claim that he owes $10,049 on an auto loan and with the $2,007 deduction he took for "new motor vehicle taxes" on his 2009 federal tax return. As FINRA also points out, Murphy's claim of $59,723 in monthly expenses is unreliable as the figure appears to include some monthly and some yearly expenditures. In sum, given the gaps, inconsistencies, and seeming inaccuracies in Murphy's financial submission, we agree that the information Murphy submitted is unreliable and sustain FINRA's finding that Murphy failed to demonstrate an inability to pay the disgorgement order.

B. The remedial sanction FINRA imposed on Birkelbach is not excessive or oppressive.

FINRA barred Birkelbach for his supervisory failures. Birkelbach contends that a bar in all capacities is not appropriate for the supervisory violations at issue here. Pointing to the sanctions imposed in other disciplinary cases, Birkelbach argues that a bar is an unprecedented and unwarranted sanction in the circumstances. He also suggests that the NAC's increase of the sanction was unfair and designed to punish him for appealing the hearing panel's decision. For the reasons that follow, we reject these arguments and conclude that Birkelbach has failed to show that FINRA's sanction is excessive or oppressive.

Birkelbach argues that "when the offense involves actions performed in a supervisory capacity, it is proper for any suspension or bar to be limited to the supervisory capacity."[153] But

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151 *Bruce M. Zipper*, Exchange Act Release No. 33376, 51 SEC 928, 1993 WL 538925, at *2 (Dec. 23, 1993).

152 *Castle Sec. Corp.*, Exchange Act Release No. 52580, 58 SEC 826, 2005 WL 2508169, at * 6 (Oct. 11, 2005).

153 Birkelbach's Reply Br. in Supp. of Appl. for Review at 10.

the Sanction Guidelines recommend up to a bar "in any or all capacities" for egregious supervisory failures.[154] This recommendation is based on solid reasoning: in some circumstances supervisory failures are so serious that a bar in all capacities is an appropriate sanction to protect investors from individuals who have shown themselves unfit to remain in the industry. Contrary to Birkelbach's claim, suspensions or bars in all capacities for supervisory violations are not unprecedented—we recently rejected the argument that a suspension in all capacities was "not sufficiently tailored to" misconduct that "involved only supervisory violations."[155] Because proper supervision serves such an important role in protecting investors, egregious violations of supervisory rules often warrant the most severe sanctions.[156]

Such is the case here. Despite numerous and obvious warning signs, including an awareness of Murphy's disciplinary history involving unauthorized trading, Birkelbach permitted Murphy's churning of Lowry's account to continue for years without taking any reasonable steps to curb Murphy's unauthorized, unsuitable, and excessive trading. And even after he was aware that FINRA was investigating Murphy and had recommended increased supervision, Birkelbach assigned Martinelli's account to Murphy and did nothing while Murphy aggressively churned that account. As a result, Murphy's customers incurred significant harm. Given Birkelbach's complete failure to take reasonable supervisory steps in the face of obvious red flags, we agree with FINRA that Birkelbach's supervisory failures appear to involve some degree of intent. Indeed, Birkelbach had an economic incentive to permit Murphy's churning. Lowry's account represented 18% of BIS's total revenue from the third quarter of 2002 through the end of 2005, and Birkelbach had a financial stake in BIS.

In addition, Birkelbach has a relevant disciplinary history. In 1999, the Illinois Securities Department censured Birkelbach, imposed a six-month suspension with a requalification requirement, and ordered $50,000 in restitution to five customers for unauthorized trading, unsuitable transactions, excessive trading, and churning customer accounts—the same conduct that Birkelbach's supervisory failures allowed to occur here. Given his own misconduct in these areas, Birkelbach should have been particularly careful about detecting and preventing similar

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154 Sanction Guidelines at 108.

155 *Dennis S. Kaminski*, Exchange Act Release No. 65347, 2011 WL 4336702, at * 14 (Sept. 16, 2011) (sustaining 18-month suspension in all capacities for supervisory failures); *see also Michael Studer*, 2004 WL 2735433, at *7 (sustaining bar for failure to supervise); *Dep't of Mkt. Reg. v. Kresge*, Complaint No. CMS030182, 2008 WL 4592834, at *3-10 (NAC Oct. 9, 2008) (barring respondent for failure to supervise, to register an individual, and to report customer complaints). Birkelbach's argument that the NAC's sanction "appears unprecedented" has shifted. Birkelbach's Reply Br. in Supp. of Appl. for Review at 10. In his opening brief, he argued none of the cases cited in the NAC decision involved a bar in all capacities for supervisory violations. Then, in his reply brief, after FINRA had come forward with relevant cases, he argued that the NAC's *increasing* a sanction from a suspension to a bar is unprecedented. In any event, the sanction imposed here is consistent with the Sanction Guidelines, and, as discussed *infra*, we evaluate the sanction in the context of the particular facts and circumstances of the case before us, not in relation to other cases.

156 *See Kaminski*, 2011 WL 4336702, at * 11 ("Proper supervision is the touchstone to ensuring that broker-dealer operations comply with the securities law and NASD rules. It is also a critical component ensuring investor protection.").

misconduct by those whom he supervised. And Birkelbach's prior discipline for misconduct related to his own customers supports FINRA's conclusion that a bar in all capacities is appropriate for the protection of investors because of the supervisory failures in this matter. More recently, Birkelbach consented to a FINRA order censuring him and imposing a 30-day suspension in all capacities, a 90-day suspension in principal capacities, and a $25,000 fine for alleged conduct between 2007 and 2009 that included, *inter alia*, a failure to adequately supervise in violation of NASD Rules 3010 and 2010.[157] Another aggravating factor is Birkelbach's continued insistence on shifting the blame for his supervisory failures to others, such as Lowry, DeRose, and Lowry's accountants. Under the circumstances, we agree with FINRA that Birkelbach's supervisory failures are egregious and that a bar in all capacities is an appropriate sanction, one necessary to protect the investing public from further harm.

Birkelbach points to other disciplinary cases in arguing that FINRA's sanction is unwarranted, but Birkelbach's reliance on other cases is misplaced for several reasons. First, as we consistently have held, the appropriateness of a sanction "depends on the facts and circumstances of each particular case and cannot be precisely determined by comparison with action take in other proceedings."[158] In any event, the FINRA cases relied upon by Birkelbach—*Department of Enforcement v. Pellegrino*[159] and *Department of Enforcement v. Midas Securities, LLC* [160]—are readily distinguishable. In *Pellegrino*, the NAC modified a hearing panel's sanction for a supervisor from a suspension in all capacities to a bar in any principal capacity. But Pellegrino's misconduct was less severe than Birkelbach's: it involved supervisory failures over less than two years, the underlying violations involved only unsuitable recommendations, Pellegrino made mitigating compliance efforts, and he had no relevant disciplinary history.[161] In *Midas*, the NAC suspended three principals in a principal capacity for 30 business days, 45 business days, and two years for failing to establish and maintain a reasonable supervisory system and failing to supervise registered representatives who were selling unregistered securities. The underlying facts in *Midas* are different than those in the present case: the violations occurred over just four months, there was no evidence of customer harm, and two of

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[157] On November 14, 2011, FINRA filed a motion to adduce additional evidence related to this subsequent disciplinary history. We grant FINRA's motion.

[158] *PAZ Sec., Inc.*, 2008 WL 1697153, at *9; *see also Butz v. Glover Livestock Comm'n Co.*, 411 U.S. 182, 187 (1973) ("'The employment of a sanction within the authority of an administrative agency is thus not rendered invalid in a particular case because it is more severe than sanctions imposed in other 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."); *David Wong*, Exchange Act Release No. 45426, 55 SEC 602, 2002 WL 200089, at *5 (Feb. 8, 2002) ("We consistently have held that the appropriate sanctions in a case depend on its particular facts and circumstances and cannot be determined by comparison with action taken in other cases.").

[159] Complaint No. C3B20050012, 2008 WL 115195 (NAC Jan. 4, 2008), *aff'd*, 2008 WL 5328765.

[160] Complaint No. 2005000075703, 2011 WL 786035 (NAC Mar. 3, 2011), *aff'd*, 2012 WL 169138, *and aff'd sub nom. World Trade Financial Corp.*, Exchange Act Release No. 66114, 2012 WL 32121 (Jan. 6, 2012).

[161] *See Pellegrino*, 2008 WL 5328765, at *4-6, *17.

the principals had no disciplinary history.[162] *Pellegrino* and *Midas* provide no basis for us to question FINRA's choice of sanction here.

Finally, Birkelbach insists that it was inappropriate for the NAC to increase the hearing panel's sanction, and he suggests that the NAC was motivated by bias or a desire to retaliate against him for bringing an appeal. It is well established, however, that "the NAC reviews hearing panel decisions *de novo* and has broad discretion to review hearing panel decisions and sanctions."[163] FINRA's rules make clear that the NAC "may affirm, modify, reverse, increase, or reduce any sanction, or impose any other fitting sanction."[164] Moreover, "FINRA is not required to state why a lesser sanction would be insufficient in order to justify the sanction it imposed as being remedial."[165] Furthermore, we find nothing in the record to support Birkelbach's vague claim of improper bias on the part of FINRA or that the sanction increase was in retaliation for Birkelbach's bringing the appeal.[166]

In sum, considering the evidence in the record, we agree with FINRA's assessment "that Birkelbach is a serious risk to the investing public, in whatever capacity he would function, that his failure to supervise was egregious, and that sanctions at the high end of the relevant range are warranted."[167] Accordingly, we conclude that barring Birkelbach in all capacities is neither excessive nor oppressive and that the sanction serves a remedial purpose of protecting investors and deterring future misconduct.

An appropriate order will issue.[168]

By the Commission (Chair WHITE and Commissioners WALTER, PAREDES and GALLAGHER); Commissioner AGUILAR not participating.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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[162] *See Midas Sec., LLC*, 2011 WL 786035, at *3, *8-11.

[163] *Cody*, 2011 WL 2098202, at *21.

[164] NASD Rule 9348; *see also Cody*, 2011 WL 2098202, at *21; *Harry Friedman*, Exchange Act Release No. 64486, 2011 WL 1825025, at *7 (May 13, 2011). Birkelbach acknowledged in a brief before the NAC that under FINRA rules the NAC could increase the sanctions imposed by the hearing panel, so his suggestion that he was somehow blindsided by the increase rings hollow.

[165] *Friedman*, 2011 WL 1825025, at *7.

[166] The NAC's decision—consistent with the Sanction Guidelines—took into account Birkelbach's failure to accept responsibility for his actions, finding that this was evidenced not by his decision to appeal but by his continued attempts to shift blame to others.

[167] *Murphy*, 2011 WL5056463, at *37.

[168] 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. 69923 / July 2, 2013

Admin. Proc. File No. 3-14609

In the Matter of the Application of

WILLIAM J. MURPHY and CARL M. BIRKELBACH

For Review of Disciplinary Action Taken by

FINRA

ORDER SUSTAINING DISCIPLINARY ACTION TAKEN BY FINRA

On the basis of the Commission's opinion issued this day, it is

ORDERED that the disciplinary action taken, and the costs imposed, by FINRA against William J. Murphy and Carl M. Birkelbach are sustained.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9411 / July 3, 2013

In the Matter of **Clearpoint Resources Inc.** **Registration No. 333-185849**	**ORDER DENYING WITHDRAWAL OF REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**

1. Clearpoint Resources Inc. ("Clearpoint") filed a Form S-1 registration statement with the Commission on January 2, 2013 (the "Registration Statement"). The Registration Statement is still pending. The Registration Statement was filed with respect to 8 million shares of common stock of Clearpoint.

2. On June 25, 2013 Clearpoint filed an application to withdraw its Registration Statement under Rule 477 of Regulation C of the Commission's General Rules and Regulations under the Securities Act of 1933 ("Securities Act"), 17 C.F.R. § 230.477.

3. After considering Clearpoint's application, the Commission has determined that the granting of the withdrawal request is not consistent with the public interest and the protection of investors. Accordingly, it is hereby:

ORDERED that Clearpoint's application to withdraw its registration statement on Form S-1 filed on January 2, 2013 is denied in accordance with Rule 477.

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. 9410 / July 3, 2013

In the Matter of **Braxton Resources Inc.** **Registration No. 333-185850**	**ORDER DENYING WITHDRAWAL OF REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**

1. Braxton Resources Inc. ("Braxton") filed a Form S-1 registration statement with the Commission on January 2, 2013 (the "Registration Statement"). The Registration Statement is still pending. The Registration Statement was filed with respect to 12 million shares of common stock of Braxton.

2. On June 26, 2013 Braxton filed an application to withdraw its Registration Statement under Rule 477 of Regulation C of the Commission's General Rules and Regulations under the Securities Act of 1933 ("Securities Act"), 17 C.F.R. § 230.477.

3. After considering Braxton's application, the Commission has determined that the granting of the withdrawal request is not consistent with the public interest and the protection of investors. Accordingly, it is hereby:

ORDERED that Braxton's application to withdraw its registration statement on Form S-1 filed on January 2, 2013 is denied in accordance with Rule 477.

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. 9412 / July 3, 2013

In the Matter of **La Paz Mining Corp.** **Registration No. 333-182751**	**ORDER DENYING WITHDRAWAL OF REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**

1. La Paz Mining Corp. ("La Paz") filed a Form S-1 registration statement with the Commission on July 19, 2012 and filed one amendment thereto on September 25, 2012 (collectively, the "Registration Statement"). The Registration Statement is still pending. The Registration Statement was filed with respect to 10 million shares of common stock of La Paz.

2. On June 25, 2013 La Paz filed an application to withdraw its Registration Statement under Rule 477 of Regulation C of the Commission's General Rules and Regulations under the Securities Act of 1933 ("Securities Act"), 17 C.F.R. § 230.477.

3. After considering La Paz's application, the Commission has determined that the granting of the withdrawal request is not consistent with the public interest and the protection of investors. Accordingly, it is hereby:

ORDERED that La Paz' application to withdraw its registration statement on Form S-1 filed on July 19, 2012 and its amendment thereto filed on September 25, 2012 is denied in accordance with Rule 477.

By the Commission.

Elizabeth M. Murphy
Elizabeth M. Murphy
Secretary

Chair White
Commissioner Aguilar
not participating

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 69930 / July 3, 2013

Admin. Proc. File No. 3-14795

In the Matter of the Application of

S.W. HATFIELD, C.P.A.
and
SCOTT W. HATFIELD, C.P.A.
c/o John A. Koepke
Jackson Walker L.L.P.
901 Main St., Ste. 6000
Dallas, TX 75202

For Review of Disciplinary Action Taken by

PCAOB

OPINION OF THE COMMISSION

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD -- REVIEW OF DISCIPLINARY PROCEEDINGS

Violation of Board Rules

Improper Professional Conduct

Registered public accounting firm and associated person engaged in improper professional conduct in the audit of the financial statements of two public companies. *Held*, findings of violations and sanction imposed are *sustained*.

APPEARANCES:

John A. Koepke, of Jackson Walker, L.L.P, for S.W. Hatfield, CPA, and Scott W. Hatfield, CPA.

J. Gordon Seymour and *Davis B. Tyner* for the PCAOB.

Appeal filed: March 8, 2012
Last brief received: June 13, 2012

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I.

S.W. Hatfield, a registered public accounting firm (the "Firm"), and Scott W. Hatfield, C.P.A., the Firm's sole owner and employee (collectively, "Applicants"), filed an application pursuant to § 107(c) of the Sarbanes-Oxley Act of 2002[1] for review of disciplinary action taken by the Public Company Accounting Oversight Board ("PCAOB" or the "Board"). Acting pursuant to § 105(c)(4) of Sarbanes-Oxley[2] and PCAOB Rule 5300(a),[3] the Board found that Applicants violated PCAOB Rules 3100[4] and 3200T[5] by failing to adhere to professional standards during their audits of financial statements of two unrelated public companies. The Board further found that Applicants' conduct was at least reckless and that it was therefore in the public interest to permanently revoke the Firm's registration and permanently bar Hatfield from association with a registered public accounting firm. We base our findings on an independent review of the record.

II.

Pursuant to § 107(c)(2) of Sarbanes-Oxley, we will sustain the Board's conclusion that Applicants violated PCAOB rules if the record shows that Applicants engaged in the alleged violative conduct, that such conduct violated PCAOB rules, and that the PCAOB applied those rules in a manner consistent with the purposes of the Securities Exchange Act of 1934 and Sarbanes-Oxley.[6] In performing this analysis, we conduct a *de novo* review, pursuant to which

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[1] 15 U.S.C. § 7217(c).

[2] *Id.* § 7215(c)(4). Section 105(c)(4) of Sarbanes-Oxley authorizes the Board to impose sanctions, including revocation of the registration of a public accounting firm and a bar from association of an associated person, if a registered firm or an associated person violates PCAOB rules or professional standards.

[3] Rule 5300(a) provides that the Board may impose "such disciplinary or remedial sanctions as it determines appropriate," including "permanent revocation of registration" and "permanent suspension or bar of a person from further association with any registered public accounting firm." PCAOB rules may be found at the Board's website: http://pcaobus.org.

[4] PCAOB Rule 3100 requires registered public accounting firms and their associated persons to comply with the Board's "auditing and related professional practice standards" in connection with the preparation or issuance of any audit report for an issuer, as defined in Sarbanes-Oxley. Rule 1001(a)(viii) defines the term "auditing and related professional practice standards" to mean "the auditing standards, related attestation standards, quality control standards, ethical standards, and independence standards (including any rules implementing Title II of Sarbanes-Oxley), and any other professional standards, that are established or adopted by the Board under Section 103 of the [Sarbanes-Oxley] Act."

[5] In April 2003, the Board adopted certain preexisting standards as its interim standards. PCAOB Rule 3200T states that, "[i]n connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with generally accepted auditing standards, as described in the AICPA Auditing Standards Board's Statement of Auditing Standards No. 95, as in existence on April 16, 2003 (Codification of Statements on Auditing Standards, AU § 150 (AICPA 2002)), to the extent not superseded or amended by the Board." The interim standards are hereinafter cited as "AU §__."

[6] 15 U.S.C. § 7217(c)(2) (stating that the provisions of Exchange Act §§ 19(d)(2) and 19(e)(1), 15 U.S.C. §§ 78s(d)(2) and (e)(1), "shall govern the review by the Commission of final disciplinary sanctions imposed by the Board . . . as fully as if the Board were a self-regulatory organization and the Commission were the appropriate regulatory agency for such organization for purposes of those sections 19(d)(2) and 19(e)(1)").

we apply a preponderance of the evidence standard to determine whether the record supports the PCAOB's findings that Applicants' conduct violated its rules.[7] We find here that the record supports the PCAOB's findings that Applicants violated PCAOB Rules 3100 and 3200T by repeatedly failing to adhere to the Board's interim auditing standards during audits of two unrelated public companies: Bidville, Inc., and Epicus Communications Group, Inc.

As we explain below, Applicants failed to adhere to a variety of interim auditing standards, but Applicants' overarching failing was not exercising the necessary professional skepticism required to obtain sufficient audit evidence on which to base their audit opinion. Applicants consistently lacked the professional skepticism essential to evaluate the reliability and pertinence of the evidence on which they based their auditing opinions,[8] and it was this core deficiency that ultimately led to Applicants' more specific auditing violations.[9] Applicants failed to meet this requirement in the audits at issue multiple times and in multiple ways, but two defects permeated their problematic auditing approach. First, Applicants frequently relied on generalized experience from their past history with other clients to draw conclusions about the Bidville and Epicus financial statements without any reasoned basis for concluding that such experience was applicable to Bidville or Epicus. Second, Applicants repeatedly deferred to untested management representations—in the face of red flags that should have raised questions about the reliability of those representations—as an excuse not to undertake meaningful audit procedures. Although management representations are part of the evidential matter auditors may obtain during an audit, the interim auditing standards explain that they "are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit."[10] Instead, representations are a complement to other auditing procedures, and "[b]ased on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified."[11]

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7 *Cf. Seaton v. SEC*, 670 F.2d 309, 311 (D.C. Cir. 1982) (upholding preponderance of evidence standard in NASD disciplinary proceeding); *Richard G. Cody*, Exchange Act Release No. 6456, 2011 WL 2098202, at *9 (May 27, 2011) (applying preponderance of evidence standard in FINRA disciplinary proceeding).

8 *See, e.g.*, AU § 326.02, *Evidential Matter* ("The pertinence of the evidence, its objectivity, its timeliness, and the existence of other evidential matter corroborating the conclusions to which it leads all bear on its competence.").

9 This appeal concerns only Applicants' failures to comply with auditing standards. Therefore, unless otherwise stated, this opinion does not make any determination with respect to whether Applicants' recommendations or Bidville's or Epicus's financial statements complied with generally accepted accounting principles ("GAAP").

10 AU § 333.02, *Reliance on Management Representations*.

11 AU § 333.04, *Reliance on Management Representations*.

A. The Bidville Audit

Bidville, a Nevada corporation based in Florida, first engaged Applicants to audit the company's 2003 financial statements, which covered the period from March 1, 2003 through December 31, 2003.[12] At the time, Bidville's stock was quoted on the OTC Bulletin Board and its business plan was to operate an internet online auction site as a competitor to eBay.[13] Applicants, however, had concerns about Bidville. As Hatfield testified during the PCAOB's investigation, he believed the company was "an eBay wannabe"[14] and had been created as a "great stock spoof,"[15] and "had a high probability of being a market play."[16] Applicants' audit work papers similarly described Bidville as a "stock scam w/ no intent to run [a company]."[17] Despite these concerns about Bidville's trustworthiness, Applicants' audit opinion was based in substantial part on their generalized experience with other clients and on Bidville management's representations, but Applicants did not undertake any procedures to test the reasonableness of their reliance on that audit evidence.

1. Applicants audit Bidville's private placement agreement.

(a) Background

The first issue involves Applicants' approach during their 2003 audit to a December 2003 private placement in which Bidville sold 4,410,000 shares of restricted, unregistered common stock at $0.50 per share. With each share that Bidville sold in the transaction, Bidville included an unregistered warrant to purchase another one-half share of Bidville restricted, unregistered common stock at a price of $1.00 per share. Applicants recommended that Bidville report the transaction as a "compensation expense related to common stock issuance at less than 'fair value.'"[18] Applicants further recommended that Bidville calculate the compensation expense by applying a fifty percent "haircut" to the stock's closing price on the date of the transaction and then, from that number, subtracting the $0.50 per share selling price.[19] Applicants also

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12 Applicants' audit report covered the transition period from March 1, 2003, through December 31, 2003, because Bidville changed its fiscal year-end from February 28 to December 31 in connection with a December 2003 reverse merger in which Bidville acquired NoBidding, Inc., a New Jersey corporation.

13 On November 8, 2011, the Commission revoked the registration of Bidville's registered securities pursuant to Section 12(j) of the Exchange Act because of the company's failure to file a periodic report since it filed a Form 10-QSB for the period ended September 30, 2005, in which Bidville reported a net loss of more than $2 million for the previous nine months. Order Making Findings and Revoking Registrations by Default as to Six Respondents, Exchange Act Release No. 65701, 2011 WL 5357822, at *2, *4 (Nov. 8, 2011).

14 Division Exhibit ("DX") 3 at 35.

15 *Id.* at 36.

16 Transcript of Hearing ("Tr.") at 97.

17 DX-15 at 217.

18 DX-7 at 109.

19 Hatfield testified that he believed the stock's closing price reflected the true value of the stock because, "It's been my perspective that if the market sets the value, then that's a valid value to use." Tr. at 104. At the same time, however, Hatfield acknowledged that the Bidville stock had no "market support." *Id.*

recommended that Bidville assign no value to the warrants. Using this methodology, Applicants recommended that the company state the value of the stock Bidville sold in its private placement as approximately $10 million less than the stock's trading value.

Hatfield acknowledged during his investigatory testimony that he did not ask, or even consider, whether Bidville's private placement was actually a compensation-related expense. He testified that he did not know or investigate whether any services were provided by the shareholders with regard to the transaction, nor did he know or consider whether the shareholders had any particular relationship to the company. And when asked whether he thought the transaction was a compensation-related expense, Hatfield responded, "no, ma'am, it's not. Never has been. It's not related to services."[20] Hatfield explained that Applicants nevertheless made that recommendation because of what Hatfield described as "directions from the Securities and Exchange Commission staff" during audits of previous clients.[21] Hatfield admitted, however, that he did not discuss the Bidville transaction with Commission staff, nor was he aware of anything in writing from the Commission that directly supported his methodology other than Commission comment letters issued during the review of registration statements filed by other entities in which the Commission had not taken issue with those entities' disclosures of compensation-related expenses. Hatfield also testified that he did not know whether GAAP supported either the need for a compensation expense adjustment or the application of a fifty-percent discount. As Hatfield explained, "[w]hile there may or may not be GAAP on this point specifically, the review comments received on other similar transactions have taught me that this is the appropriate methodology."[22]

At Applicants' disciplinary hearing, Hatfield further explained that they made their recommendation based on their understanding of "unwritten industry accepted position . . . that the acceptable discount was 50 percent."[23] Hatfield testified that he first reached this understanding based on discussions with "a client who had significant securities experience" and that this understanding "was later supported by the SEC through not issuing any comments [about this practice] during reviews of registration statements."[24] Hatfield also introduced a list of nineteen other auditing clients that he claimed had applied a similar reduction in value to their stock sales and claimed that the Commission had never issued a negative comment regarding those companies' approaches.

As for Applicants' recommendation not to assign any value to the warrants, Hatfield acknowledged during his investigative testimony that it may have been inconsistent for him to recommend ascribing a value for the underlying stock but not for the warrants to buy stock: "Sitting here discussing it now, yes, sir, and I may have missed one."[25] But Hatfield later

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20 DX-3 at 110.

21 *Id.*

22 *Id.* at 108.

23 Tr. at 126.

24 *Id.*

25 DX-3 at 116.

testified at the hearing that he had "revisited the situation"[26] and now believed, based on "my personal experience with comparable situations,"[27] that Applicants were correct in assigning no value to the warrants. Hatfield acknowledged, however, that his analysis regarding the warrants was something he had done after responding to PCAOB staff. Hatfield nevertheless reasoned that, "I believe, while I have two different methodologies then and now, the answer is the same [*i.e.*, that the warrants had no value]."[28]

Bidville accepted Applicants' recommendations and listed the private placement as a compensation expense in its 2003 financial statements filed with the Commission in Bidville's Form 10-KSB on April 2, 2004. Accompanying Bidville's financial statements was Applicants' audit report, in which Applicants opined that Bidville's financial statements were fairly stated, in all material respects, in conformity with GAAP.

(b) Analysis

The PCAOB found that Applicants failed to meet the interim auditing standards' requirements that Applicants (i) exercise due care during their audit and in preparing their audit report[29] and (ii) obtain evidence sufficient to afford a reasonable basis for their audit opinion with respect to the financial statements under audit.[30] We agree with these findings.

To exercise due care, auditors must maintain an attitude of professional skepticism, which includes "a questioning mind and a critical assessment of audit evidence."[31] Applicants failed to fulfill this duty when determining whether Bidville had correctly valued and disclosed the private placement in the company's 2003 financial statements. Applicants blindly relied on their past experience instead of making any meaningful attempt to understand the facts relevant to the private placement. Other than checking Bidville's closing stock price, Applicants relied only on what another client told them was an "unwritten industry accepted position"[32] and on a methodology Applicants claim nineteen other clients had used when valuing their own stock sales.[33] This was not enough.

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26 Tr. at 108.

27 *Id.* at 109.

28 *Id.*

29 AU § 150.02, *Auditing Standards* ("Due professional care is to be exercised in the performance of the audit and the preparation of the report."), § 230.01, *Due Professional Care in the Performance of Work* (same).

30 AU § 150.02 ("Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit."), § 326.01, *Evidential Matter* (same).

31 AU § 230.07, *Professional Skepticism*; *see also* AU § 230.08, *Professional Skepticism* ("Since evidence is gathered and evaluated throughout the audit, professional skepticism should be exercised throughout the audit process.").

32 Tr. at 126.

33 In their briefs, Applicants also cite to testimony by the concurring reviewer on the Bidville audit, Stephen Durland, who testified at a deposition during the PCAOB's investigation in this case that he also believed that use of a fifty-percent discount had "been accepted practice by the [C]omission staff for a number of years." DX-39 at 106.

(continued . . .)

Although a reasonable place to begin one's audit, Applicants' evidence concerning other companies' experiences told Applicants little about whether *Bidville* appropriately presented its private placement as a compensation expense or whether *Bidville* appropriately applied a fifty-percent discount when calculating that expense. To the contrary, Hatfield did not actually believe Bidville's private placement should have been classified as a compensation expense. This contradiction alone should have alerted Applicants that the other companies' approaches might not have been applicable to Bidville. But Applicants undertook no further analysis of whether these other companies' valuation approaches were appropriate for Bidville.

Applicants' small sample size of other companies' supposed audit approaches also fell well short of establishing what Applicants claim was a uniform, industry-wide practice.[34] At most, all Applicants knew was what a select group of companies did in a few isolated instances, not what all companies did uniformly as an across-the-board policy. Moreover, the supposed silence or inaction of Commission staff in its reviews of these other companies' registration statements may not be construed as Commission approval of those companies' practices, let alone be construed as approval of Applicants' approach to valuing Bidville's stock transactions.[35] Even Applicants' own expert conceded in his report that "[i]n 2003, there was no clear guidance from the SEC, FASB, or PCAOB except for the 'up to 50% discount' which was the limit to what was generally allowable"[36] and that using a fifty percent discount was not a "hard, fast rule."[37] Applicants acknowledge "there is no specific comment letter from the SEC staff that approves the use of a 50% 'haircut' on a stock's closing price for valuation purposes."[38] In short,

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(...continued)

Durland could not recall, however, any specifics about how he reached that conclusion other than to refer generally to "[y]ears of dealing with the SEC where I have run into the same issue in the past." *Id.* at 100.

34 *Cf. Midas Sec., LLC*, Securities Act Release No. 66200, 2012 WL 169138, at *11 (Jan. 20, 2012) (finding that fact witness testimony about certain practices in the brokerage industry was "evidence only that the practice was widespread at these particular firms, not industry-wide").

35 *Cf., e.g.,* 15 U.S.C. § 78z ("No action or failure to act by the Commission . . . shall be construed to mean that the particular authority has in any way passed upon the merits of, or given approval to, any security or any transaction or transactions therein, nor shall such action or failure to act with regard to any statement or report filed with or examined by such authority pursuant to this title or rules and regulations thereunder, be deemed a finding by such authority that such statement or report is true and accurate on its face or that it is not false or misleading."); *Capital Funds, Inc. v. SEC*, 348 F.2d 582, 588 (8th Cir. 1965) (rejecting defendants' argument that the Commission should be estopped from alleging a scheme to sell unregistered securities because, defendants claimed, "the Commission investigated the . . . situation at that time but took no action").

36 Respondents' Exhibit ("RX") 62 at 30.

37 Tr. at 359.

38 Appellants' Br. in Supp. of Pet. for Review at 19. On April 30, 2012, Applicants filed a motion pursuant to our Rule of Practice 452 seeking to introduce the following evidence: (i) a Financial Reporting Manual by the Division of Corporation Finance; (ii) a printout of a portion of the American Institute of Certified Public Accountants' website titled "Accounting for Certain Equity Transactions;" (iii) a comment letter, dated July 11, 2006, from the

(continued . . .)

Applicants had no valid basis for believing their practice with respect to these other nineteen companies was appropriate for Bidville. Moreover, even if there had been some basis for assuming that the approach taken in those other matters was generally applicable to compensation-related expenses, Applicants conceded that they did not believe that Bidville's private stock placement actually was a compensation-related expense. And Applicants have identified no basis for failing to assign a value to the warrants.

Applicants' approach showed an astonishing lack of professional skepticism and failure to exercise due care. Their reliance on supposed past experience also resulted in Applicants not obtaining sufficient audit evidence. As we have explained, "if an auditor fails to exercise due professional care, he may not obtain sufficient competent evidential matter to support an audit conclusion that the financial statements were prepared in compliance with GAAP."[39] This is exactly what occurred here. At best, Applicants knew only what some other companies had allegedly done in different situations. Applicants had no evidence about how those approaches were applicable to Bidville, and they sought no other evidence that would help them analyze

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Division of Corporation Finance to the president of Signet International Holdings, Inc. regarding Signet's Form SB-2 filed June 2, 2006, which included Applicants' audit report; (iv) a copy of a publication by the law firm Drinker Biddle, dated June 30, 1998, titled "Understanding and Avoiding the Cheap Stock Problem;" and (v) an undated document, written by an unknown author, that purports to summarize, among other things, the Commission's and various companies' treatment of "cheap stock" and "operating expenses." Rule 452 allows us to accept additional evidence if the evidence is material and there were reasonable grounds for failure to adduce such evidence previously. 17 C.F.R. § 201.452.

Applicants state that the evidence they seek to introduce is material because it demonstrates that they had consistently treated and valued the results of private placements and compensation expense discounts "in conformity with the tacit approval given by the Commission to such treatment." Reply Brief [in Support of Applicants' Motion to Submit Additional Evidence] at 1. Applicants claim they did not attempt to introduce this evidence earlier because its relevance only became apparent after the Board issued its Final Decision.

Applicants have not established grounds for their failure to adduce such evidence previously. Applicants should have been well aware that the valuation of Bidville's private placement was relevant to Applicants' audits when the Board alleged in its OIP that Applicants "failed to perform sufficient audit procedures to determine whether the company had valued and presented the [private placement] transaction appropriately." Order Instituting Disciplinary Proceedings at 8. As an exercise of discretion, we nevertheless take official notice pursuant to Rule of Practice 323, 17 C.F.R. § 201.323, of AICPA's website and the Division of Corporation Finance's reporting manual and comment letter, which are publicly available, and admit the remaining evidence that Applicants seek to admit pursuant to Rule 452.

However, none of that evidence affects the outcome here. The Board does not challenge whether Applicants' approach during the Bidville audit was consistent with their approach during audits of other companies. Instead, the issue is whether Applicants took appropriate steps to determine whether such an approach was appropriate for Bidville, and none of that evidence answers that question, in part for the reasons discussed in *supra* note 34 and the accompanying text.

39 *James Thomas McCurdy, CPA*, Exchange Act Release No. 49182, 57 SEC 277, 2004 WL 210606, at *4 (Oct. 29, 2003) (noting the relationship between the duty to exercise due professional care and the duty to obtain sufficient evidence).

whether Bidville accurately disclosed its private placement as a compensation expense or accurately calculated that expense by applying a fifty-percent discount.

2. Applicants audit Bidville's consulting agreement.

(a) Background

The next area at issue concerned a December 2003 consulting agreement among Bidville, National Securities Corporation, and the Royal Palm Capital Group and the agreement's impact on Bidville's 2003 and first quarter of 2004 financial statements.[40] Under the agreement, National Securities was to provide consulting advice to Bidville; Royal Palm was to transfer 3,966,700 shares of Bidville stock to National Securities; and Royal Palm was to receive $500 from National Securities.

(i) Bidville's 2003 Financial Statements

Hatfield testified that, during their 2003 audit, Applicants had asked Bidville to provide copies of all consulting contracts involving the company, but that the company had "withheld"[41] the National Securities and the Royal Palm consulting agreement from Applicants until April 22, 2004, several weeks after Bidville's April 2, 2004 filing of its 2003 financial statements in its Form 10-KSB. After Applicants became aware of the agreement, Bidville's vice president of finance emailed Applicants that the company intended to file an amended Form 10-KSB, which would impact its 2003 financial statements. After reviewing an initial draft of the proposed amended filing, Hatfield emailed Bidville's president on April 29, 2004 about concerns he had with Bidville's disclosures. Hatfield wrote that he believed Bidville had "[n]o one that knows how to characterize and disclose the myriad of deals and contracts being entered into."[42] He added that "I feel like I'm all alone on this project and I will resign in about 30 seconds if something doesn't change."[43] On May 3, 2004, Hatfield again emailed Bidville's president that Applicants were "concerned" with Bidville's "disclosures related to the various contracts, etc. which were not reflected in the footnotes" and with "other new disclosures which were not disclosed to us during the performance of our fieldwork on the audit of your financial statement."[44] Hatfield also wrote that "this behavior pattern and lack of internal control is completely and totally unacceptable" and that Applicants were evaluating whether they would continue to serve as Bidville's auditors.[45]

40 National Securities conducted the above-mentioned private placement on Bidville's behalf. Royal Palm was a Florida company controlled by Bidville's president and chairman, Gerald C. Parker, and was a major shareholder of Bidville.

41 Tr. at 111.

42 RX-18.

43 *Id.*

44 RX-19.

45 *Id.*

Bidville nevertheless filed its amended Form 10-KSB with the Commission on May 7, 2004. In that filing, Bidville disclosed the consulting agreement, but did not adjust its previously filed 2003 financial statements. The amended Form 10-KSB also included Applicants' unqualified audit report, dated May 5, 2004, which stated that Bidville's previously filed financial statements were fairly presented in conformity with GAAP, in all material respects, and that the consulting agreement "had no effect" on those financial statements.[46]

Hatfield testified that Applicants reached this auditing conclusion based on Bidville's representation that the contract had not been triggered because Bidville's shares had not yet been transferred to National Securities. Hatfield testified that the only step Applicants took to determine whether management's representation about the shares was correct was to look at a single Bidville shareholder list, which Applicants "receive[d] somewhere in the course of time" and from which Applicants "could not ascertain [whether] the shares had been issued to National Securities."[47]

(ii) Bidville's First Quarter 2004 Financial Statements

On May 21, 2004, Applicants issued a review report in connection with Bidville's plan to file a Form 10-QSB on May 24, 2004 (for the quarter ending March 31, 2004). In that report, Applicants stated that they were "not aware of any material modifications that should be made to the accompanying financial statements for them to be in conformity with generally accepted accounting principles."[48] On May 24, 2004, however, Applicants learned from Bidville that Royal Palm had transferred its shares of Bidville stock to National Securities in February 2004. As a result, Hatfield emailed Bidville's president about how to reflect the consulting agreement in Bidville's yet-to-be filed Form 10-QSB, but added that "[t]o make this change would totally blow the timeline to file today."[49] Hatfield explained in the email that Gerald Parker, Bidville's president and chairman, had therefore "agreed to let the filing go and we'll book the effect of this off-balance sheet transaction in the next quarter."[50]

Bidville filed its Form 10-QSB a day later, on May 25, 2004. The filing did not disclose the financial impact of the consulting agreement. At Applicants' disciplinary hearing, Hatfield testified that Applicants did not object to Bidville's filing because, Hatfield claimed, Bidville's management had told Applicants that the company would file an amended Form 10-QSB with corrected financial statements within five days of the initial filing. The PCAOB hearing officer, however, did not find Hatfield's testimony credible, noting that "no such management

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46 DX-9 at 110.

47 Tr. at 113-14. The record is not clear about when, if, or to what extent National Securities provided consulting services to Bidville as contemplated in the agreement.

48 DX-17 at 14.

49 DX-16 at116.

50 *Id.*

representation is mentioned in Hatfield's contemporaneous emails or [Applicant]s' resignation letter."[51]

Bidville did not amend its Form 10-QSB within the promised five days. Instead, approximately a month after Bidville filed its misstated Form 10-QSB, Hatfield emailed Bidville's president, reminding him that "the 3/31/04 10-QSB should be amended as [the National Securities] transaction took place in 2/04 and was not recorded in the Bidville financial statements."[52] An outside accountant that Bidville had hired, Gary Alexander, responded to Hatfield a couple of days later, writing that Alexander was "actively working on this matter" and "that a satisfactory explanation and/or correction will be made and properly disclosed."[53] After Applicants sent another reminder to Bidville on June 30, 2004 about amending the company's Form 10-QSB, Applicants withdrew as Bidville's auditor via a letter dated August 2, 2004. In doing so, Applicants cited the circumstances surrounding the National Securities consulting agreement, writing that Bidville's failure to account for the consulting agreement in the Form 10-QSB caused the company's financial statements "to not be 'materially correct' and not presented in accordance with generally accepted accounting principles."[54]

(b) Analysis

The PCAOB found that Applicants, in connection with their fiscal year 2003 audit of Bidville, failed to properly respond after they became aware, in April 2004, of a December 2003 consulting agreement that had not been disclosed or accounted for in Bidville's 2003 financial statements, thereby violating the auditing requirements to exercise due care and to obtain sufficient competent evidence. The PCAOB also found that Applicants violated the additional auditing requirement that an auditor who becomes aware of certain facts after the issuance of his report take steps to determine if "his report would have been affected if the information had been known to him at the date of his report and had not been reflected in the financial statements."[55] Under that standard, if an auditor determines that the subsequently learned facts would have affected his report, the auditor should then take action to prevent further reliance on his report.[56] These steps depend on the circumstances, but may include the issuance of revised financial statements and a revised auditor's report to ensure that those relying on the financial statements

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51 Hr'g Officer Initial Decision at 47.

52 DX-16 at 120.

53 *Id.* at 125.

54 RX-8 at 1. After Applicants resigned, Bidville approached Applicants about assisting with a restatement of the company's 2003 financial statements. Applicants accepted the assignment, and, on October 1, 2004, Bidville filed an amended Form 10-KSB, with the corrected financial statements recognizing the impact attributable to the consulting agreement. Applicants wrote in their audit report accompanying the financial statements that, although Bidville had previously determined that the appropriate date for recording the transaction was February 2004, the company determined, "upon further evaluation of the underlying contract, . . . that the appropriate measurement date for recording the economic transaction was the contract execution date of December 12, 2003." DX-10 at 123.

55 *See* AU § 561.05, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.*

56 AU § 561.06.

are notified of the effects of the subsequently discovered facts.[57] We agree with the PCAOB that Applicants violated these standards.

The PCAOB also found that Applicants, in connection with their review of the Form 10-QSB that Bidville filed on May 25, 2004, failed to comply with the interim auditing standards requiring them to exercise due care and professional skepticism. We also agree with that finding.

(i) Consulting Agreement's Impact on Bidville's 2003 Financial Statements

Applicants' reliance on Bidville's claim that consideration for the consulting agreement had not yet changed hands was a plain failure to exercise due care. Applicants believed that Bidville was engaged in a "pump and dump" scheme and that the company had hidden its consulting agreement from them.[58] This should have raised red flags about Bidville's trustworthiness and caused Applicants to view Bidville's representations about the consulting agreement with skepticism. Instead, Applicants' only effort to confirm Bidville's representation was to review a single, third-party transfer agent report, from which Hatfield testified he "could not ascertain" whether or not the shares had been transferred.[59] Applicants could have taken any number of easy, obvious follow-up steps to confirm Bidville's representations about the stock issuances, such as contacting the transfer agent directly or sending a confirmation request to the parties to the agreement. But Applicants made no such effort. Given Applicants' concerns about Bidville's trustworthiness, this failure to take simple follow-up measures to verify management's representations displayed a remarkable lack of professional skepticism.

This lack of due care again led to the related failure to obtain sufficient audit evidence on which to base an audit opinion. As the interim standards explain, "representations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit."[60] Here, Applicants relied on representations by a company Applicants did not trust and on a single, third-party transfer agent report, which Applicants admitted did not provide the assurances they needed to confirm management's representation. This evidence provided no meaningful basis from which Applicants could opine about Bidville's disclosure regarding the consulting agreement. These failures also led to Applicants' more specific auditing failure to take steps to determine if the consulting agreement would have affected their 2003 audit report had they known about the agreement at the date of that report.[61]

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57 *See id.*

58 DX-3 at 157.

59 Tr. at 114.

60 AU § 333.02, *Reliance on Management Representations.*

61 *See* AU § 561.

(ii) Consulting Agreement's Impact on Bidville's 2004 Q1 Financial Statements

Even more troubling than the foregoing auditing failures was how Applicants responded when they learned that the consulting agreement had gone into effect in February 2004 but that Bidville still did not intend to disclose the consulting agreement's impact in its about-to-be-filed financial statements. Hatfield testified that, despite believing that Bidville was a scam and wanted to do "a pump and dump" of its stock, Applicants "rolled over" and allowed Bidville to file its quarterly report without objection.[62] Although Applicants eventually withdrew as Bidville's auditors, they did not do so until more than two months after learning that Bidville would be filing misstated financial statements. In the intervening time, Applicants took no steps other than sending occasional emails to Bidville management, which did nothing to prevent investors from relying on what Applicants believed were materially misstated financial statements.

Applicants based these decisions on Bidville's purported promise to file an amended quarterly report within five days. Applicants contend they accepted this promise because of Exchange Act Rule 12b-25, which provides an issuer, under certain circumstances, an additional five calendar days to file a quarterly report if the issuer timely files a Form 12b-25.[63] Regardless of whether Bidville filed a Form 12b-25 or a late Form 10-QSB, nothing in Rule 12b-25 provides—or even implies—that an issuer may file a materially misleading quarterly report if the issuer promises to correct that filing within five days.

Even more disturbing is that, in making this argument, Applicants imply that Bidville's filing of a materially misleading quarterly report was somehow acceptable because investors would be misled for only five days. Such an assertion displays a profound disregard for Applicants' responsibility to public investors.[64] A promise by Bidville to file within five days would not change Applicants' responsibility to exercise due care in ensuring that Bidville's interim financial statements could properly be relied upon by investors.[65] Applicants plainly failed in this duty by allowing Bidville to file without objection what Applicants believed was a materially misstated quarterly report. Nor would such a promise change Applicants' responsibility to take steps to prevent reliance on that misstated quarterly report, such as issuing a revised review report to ensure that those relying on the financial statements were notified of

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[62] DX-3 at 157-58

[63] 17 C.F.R. § 240.12b-25(a) (requiring issuers to provide notice of 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); *Id.* § 249.322 (Form 12b-25). Bidville filed a Form 12b-25 on May 17, 2004, which was eight days before the company finally filed its amended Form 10-QSB.

[64] *See generally United States v. Arthur Young & Co.*, 465 U.S. 805, 817–18 (1984) (noting that independent auditors owe "ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public").

[65] *See* AU § 722.46, *Subsequent Discovery of Facts Existing at the Date of the Accountant's Report* (noting that, when discovering facts after the date of a review report, "the accountant should consider the guidance in section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*").

the effects of the subsequently discovered facts. But Applicants took no action for more than two months.

Moreover, the record offers no credible evidence that Bidville actually promised to file an amended quarterly report within five days. As the hearing officer accurately observed, "no such management representation is mentioned in Hatfield's contemporaneous emails or [Applicant]s' resignation letter."[66] Given the importance that Applicants place on Bidville's supposed promise, one would expect some mention of it in Applicants' audit work papers or correspondence with Bidville. Instead, the only evidence of such a promise is Applicants' own testimony, which the hearing officer found not credible, and the testimony of Bidville's outside accountant consultant, Gary Alexander, who testified only that Bidville promised to file an amended report "as quickly as we could."[67]

Applicants nevertheless defend their audit procedures by pointing to their expert's testimony that "it was accepted" that an auditor could wait until the next quarterly report to issue a nonreliance report if that auditor discovered a material misstatement in quarterly financially statements for which the auditor had already issued a review report.[68] Applicants claim this supports their decision not to object or withdraw because "a disclosure in interim statements was sufficient until the exact quantification for the adjustment could be determined."[69] Applicants, however, discovered the material misstatement before Bidville filed its quarterly report. Moreover, Applicants did not need additional time to quantify an exact adjustment. Applicants already knew what adjustment Bidville needed to make.

Applicants further attempt to justify their inaction by claiming that "three massive hurricanes in Florida occurred, impeding effective communications with Applicants from May 25 to August 2, 2004."[70] Neither the record nor Applicants' briefs indicate how such hurricanes impeded their communications or audit. To the contrary, the record shows that at least some communication existed throughout the relevant period, as the record contains email correspondence between Applicants and Bidville from this time. But this is beside the point. Any difficulty in communication does not change that Applicants admit to "rolling over"; allowing Bidville to file, without objection, what they believed were materially misstated financial statements; and taking no meaningful steps to prevent investor reliance on those financial statements for more than two months.

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66 Hr'g Officer Initial Decision at 47.

67 Tr. at 479.

68 *Id.* at 444.

69 Appellants' Br. in Supp. of Pet. for Review at 24.

70 *Id.* at 23.

B. The Epicus Audits

Epicus engaged Applicants to audit the company's 2002 through 2007 financial statements. Epicus was a Florida corporation, whose only active business during the relevant period was the resale of telecommunication services through a subsidiary. At issue here are certain aspects of Applicants' audits of Epicus's fiscal year 2004 and 2005 financial statements.[71] During these audits, Applicants again repeatedly violated multiple auditing responsibilities by relying on their own untested assumptions or on Epicus's unverified representations—despite concerns about Epicus's reliability—to reach certain auditing conclusions.

1. Applicants audit Epicus's 2004 revenue recognition.

(a) Background

During their audit of Epicus's 2003 financial statements (which are not at issue here), Applicants determined that the company's revenue recognition policy did not comply with GAAP. Specifically, Applicants determined that GAAP required Epicus to recognize the income from telephone services at the time the services were provided to (or earned from) Epicus's customers.[72] Epicus, however, was recognizing revenue when the company billed its services to customers. Applicants recommended that, to conform to GAAP, Epicus should change its policy so that, for local and bundled services, Epicus would recognize revenue as it was earned, on a per-day basis, and, for long distance service, recognize revenue when it was provided. Applicants further recommended that Epicus (i) make the changes as of the 2003 fiscal year end; (ii) disclose the changes in a Form 10-KSB or Form 8-K; and (iii) quantify the GAAP violation's impact on the financial statements.

Instead of changing its revenue recognition policy, however, Epicus changed only its disclosure. Epicus had stated in its 2003 financial statements that the company recognized revenue on the date "of billing," but changed the disclosure in 2004 to state that Epicus recognized revenue "as earned."[73] Hatfield testified during his disciplinary hearing that he knew Epicus's disclosure did not accurately reflect how the company was recognizing revenue.

During the investigatory phase of these proceedings, Hatfield testified that he could not recall performing any specific analysis to determine whether this inaccurate disclosure was material.[74] Hatfield added that, if he had done any such materiality analysis, he would have

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71 For each of the relevant years, Epicus's fiscal year ended May 31.

72 During Epicus's 2004 fiscal year, the company offered three types of telephone service: (i) local, which was billed monthly in advance of service, at a flat rate; (ii) long distance, which was billed monthly after service was provided, based on calls made; and (iii) bundled, combining unlimited local and long distance service, which was billed monthly in advance of service, at a flat rate.

73 *Compare* DX-20 at 47 *with* DX-21 at 54.

74 *See* AU § 110.02, *Responsibilities and Functions of the Independent Auditor* ("The auditor has a responsibility 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.").

expected to find such analysis reflected in the work papers and that the absence of any such evidence in the work papers indicated to Hatfield that "there was nothing available for me to do."[75] Similarly, when responding to a notice from the PCAOB's Division of Enforcement and Investigations that it intended to recommend that the Board issue an Order Instituting Proceedings, Applicants did not dispute the Division's allegation that, among other things, Applicants had failed to conduct a materiality evaluation. Instead, Applicants claimed only that Epicus's management was unable to provide the information necessary to perform such an analysis.

Hatfield changed his testimony at his disciplinary hearing. There he claimed for the first time that Applicants had done an analysis to determine whether Epicus's inaccurate disclosure of how the company was recognizing revenue was material. Hatfield described this analysis as "a visual and mental check," which consisted of looking at Epicus's 2003 and 2004 billing cycles and "kind of just rough in my mind look[ing] to see where the difference was."[76] Hatfield added that, based on this rough estimation, he "did not believe at that time that [Epicus's inaccurate disclosure of its actual revenue recognition policy] would significantly misstate or distort the financial statements."[77]

Hatfield acknowledged he had not previously claimed to have conducted such an analysis. Hatfield further acknowledged that he could not recall what numbers he came up with during this supposed evaluation; that, whatever those numbers were, they would have exceeded the quantitative materiality thresholds Applicants had set during the audit; and that he could not recall whether he had even considered whether the results of his supposed analysis exceeded Applicants' materiality thresholds.

Applicants' expert similarly admitted during the hearing that a hypothetical work paper he had created in an attempt to duplicate Hatfield's claimed visual and mental check yielded a result that exceeded Applicants' planning materiality and tolerable misstatement thresholds. The expert argued that the amount he calculated was nevertheless not material when compared with Epicus's earning per share, but he acknowledged that such a comparison was not in Applicants' work papers.

(b) Analysis

The PCAOB found that Applicants, after learning of Epicus's GAAP violation, did not satisfy the requirement to exercise due professional care, and we agree. Applicants knew that Epicus's revenue recognition practice failed to comply with GAAP and that the interim auditing standards required them to obtain reasonable assurance that the GAAP violation was not

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75 DX-4 at 35.

76 Tr. at 33, 157-58.

77 *Id.* at 158.

material.[78] The interim auditing standards also expressly warn auditors to presume a risk of material misstatement in revenue recognition due to fraud.[79] Despite these strictures, Applicants repeatedly admitted that they did nothing to determine whether Epicus's misstatement of the way it actually disclosed revenue was material. Only at Applicants' disciplinary hearing did Hatfield state, for the first time, that Applicants had performed a "visual and mental check."[80] The hearing officer observed that Hatfield "appeared uncertain and unconvinced of his own claim that he conducted a materiality evaluation" and concluded that Hatfield's "demeanor strongly suggested that his testimony in that regard was fabricated."[81] The hearing officer added that Hatfield "could not explain in any coherent manner how . . . he concluded that Epicus's GAAP departure was not material" given his admission that the results of his supposed materiality analysis exceeded Applicants' tolerable misstatement thresholds.[82] "Hatfield's inability to offer an intelligible description of the materiality assessment he claims to have conducted," the hearing officer concluded, "is additional evidence that he did not perform it."[83]

We defer to such credibility determinations unless the record contains substantial evidence to support overturning them.[84] Here, the record provides no such basis for revisiting the hearing officer's credibility finding. Instead, as the PCAOB observed, the record "provides ample reason not to credit Hatfield's testimony on this point."[85] Most telling is Applicants' repeated failure during the investigatory stage of these proceedings to claim to have conducted a materiality analysis. Hatfield even acknowledged that, if he had done any such materiality analysis, he would have expected to find it reflected in the work papers and that the absence of such evidence in the work papers indicated to him that "there was nothing available for me to do."[86]

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78 AU § 110.02, *Responsibilities and Functions of the Independent Auditor* ("The auditor has a responsibility 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.").

79 AU § 316.41, *Identifying Risks That May Result in a Material Misstatement Due to Fraud* ("[T]he auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition.").

80 Tr. at 33.

81 Hr'g Officer Initial Decision at 8.

82 *Id.* at 9.

83 *Id.* at 10.

84 *Cf., e.g.*, *Geoffrey Ortiz*, Exchange Act Release No. 58416, 2008 WL 3891311, at *5 & nn.14-15 (Aug. 22, 2008) ("We give great weight and deference to credibility determinations by a Hearing Panel, which can only be overcome by substantial record evidence."); *Anthony Tricarico*, Exchange Act Release No. 32356, 51 SEC 457, 1993 WL 183678, at *3 (May 24, 1993) ("It is well settled that credibility determinations of an initial fact finder are entitled to considerable weight" and "can be overcome only where the record contains 'substantial evidence' for doing so." (citing *Universal Camera v. NLRB*, 340 U.S. 474, 496 (1950)), *petition denied*, 230 F.3d 362 (D.C. Cir. 2000).

85 PCAOB Final Decision at 4.

86 DX-4 at 35. Hatfield's acknowledgment is also consistent with case law in which we have noted that "[w]e consider the absence of work papers to be evidence that the audit team did not devote substantial, if any, effort to

(continued . . .)

Furthermore, even if Applicants had performed their supposed "mental check and sight analysis," such an analysis still would not have satisfied Applicants' duty to exercise due care. Applicants characterized their supposed materiality analysis as only a cursory, "rough in [their] mind," assessment of whether Epicus's GAAP violations were material.[87] In any event, the amount that they claim their cursory analysis yielded was an amount that exceeded the quantitative materiality thresholds Applicants set during the audit. And when confronted during the hearing about this discrepancy between their analysis and materiality thresholds, Hatfield could not remember whether he had even considered the issue. Instead, Applicants claim they simply considered "the context of Epicus['s] financial condition and performance,"[88] concluded that qualitative factors did not make Epicus's misstatement material, and continued on with their audit. Even if Applicants had actually performed such an analysis, such a lackadaisical auditing approach to an area of such importance as revenue recognition would represent a clear failure to exercise due care and professional skepticism.

2. Applicants fail to seek confirmations related to Epicus's 2004 accounts receivable.

(a) Background

Applicants decided not to send third-party requests to confirm the approximately $5.7 million in accounts receivable that Epicus reported in its 2004 financial statements—an amount that represented more than seventy-five percent of Epicus's reported year-end total assets.[89] In that financial statement, Epicus classified its accounts receivable as either (i) amounts due from residential or commercial customers; or (ii) carrier access fees due from the telecommunications companies whose services Epicus resold. For accounts receivable in the first category, Epicus further subdivided those receivables into active and inactive accounts. For receivables related to inactive accounts, Epicus assigned those receivables out for collection by either Epicus's in-house staff or outside collection agencies.[90]

During the hearing, Hatfield testified that Applicants were concerned about Epicus's accounts receivable because it had been a trouble area in the past, and he acknowledged the

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(...continued)

review the areas in question." *Gregory M. Dearlove, CPA*, Exchange Act Release No. 57244, 2008 WL 281105, at *10 n.39 (Jan. 31, 2008) (noting that "workpapers are ordinarily the foundation on which support for audit conclusions is demonstrated").

87 Tr. at 157.

88 Appellants' Br. in Supp. of Pet. for Review at 6.

89 In its Form 10-KSB, filed on October 10, 2004, Epicus reported total assets of $7,568,803 for the fiscal year ending May 31, 2004.

90 Approximately $2.6 million of Epicus's accounts receivable was due from inactive accounts, and Epicus assigned approximately $1 million of that amount to outside collection agencies.

importance of verifying the existence of Epicus's receivables.[91] Applicants' work papers included an audit program that stated, "Select those groups that will be confirmed 100 percent by the use of positive confirmation letters."[92] Yet Applicants did not send any letters seeking positive confirmation of the accounts receivable. Instead, Applicants sent an email to Epicus management about opting out of sending positive confirmation requests "so that time can be saved."[93] Applicants' work papers further explained that they decided not to send such letters because of a "[l]arge # of small accounts with little possibility of accurate response"[94] and because "[t]he use of positive audit confirmations is not practical due to the existence of approximately 40,000 separate accounts with no single account or group of accounts being significant within the population. Accordingly the confirmation response rate would not be cost effective."[95] At the hearing, however, Hatfield acknowledged that the majority of Epicus's carrier access fees were billed to only four large telecommunications companies.

(b) Analysis

The PCAOB's interim auditing standards state that there is a "presumption that the auditor will request the confirmation of accounts receivable during an audit."[96] The standards define that confirmation process as "the process of obtaining and evaluating a direct communication from a third party in response to a request for information about a particular item affecting financial statement assertions."[97] The reason for this process, the standards explain, is that "it is generally presumed that evidence obtained from third parties will provide the auditor with higher-quality audit evidence than is typically available from within the entity."[98] As a result, the standards state that "[a]n auditor who has not requested confirmations in the examination of accounts receivable should document how he or she overcame this presumption."[99] The PCAOB found that Applicants violated this standard, along with the duty to

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[91] Applicants, at various times, testified and wrote in their work papers about concerns with Epicus's recordkeeping. For example, during his investigatory testimony, Hatfield described Epicus as having "sloppy bookkeeping," and Applicants wrote in their work papers that a rewrite of Epicus's accounts receivable reporting system in 2004 "created a total failure in management reporting." DX-3 at 219; DX-28 at 238. At the hearing, however, Hatfield tried to qualify these earlier comments by describing Epicus's bookkeeper as "relatively accurate and reliable" and testifying that, although the company's bookkeeping was sloppy, its cash management was not. Tr. at 63.

[92] DX-27 at 244.

[93] DX-25 at 114.

[94] DX-27 at 244.

[95] DX-28 at 238.

[96] AU § 330.34, *Confirmation of Accounts Receivable.*

[97] AU § 330.04, *Definition of the Confirmation Process* (noting that the process includes selecting items for which confirmations are to be requested; designing the confirmation request; communicating the confirmation request to the appropriate third party; obtaining the response from the third party; and evaluating the information, or lack thereof, provided by the third party about the audit objectives, including the reliability of that information).

[98] AU § 330.34.

[99] AU § 330.35, *Confirmation of Accounts Receivable.*

exercise due professional care and to obtain sufficient audit evidence, by deciding not to send positive confirmation requests and by not having a reasonable basis for making that decision. We agree.

The reason Applicants listed in their work papers for not sending out positive confirmation requests was that, because Epicus had a large number of small accounts, there was "little possibility of accurate response."[100] Applicants, however, did nothing to confirm the actual likelihood of an accurate response. During the hearing, Hatfield claimed that Applicants based their conclusion on their experience during audits of another, supposedly similar, municipal utility. The interim auditing standards, however, expressly state that auditors should document why they did not send positive confirmation requests,[101] and Applicants did not document in the work papers their reliance on past experience as a basis for not sending such requests.[102] Moreover, during the previous audits on which Applicants supposedly relied, Applicants never actually sent positive confirmation requests, and thus had no basis for determining the likelihood that sending such requests would yield an accurate response.[103] The only other audit Applicants identify that could provide some indication about the possibility of an accurate response was their failed attempt to obtain positive confirmations from Bell South during a subsequent audit. Because that audit occurred after Applicants performed the Epicus audit at issue here, however, it could not have been the basis for Applicants' determination during the Epicus audit.

Applicants' claim that seeking confirmations would have been impracticable because of Epicus's numerous small accounts does not explain their decision not to seek confirmations related to Epicus's carrier access fees. As Hatfield acknowledged at the hearing, the majority of Epicus's carrier access fees were billed to only four large telecommunications companies. Applicants argue on appeal that they had explained in their work papers that the collectability of carrier access fees was "relatively assured by statute as long as the carrier in question remains solvent and operating."[104] Applicants claim that, "[s]ince the carrier access fees were a statutory creation, this validates and confirms the existence of such a receivable."[105] Any legal requirement that carriers must pay their fees, however, does not establish that any particular carrier actually incurred such a legal obligation to Epicus, which was the point of sending positive confirmations in the first place.

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100 DX-27 at 244.

101 AU § 330.35 ("An auditor who has not requested confirmations in the examination of accounts receivable should document how he or she overcame this presumption.").

102 *Cf. Michael J. Marrie*, Exchange Act Release No. 48246, 56 SEC 760, 2003 WL 21741785, at *12 (July 29, 2003) (rejecting "an after-the-fact justification for [respondents'] failure to exercise the required degree of professional care"), *rev'd on other grounds*, 374 F.3d 1196 (D.C. Cir. 2004).

103 *See* AU § 330.23, *Prior Experience* ("In determining the effectiveness and efficiency of employing confirmation procedures, the auditor may consider information from prior years' audits or audits of similar entities.").

104 DX-28 at 246.

105 Appellants' Br. in Supp. of Pet. for Review at 12.

As the PCAOB's expert wrote in his report, "Auditing is not a guessing game. It is based on the concept of developing corroboration for assertions."[106] Here, other than their unsupported belief that seeking confirmations would be ineffective and that opting out of the positive confirmation process would save time, Applicants developed no basis for deciding not to send confirmation requests. This failure to have any documented or supported basis for not sending confirmation requests represented a clear failure to exercise due care and a failure to comply with the duties regarding such confirmation requests. Not sending any confirmation requests also led directly to Applicants' related failure to obtain sufficient audit evidence because, as explained in the following section, Applicants had essentially no evidence on which to base their audit opinion regarding Epicus's accounts receivable.

3. Applicants use an alternative procedure for testing Epicus's accounts receivable.

(a) Background

Instead of sending confirmations, Applicants claim they used an alternate procedure to test Epicus's accounts receivable. This alternate procedure supposedly involved Applicants' reviewing the company's year-end cash receipts from a fifty-three-day period following the close of Epicus's 2004 fiscal year. In conducting that review, Applicants did not attempt to match the cash receipts with actual receivables being paid or otherwise attempt to trace (or "vouch") any cash receipt to the receivable balance. Instead, Applicants relied on Epicus's representations about the company's experience regarding the timing of collections. But as Hatfield acknowledged during the hearing, Applicants did not test the accuracy of those representations.

Applicants nevertheless used those representations to determine that, of the cash that Epicus collected during the fifty-three-day period after the 2004 fiscal year end, approximately $2.3 million related to Epicus's $3.1 million in active year-end residential and commercial accounts receivable and approximately $700,000 related to the company's $1.5 million in carrier access accounts receivable. Hatfield acknowledged that Applicants' alternative confirmation procedure ignored the remaining $800,000 in uncollected receivables from the residential/commercial receivables and $800,000 in uncollected receivables from carrier access receivables—amounts that, by themselves, each exceeded Applicants' planning materiality and tolerable misstatement thresholds.

During his disciplinary hearing, Hatfield acknowledged that, because Applicants did not vouch any of the cash Epicus collected during the fifty-three-day period, their alternate procedure did not establish whether that cash actually applied to Epicus's year-end accounts receivable balance. Hatfield also admitted that their alternate procedure did nothing to test the approximately $2.6 million of inactive customer accounts.

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[106] DX-40 at 30.

(b) Analysis

The PCAOB's interim auditing standards state that auditors should use alternative procedures when auditors, such as Applicants, do not use confirmation requests to test the existence of accounts receivable.[107] Under those standards, "alternative procedures may include examination of subsequent cash receipts (including matching such receipts with the actual items being paid)."[108] The PCAOB concluded that Applicants failed this requirement by relying on unverified management representations when testing part of Epicus's accounts receivable and by doing nothing to test Epicus's other accounts receivable. The PCAOB also concluded that these audit procedures failed to satisfy Applicants' duty to exercise due professional care and duty to obtain sufficient audit evidence. We agree.

Hatfield admitted that Applicants' alternate procedure could not establish whether the year-end payments applied to Epicus's year-end accounts receivable balance. Instead, despite various concerns with Epicus's accounting and bookkeeping, Applicants relied on management representations about the company's historical experience without testing the accuracy of those representations or determining whether Epicus's historical experience was relevant to Epicus's 2004 accounts receivable. Applicants' alternative testing procedure also ignored entirely more than twenty-five percent of Epicus's residential/commercial active accounts receivable, more than fifty percent of Epicus's carrier access receivables, and all of Epicus's inactive accounts receivable.

Applicants justify their failure to test the inactive accounts by arguing that Epicus was pursuing those inactive accounts through internal and external collections processes. This, Applicants claim, established the inactive accounts' existence because "obviously a receivable can't be turned over for collection unless it exists."[109] Applicants offer no basis for such a supposition, which is patently unreasonable: Issuers could recognize fabricated accounts receivable as revenue and then hide their fraudulent conduct by claiming to have turned over the aged receivable for collection. Applicants' decision to not even contact the collection agencies to see if the inactive accounts had been turned over was a clear failure to satisfy both the general requirement to exercise due care and the more specific requirement regarding the use of alternate procedures. These failures again also led to Applicants' failing to obtain sufficient audit evidence, as Applicants' flawed alternate procedures yielded essentially no reliable evidence on which to base their audit opinion regarding the existence of Epicus's accounts receivable.

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107 AU § 330.31, *Alternative Procedures* ("When the auditor has not received replies to positive confirmation requests, he or she should apply alternative procedures to the nonresponses to obtain the evidence necessary to reduce audit risk to an acceptably low level."); *see also supra* notes 96–99 and accompanying text (discussing the presumption that an auditor will request the confirmation of accounts receivable during an audit).

108 AU § 330.32, *Alternative Procedures.*

109 Appellants' Br. in Supp. of Pet. for Review at 13.

4. Applicants audit Epicus's 2004 and 2005 doubtful account allowance.

(a) Background

(i) Epicus's 2004 Accounts Receivable

In the company's 2004 financial statements, Epicus disclosed that it had approximately $5.7 million in accounts receivable, net of approximately $1.5 million in doubtful accounts. Hatfield testified that, during their audit of those financial statements, Applicants determined that the company had based its $1.5 million doubtful account allowance "on a number that was pulled out of the air."[110] Because of this, Applicants tested the company's allowance using their own calculations. In doing so, however, Applicants did not test Epicus's carrier access fee accounts because, as noted earlier, they believed the telecommunications companies had a legal obligation to pay the fees. Applicants instead tested only Epicus's active (residential and commercial) and inactive accounts.

In auditing these accounts, Applicants accepted the company's representation that ninety percent of its accounts receivable was paid within ninety days. Once again, however, Hatfield admitted that Applicants did nothing to test Epicus's representation. Nevertheless, Applicants' work papers state that, based on the company's representation, Applicants intended to calculate Epicus's uncollectible accounts by taking "an arbitrary 10%" of the company's active accounts receivable.[111] Instead of using this methodology, however, Applicants decided to estimate the doubtful account allowance by applying the ten-percent factor only to *past due* active accounts receivable. And in doing so, Applicants relied on yet another untested management representation: namely, a company-prepared summary of Epicus's accounts receivable (a so-called "aging report"), which Applicants used to conclude that $1.1 million of Epicus's $3.1 million in active receivables were past due as of May 31, 2004. Applicants then applied the arbitrary ten percent to the aging report's $1.1 million past due number to calculate a doubtful account allowance of approximately $110,000. Applicants did so despite noting in their work papers that the aging report was neither "valid" nor "workable" because of a "total failure in management reporting."[112] Hatfield further admitted that, because the aging report was invalid, Applicants had no basis to know whether the past due amounts they calculated were actually past due.[113]

Furthermore, by applying the arbitrary ten percent to only $1.1 million in active receivables, instead of the full $3.1 million, Applicants essentially assumed that the remaining $2 million balance was one hundred percent collectible. Hatfield acknowledged that Applicants

[110] DX-4 at 55.

[111] DX-28 at 238.

[112] *Id.*

[113] For example, when asked during his investigatory testimony whether he was "able to verify that the amounts listed as past due by the company were actually the amounts past due," Hatfield responded, "I don't think there was a way."

made this assumption despite knowing that Epicus itself had expected not to collect at least some of that remaining $2 million balance. Hatfield also admitted that, "in hindsight," the allowance for active account receivables "should have been 10 percent of three million one instead of one million one . . . ."[114]

As for calculating an appropriate allowance for Epicus's inactive accounts, Applicants assumed the company would collect fifty percent of the receivables Epicus assigned to in-house collection and would collect forty percent of the receivables assigned to outside collection agencies. Hatfield testified that these percentages were based on Applicants' own historical experience about what they "anticipated [to be] the best case scenario for collections," while acknowledging that the "[w]orst case" would be that the company collected nothing.[115] Applicants again did nothing to test the relevance of their historical experience to Epicus's actual situation, nor did they do anything else to verify the amount of inactive accounts, such as sending requests to the outside collection agencies to confirm whether Epicus had actually sent those accounts out for collection.

(ii) Epicus's 2005 Accounts Receivable

In its 2005 financial statements, Epicus reported year-end accounts receivable of approximately $1.4 million, net of approximately $500,000 in doubtful accounts. Epicus further disclosed that the company would retroactively write off as uncollectible any receivable amounts it did not collect within thirty days of the fiscal year end.[116] This disclosure was inconsistent with Epicus's representation during the 2004 audit, during which Epicus claimed it received payment on a substantial portion of receivables that the company had not collected within thirty days of the year end. Applicants nevertheless accepted Epicus's new representation about its 2005 doubtful accounts because, Hatfield testified, it "was one of the most conservative presentations that [Epicus] could develop."[117] Applicants wrote in their work papers, however, that "[t]he actual AR balance is much higher [than the amount collected during the 30-day period]; however, the client has no monitoring or collection protocol in place to allow any collectability reliability on delinquent AR accounts."[118] Hatfield testified that, as with Applicants' audit of Epicus's 2004 financial statements, Applicants did nothing during the 2005

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114 Tr. at 165. Given that the company's accounts receivable was approximately $3.1 million, Applicants methodology should have yielded a doubtful account allowance of approximately $310,000. Again, however, we take no position as to the appropriateness of this calculation as it relates to GAAP.

115 *Id.* at 164, 190.

116 Epicus stated:

> [T]he Company adopted the policy of recording a net accounts receivable balance equal to the actual cash collected during the 30 day period subsequent to any reporting period. Any differential between the Company's actual accounts receivable and the actual subsequent cash collections is recorded as bad debt expense in the reporting period.

DX-23 at 57-58.

117 Tr. at 173.

118 DX-30 at 201.

audit to test whether any of Epicus's year-end cash related to any specific receivable. Nor did Applicants send any confirmation requests to establish the existence of any receivable. Instead, Hatfield admitted that Applicants simply accepted what Epicus told them.

(b) Analysis

The PCAOB concluded that Applicants failed to exercise due professional care and to collect sufficient competent evidential matter during their audit of Epicus's 2004 and 2005 doubtful account allowances, and we agree. Once again, Applicants based their audit opinion on untested management representations and their own untested, undocumented historical experience.

With respect to Epicus's 2004 active accounts receivable, Applicants applied what they conceded was an arbitrary ten percent against a company-generated aging report that Applicants themselves described as invalid and unworkable. And in doing so, Applicants applied the arbitrary ten percent to only Epicus's past-due receivables, which meant that Applicants assumed that approximately two-thirds of the company's active accounts receivable was one hundred percent collectible, despite knowing that Epicus did not expect to collect some of that amount. Applicants then ignored entirely Epicus's carrier access fee receivable.[119]

And when calculating an appropriate allowance for Epicus's inactive accounts, Applicants relied on their own historical experience about what they expected would be "the best case scenario," while doing nothing to test the relevance of that historical experience to Epicus's specific situation. Applicants also relied on management's untested representation about assigning some of the inactive accounts to outside collection agencies. Nor did Applicants do anything else to verify the amount of Epicus's 2004 inactive accounts, such as sending confirmation requests to the outside collection agencies to confirm whether Epicus had actually sent those accounts out for collection.

Applicants took a similar approach in 2005 by again relying on Epicus's representations, but this time Applicants relied on a representation about the company's collection expectations. Applicants contend this was reasonable because they saw no evidence that would have caused them to question Epicus's 2005 representation. But management's 2005 representation was inconsistent with management's 2004 representation, and this should have caused them to question the later representation. Applicants also wrote in their work papers that Epicus has "no monitoring or collection protocol in place to allow any collectability reliability on delinquent AR accounts."[120] The interim standards expressly state that "[i]f a representation made by management is contradicted by other audit evidence, the auditor should investigate the

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119 Applicants again argue that they ignored these receivables because telecommunication companies had a legal obligation to pay carrier access fees. As previously explained, a general legal obligation does not establish that a particular company actually owed any particular obligation to Epicus. Nor would a particular company's legal obligation necessarily mean that the company had the resources, or intention, to actually pay. *See* discussion *supra* Section II.B.2(b).

120 DX-30 at 201.

circumstances and consider the reliability of the representation made."[121] But Applicants undertook no such investigation.

On appeal, Applicants claim they took a variety of additional audit steps, such as conducting a risk assessment, interviewing appropriate company personnel, finding reliable and accurate recordkeeping protocols, and testing management's representations. The record, however, contains no evidence of this. To the contrary, Hatfield repeatedly testified that Applicants relied only on untested management representations and on their own historical experience, which they did nothing to test for suitability to Epicus's particular situation. Applicants also claim that Epicus's cash receipts "provided a reasonably accurate estimate of the year end accounts receivable balance,"[122] but Applicants' own work papers stated Epicus's accounts receivable monitoring and collection protocol was not reliable.

5. Epicus changes its revenue recognition policy in 2005.

(a) Background

Epicus filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code on October 25, 2004 (*i.e.*, during Epicus's 2005 fiscal year). The company remained in operation during the bankruptcy and, in its 2005 financial statements, reported total revenue of approximately $18.8 million for the 2005 fiscal year. Partway through the 2005 fiscal year, however, Epicus changed its revenue recognition policy. The company included a description of this new policy in its Form 10-KSB filed on September 3, 2005, but did not disclose that the policy was a change from the previous year's revenue recognition policy.[123] Although Applicants knew that Epicus had changed its revenue recognition policy, Applicants' work papers contain no indication that they made any attempt to determine whether that change had a material effect on the comparability of Epicus's 2004 and 2005 financial statements. To the contrary, Hatfield stated during his investigative testimony that he was not sure he had even considered whether Epicus needed to disclose the change to its revenue recognition policy. Applicants instead simply issued an unqualified audit report in connection with Epicus's 2005 Form 10-KSB without disclosing in their audit opinion that the company had changed its revenue recognition policy or what effect Epicus's change in policy had on an investor's ability to compare Epicus's 2004 and 2005 financial statements.

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[121] AU § 333.04.

[122] Appellants' Br. in Supp. of Pet. for Review at 17.

[123] Epicus's Form 10-KSB stated:

> Revenue for services billed in advance is recognized on a pro-rata basis over the course of the related billing cycle and revenue for long distance service billed in arrears is recognized at the respective billing date. Accordingly, the Company has recognized an unearned revenue item in the accompanying balance sheet for unearned advance billings for service.

DX-23 at 59.

(b) Analysis

The PCAOB found that Applicants violated the auditing requirement that Applicants' audit report should identify those circumstances in which accounting principles were not applied consistently in a company's current reporting period in relation to the preceding period.[124] The PCAOB further found that, in failing this requirement, Applicants also failed to exercise due care. We agree with the PCAOB's findings.

Applicants do not dispute that they failed to evaluate whether Epicus's change to its revenue recognition policy materially affected the comparability of Epicus's 2003 and 2004 financial statements. Applicants instead argue that the relevant interim auditing standards did not apply because Epicus planned to adopt fresh start accounting pursuant to AICPA Statement of Position 90-7 ("SOP 90-7"). That provision states, "Fresh-start financial statements prepared by entities emerging from bankruptcy will not be comparable with those prepared before their plans were confirmed because they are, in fact, those of a new entity." Applicants assert that, as a result, "'[f]resh start' financial statements do not need to compare change[s] in accounting policy or the material effect thereof."[125]

SOP 90-7, however, does not allow fresh start accounting to begin until a bankruptcy court confirms the entity's reorganization plan, and Applicants concede that the bankruptcy court did not confirm Epicus's reorganization plan until December 2005, which was after the date of Applicants' audit report. Applicants nevertheless argue that they could still consider Epicus's financial statements as a "fresh start" based on AU § 560.03, which states that "[a]ll information that becomes available prior to the issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates were based." That section is not relevant here. AU § 560.03 deals with "those events that provide additional evidence with respect to conditions *that existed at the date of the balance sheet*." (Emphasis added). Epicus, however, was not a "new entity" as defined in SOP 90-7 at the date of Epicus's balance sheet nor at any point during Epicus's 2005 fiscal year. At the date of the balance sheet, Epicus was the same entity it had been during the 2004 fiscal year. As a result, neither SOP 90-7 nor AU § 560 excused Applicants from their obligation to ensure that their audit report identified the circumstances in which Epicus's accounting principles were not applied consistently during the 2005 fiscal year or in relation to the preceding periods.

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[124] AU § 420.01, *Consistency of Application of Generally Accepted Accounting Principles* (stating that an auditors' report "shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period"). AU § 420.02 explains:

> The auditor's standard report implies that the auditor is satisfied that the comparability of financial statements between periods has not been materially affected by changes in accounting principles and that such principles have been consistently applied between or among periods because either (a) no change in accounting principles has occurred, or (b) there has been a change in accounting principles or in the method of their application, but the effect of the change on the comparability of the financial statements is not material. In these cases, the auditor would not refer to consistency in his report.

[125] Appellants' Br. in Supp. of Pet. for Review at 16.

Moreover, Applicants' argument about AU § 560.03 is simply an after-the-fact excuse. Hatfield admitted that he could not recall even considering the implications of Epicus's change in revenue policy, and nothing in the record indicates that Applicants actually did so. To not even consider these factors was a complete failure to comply with the general auditing requirement to exercise due care and with the more specific requirement to consider such changes in a company's revenue recognition policy.

III.

Based on the above violations, the PCAOB found that it would be in the public interest to permanently revoke the Firm's registration and permanently bar Hatfield from associating with any registered public accounting firm. Section 107(c)(3) of Sarbanes-Oxley directs us to sustain the PCAOB's sanctions unless we find, having due regard for the public interest and the protection of investors, that the sanctions are excessive or oppressive or impose an unnecessary or inappropriate burden on competition.[126] As part of our review, we "may enhance, modify, cancel, reduce, or require the remission of a sanction imposed by the Board upon a registered public accounting firm or associated person thereof."[127] Applying that standard, we sustain the PCAOB's imposition of sanctions.

As a preliminary matter, we note that Applicants take issue with a footnote in the PCAOB's decision, which states that "[c]ertain members of the Board participated in this decision without having been present for the oral argument before the Board on July 27, 2010. Pursuant to PCAOB Rule 5463(d), each such Board member reviewed the transcript of the oral argument prior to such participation."[128] Applicants argue that, "[i]f any member of the PCAOB only reviewed the transcript of the oral argument of July 27, 2010, and did not read and consider the transcript and all exhibits from the July 28-29, 2009 hearing, then Applicants have not had a full and fair review—and due process rights have not been afforded to Applicants."[129] But nothing in the language of either PCAOB Rule 5463(d) or the PCAOB's decision suggests that the Board members who participated in the decision did not appropriately consider the record in this matter. Rather, Rule 5463(d) is intended simply to ensure that Board members who do not

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126 15 U.S.C. § 7217(c)(2) (stating that the provisions of Exchange Act § 19(e)(1), 15 U.S.C. 78s (e)(1), "shall govern the review by the Commission of final disciplinary sanctions imposed by the Board . . . as fully as if the Board were a self-regulatory organization and the Commission were the appropriate regulatory agency for such organization for purposes of [§ 19(e)(1)]").

127 15 U.S.C. § 7217(c)(3).

128 PCAOB Final Decision at 27 n.25. PCAOB Rule 5463(d) provides, "A member of the Board who was not present at the oral argument may participate in the decision of the proceeding, provided that the member has reviewed the transcript of such argument prior to such participation. The decision shall state whether the required review was made."

129 Appellants' Br. in Supp. of Pet. for Review at 28.

attend oral arguments review the transcript of the argument. Our rules provide for a similar procedure.[130]

A. Applicants' conduct was reckless and often knowing.

Under § 105(c)(5) of Sarbanes-Oxley, the PCAOB may impose a revocation or bar only for "intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard."[131] Recklessness represents an "extreme departure from the standards of ordinary care, . . . which presents a danger" to investors or the markets "that is either known to the (actor) or is so obvious that the actor must have been aware of it."[132] Here, the applicable standard of care against which we measure Applicants' conduct is provided by PCAOB's interim auditing standards,[133] and as the PCAOB accurately observed, the record is "replete with examples of [Applicants'] extreme departures" from that standard of care.[134] If anything, the PCAOB understated the extent of Applicants' auditing failures.

Applicants' most alarming departure from the standard of care was their decision, as Hatfield testified, to "roll[] over" and allow Bidville to file quarterly financial statements, without objection, that Applicants believed were materially misstated.[135] And Applicants did so despite their stated belief that the company was a "scam" and "want[ed] to get filings into the marketplace as quick as possible so that they can do smoke-and-mirror fluffing press releases to pump the stock." Bidville's filing therefore should have set off alarm bells. Other than sending an occasional email to Bidville's management, however, Applicants did nothing for months to prevent investors from relying on the company's misstated financial statements.

Applicants' claim that they took comfort from Bidville's supposed promise to file corrected financial statements within five days is likewise very troubling. Applicants' apparent belief that it is acceptable for investors to be misled for five days, and to knowingly allow false documents to be filed with the Commission, reflects a serious misunderstanding of their auditing responsibilities. Hatfield essentially "held his nose, closed his eyes, and signed off on [Bidville's financial statements], even though the circumstances surrounding [Bidville's filing] plainly

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130 Commission Rule of Practice 451(d), 17 C.F.R. § 201.451(d) ("A member of the Commission who was not present at the oral argument may participate in the decision of the proceeding, provided that the member has reviewed the transcript of such argument prior to such participation. The decision shall state whether the required review was made.").

131 15 U.S.C. § 7215(c)(5).

132 *Gately & Assocs.*, Exchange Act Release No. 62656, 2010 WL 3071900, at *11 (Aug. 5, 2010) (parentheses in original) (quoting *Amendment to Rule 102(e) of the Commission's Rules of Practice*, Securities Act Release No. 7593, 63 Fed. Reg. 57,164, 1998 WL 729201, at *6 (Oct. 26, 1998)).

133 *Cf. Dearlove*, 2008 WL 281105, at *5 (noting that, when disciplining accountants under Rule 102(e), the Commission has consistently measured auditors' conduct by their adherence to or deviation from generally accepted auditing standards).

134 PCAOB Final Decision at 25.

135 DX-3 at 158.

required . . . a disclaimer."[136] This represented "an egregious refusal to see the obvious or investigate the doubtful by any measure."[137]

Applicants' repeated reliance on their specialized experience auditing "microcap" and "nanocap" companies like Bidville and Epicus as an excuse not to undertake appropriate audit procedures was similarly problematic. Perhaps the most notable example of this was Applicants' recommendation that Bidville report its private placement as a compensation expense. Applicants did so without actually believing the private placement was a compensation expense. And they made the recommendation based entirely on what they and other auditors had supposedly done in the past with respect to different companies and different private placements. Applicants did nothing to investigate whether that experience was analogous or otherwise relevant to Bidville's situation.

Applicants' audit of Epicus provided examples of similarly reckless and knowing auditing failures. Applicants, for instance, failed to perform any materiality analysis of what Applicants believed was an inaccurate disclosure of Epicus's policy for recognizing revenue despite knowing that improper revenue recognition was always presumed to be a risk of material misstatement due to fraud. Applicants similarly decided not to send any confirmation requests to test Epicus's accounts receivable balance based on their untested belief that such requests would be ineffective and their judgment that skipping this necessary auditing step was permissible in order to save time. Applicants instead used an alternative procedure that ignored entire portions of the company's accounts receivable, without any valid justification for doing so. And for the portion Applicants did test, Applicants again relied entirely on untested assumptions and management representations about the company's year-end payments, despite Applicants' acknowledgement that Applicants never established whether those payments actually applied to Epicus's accounts receivable balance. Applicants similarly ignored a significant portion of Epicus's accounts receivable when testing Epicus's allowance for doubtful accounts, instead blindly relying, yet again, on untested management representations, despite Applicants' belief that Epicus's accounts receivable collection was not reliable. Applicants further admitted they never even considered the impact of Epicus's change to its revenue recognition policy during their audit.

Any one of these auditing failures would constitute a clear departure from the standards of ordinary care. This is not, however, an instance, as Applicants claim, of the PCAOB "bootstrap[ping] its way to victory . . . by stringing together separate acts of auditing negligence."[138] Each of Applicants' auditing failures, by itself, represented a reckless or knowing failure to adhere to the PCAOB's interim auditing standards. But Applicants' repeated reliance on untested representations from audit clients about which Applicants had serious questions amounted to a particularly egregious failure to comply with their professional obligations. Such

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136 *Barrie C. Scutillo*, Exchange Act Release No. 48238, 56 SEC 714, 2003 WL 21738818, at *9 (July 28, 2003) (finding auditor's failure to obtain sufficient competent evidence to be reckless).

137 *Id.*

138 Appellants' Br. in Supp. of Pet. for Review at 25.

a cavalier approach to the auditing standards "presented a risk of harm to investors and the markets that was so obvious that Applicants must have been aware of it."[139]

On appeal, Applicants argue that "the type of recklessness that is actionable against an outside auditor must approximate an actual intent to aid in the fraud being perpetrated by the audited company."[140] To the contrary, we have previously noted that "the standards of professional practice are not fraud based."[141] Applicants also argue that no evidence exists that their "alleged audit failures were material enough to impact whether a reasonable shareholder/investor would have considered such item important."[142] But whether Bidville or Epicus ultimately filed materially misleading financial statements is not the issue. An auditor "is not a guarantor of the accuracy of financial statements of public companies."[143] Instead, auditors are tasked with auditing public companies "diligently and with a reasonable degree of competence."[144] Applicants fell woefully short of that mark by repeatedly relying on what, at most, amounted to untested speculation and guesswork.

Nor are we persuaded by Applicants' arguments that the record contains no evidence of harm to investors or of an SEC investigation into Epicus's accounting. The existence of investor harm or an SEC investigation is irrelevant to the issue here, which is whether Applicants performed their audit diligently and with a reasonable degree of competence. Applicants' argument misconstrues the significance of their auditing failures. As we have noted, "[t]he fact that the Board could not identify whether there was specific harm to a particular investor does not detract from the seriousness of the misconduct."[145] In other words, our inquiry is not whether Applicants' failures actually harmed investors. Our inquiry is whether Applicants' conduct created a risk of such harm. Here, Applicants' repeated and nearly complete failures to perform adequate audit procedures created an obvious, significant, and ongoing risk to investors.

139 *Gately & Assocs.*, 2010 WL 3071900, at *12.

140 Appellants' Br. in Supp. of Pet. for Review at 25.

141 *Amendment to Rule 102(e)*, 1998 WL 729201 at *6; *see also Marrie*, 2003 WL 21741785, at *7 (rejecting applicant's claim that, to establish recklessness under Rule 102(e), the Division of Enforcement "must show a type of recklessness that approximates an actual intent to aid in the fraud being perpetrated by the audited company"); *cf. Gately & Assocs.*, 2010 WL 3071900, at *11 (noting that "our interpretations of the [Commission] Rule [of Practice]102(e) standards inform our analysis under Sarbanes-Oxley Section 105(c)(5)").

142 Appellants' Br. in Supp. of Pet. for Review at 27.

143 *See Marrie*, 2003 WL 21741785, at *17.

144 *Touche Ross & Co. v. SEC*, 609 F.2d 570, 581 (2d Cir. 1979).

145 *Cf. R.E. Bassie & Co.*, Accounting and Auditing Enforcement Release No. 3354, 2012 WL 90269, at *12 (Jan. 10, 2012) (citing *PAZ Sec., Inc.*, Exchange Act Release No. 57656, 2008 WL 1697153, at *5 (Apr. 11, 2008) ("[A] Rule 8210 violation will rarely, in itself, result in direct harm to a customer. Rather, failing to respond undermines NASD's ability to detect misconduct that may have occurred and that may have resulted in harm to investors . . . . Thus, even if the failure to respond does not result in . . . harm to investors, it is serious because it impedes detection of such violative conduct." (footnote omitted)), *petition denied*, 566 F.3d 1172 (D.C. Cir. 2009) and *Gately & Assocs.*, 2010 WL 3071900, at *14 (noting that the absence of fraud or deceit does not diminish seriousness of a failure to cooperate in PCAOB inspection that is designed, among other things, to uncover any such misconduct)).

For the same reason, we reject Applicants' argument that Bidville's misstatements in its financial statements "did not occur due to an audit failure, but due to Company management's intentional withholding of documents and subsequent consistent misrepresentations to the auditor."[146] Whether the companies withheld documents or made misrepresentations, however, did not relieve Applicants of their auditing responsibilities described in this opinion.[147] We are similarly unpersuaded by Applicants' attempts to diminish their auditing failures by returning to the fact that they required Epicus to increase its reserves for bad debt exposure.[148] Applicants were not freed from the many auditing requirements they inexcusably ignored simply because Epicus increased its reserve for bad debt. Indeed, Applicants' apparent contrary belief confirms the Board's and our finding that Applicants fundamentally misunderstand what is necessary to satisfy an auditor's responsibility to exercise due care.

B. Revocation and bar are appropriate remedial sanctions.

Having determined that Applicants' conduct was at least reckless, the Board concluded that it was in the public interest to permanently revoke the Firm's registration and to permanently bar Hatfield from associating with any registered public accounting firm. We review that determination "having due regard for the public interest and the protection of investors,"[149] based on both "the nature of the violation and the mitigating factors presented in the record."[150] In doing so, we are mindful of the responsibility to be "particularly careful to address potentially mitigating factors"[151] and the "remedial and protective efficacy" of sanctions involving expulsion of a firm or individual from the auditing industry.[152]

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146 Appellants' Br. in Supp. of Pet. for Review at 23.

147 *Cf. Michael S. Hope, CPA*, Exchange Act Release No. 23513A, 49 SEC 568, 1986 WL 73230, at *31 (Aug. 6, 1986) (noting that the Commission has repeatedly held that "being lied to" is not an automatic defense to charges of improper professional conduct); *Touche Ross & Co.*, Securities Act Release No. 5459, 45 SEC 469, 1974 WL 161425, at *1 (Feb. 25, 1974) (finding that "deception . . . did not relieve Touche of its responsibility to perform its audits in conformity with generally accepted auditing standards").

148 Applicants argue, for instance, that they "required Epicus to increase the reserve for bad debt exposure, and then to concurrently write off, and recognize, the portion of accounts receivable that were never to be collected." Appellants' Br. in Supp. of Pet. for Review at 9. "These adjustments," Applicants claim, "mitigate any materiality of the GAAP non-compliance amount." *Id.* The issue, however, is not whether Epicus's GAAP violation was ultimately material to its financial statements or whether Epicus had increased its reserves for bad debt. The issue is whether Applicants exercised due care with respect to their obligation to obtain reasonable assurance that Epicus's financial statements were free of material misstatement—an obligation Applicants repeatedly failed to meet for the reasons discussed above.

149 15 U.S.C. § 7217(c)(2)-(3).

150 *Gately & Assocs.*, 2010 WL 3071900, at *13 (quoting *McCarthy v. SEC*, 406 F.3d 179, 190 (2d Cir. 2005)).

151 *Id.* at *13 (quoting *Paz Sec. Inc. v. SEC*, 494 F.3d 1059, 1065 (D.C. Cir. 2007)).

152 *Id.* at *13 (quoting *McCarthy v. SEC*, 406 F.3d at 190). *But see Paz Sec. Inc. v. SEC*, 566 F.3d 1172, 1176 (D.C. Cir. 2009) (stating that the remedial analysis regarding a bar from association with any SRO member firm does not require the Commission to "state why a lesser sanction would be insufficient").

The public interest here weighs heavily in favor of revocation and a bar. As we have noted in the analogous Rule 102(e) context, the Commission has limited resources and therefore "must rely on the competence and independence of the auditors who certify, and the accountants who prepare, financial statements."[153] Because of this, regulators and the investing public must "rely heavily on accountants to assure corporate compliance with federal securities law requirements and disclosure of accurate and reliable financial information."[154] Here, Applicants were responsible for auditing the financial statements of two public companies. During those audits, however, Applicants repeatedly deferred to their clients' unsupported representations and to Applicants' own experience with other, different auditing clients, while doing nothing to test those assumptions and representations—despite various red flags about Bidville's trustworthiness and Epicus's reliability that should have alerted Applicants that added inquiry or verification was needed. Applicants' egregious and repeated failures to comply with auditing standards "jeopardize the achievement of the objectives of the securities laws and can inflict great damage on public investors."[155] Applicants also acted with a high degree of scienter. They were experienced auditors, who nevertheless knowingly, intentionally, and repeatedly failed to exercise the basic professional skepticism and due care that are the touchstones of an auditor's responsibilities.[156]

As the D.C. Circuit has recognized, "the existence of a violation raises an inference that it will be repeated,"[157] and Applicants have made clear they intend to remain auditors if permitted. Applicants' conduct creates a substantial risk that they will commit similar violations in the future. Particularly worrying is Applicants' refusal to recognize the wrongfulness of their conduct. Despite their repeated admissions about failing to take basic auditing steps, Applicants have consistently asserted that they planned and conducted their audits appropriately. For example, Applicants claim that there "was no instance" where Applicants "skip[ped] procedures designed to test a company's reports or look[ed] the other way despite suspicions."[158] Nor, Applicants claim, was there an instance where they "surrendered professional judgment to the demands of the client" or "failed to investigate the doubtful."[159] For all the reasons detailed above, we disagree. That Applicants admit all of the facts forming the bases of their departures from professional standards without grasping the extent of their wrongdoing raises serious

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153 *Amendment to Rule 102(e)*, 1998 WL 729201, at *4.

154 *Id.*

155 *Touche Ross & Co.*, 609 F.2d at 581.

156 Among the instances of such knowing misconduct discussed above, the most egregious example was Applicants' decision to allow Bidville to file, without objection, what Applicants believed were materially misstated financial statements and then to do nothing for more than two months to prevent investors from relying on those misstated financial statements—all based on Bidville's promise to file an amended filing within five days.

157 *Geiger v. SEC*, 363 F.3d 481, 489 (D.C. Cir. 2004) (affirming violation of Securities Act § 5 and related cease-and-desist order).

158 Appellants' Br. in Supp. of Pet. for Review at 26 (quoting *Marrie v. SEC*, 374 F.3d 1196, 1206 (D.C. Cir. 2004)).

159 *Id.*

questions about their ability to comply with those standards in the future. Worse, Applicants have insisted that the audit procedures they utilized in their Bidville and Epicus audits are the same procedures they have used in many other audits, apparently unaware of the negative implications of essentially admitting to having departed from the professional standards of care in more than just the audits at issue here.

We also find no mitigating factors that weigh against imposing a revocation or a bar. Although Applicants argue that "[w]ith unlimited time and budget, the Applicants might have been able to undertake all the steps PCAOB . . . complains were not taken,"[160] we find no evidence that Applicants' failures were due to time or budgetary constraints. Nor are we persuaded by Applicants' argument that the bar and revocation are more severe sanctions than the PCAOB has imposed in settled cases in which Applicants claim the misconduct was "significantly more egregious than complained of here."[161] Applicants do not identify any particular settled case, let alone explain how the conduct in any such case was more egregious than their conduct here. Applicants instead simply contend more broadly that the record contains no evidence "that the three audited financial statements were materially misstated, in any respect, nor that Applicants' effort did not protect the public interest."[162] As we have already explained, however, this is exactly what occurred here.[163] Such behavior by an auditor as set forth above cannot, in any sense, be described as protecting the public interest. In any event, the appropriateness of a bar and revocation do not turn on whether the financial statements were materially misstated. The inquiry is whether Applicants exercised due professional care in the performance of their audit.[164] And as we have explained, Applicants repeatedly failed to exercise such care.

"[T]he appropriate sanction depends upon the facts and circumstances of each particular case and cannot be determined precisely by comparison with actions taken in other proceedings."[165] Moreover, comparisons to settled cases are not relevant to our sanction analysis here because auditors "who offer to settle may properly receive lesser sanctions than they otherwise might have."[166] Settled cases "take into account pragmatic considerations such as the

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160 *Id.* at 27.

161 *Id.* at 26.

162 Appellants' Reply Br. at 7.

163 *See, e.g., supra* Section II.A.2.(b)(ii) (discussing how Applicants allowed Bidville to file, without objection, what Applicants believed to be a materially misstated quarterly report).

164 AU § 150.02 ("Due professional care is to be exercised in the performance of the audit and the preparation of the report"); AU § 722.02, *Interim Financial Information* (noting that the three general standards discussed in AU § 150.02 are applicable to a review of interim financial information).

165 *Ronald Pellegrino*, Exchange Act Release No. 59125, 2008 WL 5328765, at *17 n.68 (Dec. 19, 2008) (quoting *Christopher J. Benz*, Exchange Act Release No. 38440, 52 SEC 1280, 1997 WL 137027, at *4 (March 26, 1997), *petition denied*, 168 F.3d 478 (3d Cir. 1988) (Table)).

166 *Michael C. Pattison, CPA*, Exchange Act Release No. 67900, 2012 WL 4320146, at *11 (Sept. 20, 2012).

avoidance of time-and-manpower-consuming adversary proceedings."[167] Litigated cases, by comparison, typically present a fuller, more developed record of facts and circumstances for purposes of assessing appropriate sanctions than do settled matters.[168] Here, we have made extensive findings about Applicants' departures from the standards of care and carefully considered the public interest.

After weighing all of these considerations, we thus conclude that a bar and revocation are necessary to protect the public interest.[169] These sanctions are needed to protect the integrity of the Commission's processes and encourage more rigorous compliance with auditing standards both by Applicants and by other independent auditors. We accordingly find that PCAOB's decision to revoke the Firm's registration and permanently bar Hatfield from association with a registered public accounting firm is neither excessive nor oppressive and that the sanctions serve a remedial rather than a punitive purpose. An appropriate order will issue.[170]

By the Commission (Commissioners WALTER, PAREDES and GALLAGHER); Chair WHITE and Commissioner AGUILAR not participating.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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[167] *Joseph John Vancook*, Exchange Act Release No. 61039A, 2009 WL 4005083, at *19 (Nov. 20, 2009) (noting that settled cases "cannot be meaningfully compared to the sanctions imposed in litigated cases").

[168] *Pattison*, 2012 WL 4320146, at *12.

[169] While the PCAOB found, as we do, that Applicants engaged in reckless conduct, it also found that Applicants "engaged in repeated instances of conduct that was at least negligent, each resulting in a violation of the applicable statutory, regulatory, or professional standard." PCAOB Final Decision at 26 n.21. Given that negligence "is the failure to exercise reasonable care or competence," we find that, for all the reasons stated herein, Applicants' repeated failures to comply with the interim auditing standards clearly established that they engaged in repeated instances of conduct that was, at a minimum, negligent. *Byron G. Borgardt*, Securities Act Release No. 8274, 56 SEC 999, 2003 WL 22016313, at *10 (Aug. 25, 2003) (defining negligence). Repeated instances of negligent conduct can also support a bar and revocation, and given the scope of Applicants' repeated auditing failures, we find, for all the reasons stated herein, that such sanctions are appropriate here regardless of whether Applicants' conduct is deemed to be knowing, reckless, or negligent.

[170] 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

ACCOUNTING AND AUDITING ENFORCEMENT
Rel. No. 69930 / July 3, 2013

Admin. Proc. File No. 3-14795

S.W. HATFIELD, C.P.A.
and
SCOTT W. HATFIELD, C.P.A.
c/o John A. Koepke
Jackson Walker L.L.P.
901 Main St., Ste. 6000
Dallas, TX 75202

For Review of Disciplinary Action Taken by

PCAOB

ORDER SUSTAINING DISCIPLINARY ACTION TAKEN BY PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

On the basis of the Commission's opinion issued this day, it is

ORDERED that the PCAOB's disciplinary actions taken against S.W. Hatfield, C.P.A., and Scott W. Hatfield, C.P.A., be sustained.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Walter
Commissioner Gallagher
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 69937 / July 3, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15369

In the Matter of

TERRY V. KOONTZ,

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 Terry V. Koontz ("Koontz" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, Respondent consents to the Commission's jurisdiction over him and the subject matter of these proceedings and to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, 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 2010 to November 2011, Koontz purported to be affiliated with a well-known asset management firm in order to lure investors into an unregistered offering of securities in the form of a fictitious gold futures promissory notes program. Koontz was not registered as a broker-dealer or associated with a registered broker-dealer during the relevant time. Koontz, 56 years old, is currently imprisoned in Yazoo City, Mississippi.

2. On November 5, 2012, Koontz pled guilty to one count of conspiracy to commit wire fraud and mail fraud in violation of Title 18 United States Code, Section 1349 before the United States District Court for the Middle District of Florida, in United States v. Terry Vernon Koontz, Case No. 8:12-cr-00465-JDW-TGW. On March 4, 2013, a judgment in the criminal case was entered against Koontz. He was sentenced to a prison term of 115 months followed by three years of supervised release and ordered to make restitution in the amount of $3,771,701.88.

3. The count of the criminal information to which Koontz pled guilty alleged, inter alia, that Koontz was the primary architect of a scheme to defraud in which Koontz and co-conspirators persuaded victim-investors to transmit their funds and participate in a purported gold futures investment program. Koontz created false and fraudulent documents, including promissory notes and assignments of collateral, which supposedly evidenced and guaranteed, respectively, the victim-investors' participation in the purported gold futures investment program. In preparing these documents, Koontz used the names of various existing foreign and/or domestic entities as well as forged signatures of officials of same, without such entities' and individuals' knowledge or consent. Koontz and co-conspirators diverted a substantial amount of the victim-investors' funds for their own personal enrichment by transferring and causing the transfer of said funds to accounts controlled by them and/or family members or friends, and they used victim-investors' funds to purchase motor vehicles, real property, home furnishings, jewelry, and other goods and services.

IV.

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

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act that Respondent Koontz be, and hereby is:

> barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

Any reapplication for association by the 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

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-69925; File No. SR-OCC-2013-803

July 3, 2013

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of Advance Notice to Reflect Enhancements in OCC's System for Theoretical Analysis and Numerical Simulations as Applied to Longer-Tenor Options

Pursuant to Section 806(e)(1) of the Payment, Clearing, and Settlement Supervision Act of 2010 ("Clearing Supervision Act")[1] and Rule 19b-4(n)(1)(i)[2] of the Securities Exchange Act of 1934 ("Exchange Act") notice is hereby given that on June 4, 2013, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the advance notice described in Items I and II below, which Items have been substantially prepared by OCC.[3] The Commission is publishing this notice to solicit comments on the advance notice from interested persons.

I. Clearing Agency's Statement of the Terms of Substance of the Advance Notice

OCC is proposing to provide for enhancements in OCC's margin model for longer-tenor options (*i.e.*, those options with at least three years of residual tenor) and OCC intends to reflect those enhancements in the description of OCC's margin model in OCC's Rules through a corresponding proposed rule change.[4]

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

2 17 CFR 240.19b-4(n)(1)(i).

3 OCC is a designated financial market utility and is required to file advance notices with the Commission. See 12 U.S.C. 5465(e). OCC also filed the proposals contained in this advance notice as a proposed rule change under Section 19(b)(1) of the Exchange Act and Rule 19b-4 thereunder. 15 U.S.C. 78s(b)(1); 17 CFR 240.19b-4. See SR-OCC-2013-08.

4 See supra note 3.

II. Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Advance Notice

In its filing with the Commission, OCC included statements concerning the purpose of and basis for the advance notice and discussed any comments it received on the advance notice. The text of these statements may be examined at the places specified in Item IV below. OCC has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.[5]

(A) Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Advance Notice

The purpose of this advance notice is to provide for enhancements in OCC's margin model for longer-tenor options (*i.e.*, those options with at least three years of residual tenor) and OCC intends to reflect those enhancements in the description of OCC's margin model in OCC's Rules through a corresponding proposed rule change.[6]

1. Background

On August 30, 2012, OCC submitted a rule change and advance notice with respect to OCC's proposal to clear certain over-the-counter options on the S&P 500 Index ("OTC Options Filings").[7] Additional information concerning OCC's proposal to clear OTC Options is included in the OTC Options Filings. As described in the OTC Options Filings, OCC intends to use its STANS margin system to calculate margin requirements for OTC Options on the same basis as for exchange-listed options cleared by OCC. However, OCC is proposing to implement enhancements to its risk models for

5 The Commission has modified the text of the summaries prepared by the clearing agency.

6 See supra note 3.

7 See Exchange Act Release No. 68434 (Dec. 14, 2012), 77 FR 75243 (Dec. 19, 2012) (SR-OCC-2012-14 and AN-OCC-2012-01).

all longer-tenor options (including OTC Options) in order to better reflect certain risks of longer-tenor options. The changes described herein would apply to all longer-tenor options cleared by OCC and would be implemented before OCC begins clearing OTC Options.

2. Description of Current Proposed Changes

OCC states that the proposed change includes daily OTC quotes, variations in implied volatility and valuation adjustments in the modeling of all longer-tenor options under STANS, thereby enhancing OCC's ability to set margin requirements through the use of risk-based models and encouraging clearing members to have sufficient financial resources to meet their obligations to OCC. OCC states that the proposed change would not affect OCC's safeguarding of securities and funds in its custody or control because though it may change margin requirements in respect of certain longer-tenor options, it does not change the manner in which margin assets are pledged. In addition, OCC states that the proposed change allows OCC to enhance its risk management procedures and controls related to longer-tenor options.

OCC states that it calculates clearing-level margin using STANS, which determines the minimum expected liquidating value of each account using a large number of projected price scenarios created by large-scale Monte Carlo simulations. OCC is proposing to implement enhancements to the STANS margin calculation methodology with respect to longer-tenor options and to amend Rule 601 to reflect these enhancements as well as to make certain clarifying changes in the description of STANS in Rule 601. The specific details of the calculations performed by STANS are maintained in OCC's proprietary procedures for the calculation of margin and coded into the computer systems used by OCC to calculate daily margin requirements.

OCC has proposed at this time to clear only OTC Options on the S&P 500 index and only such options with tenors of up to five years. However, OCC currently clears FLEX Options with tenors of up to fifteen years. While OCC believes that its current risk management practices are adequate for current clearing activity, OCC proposes to implement risk modeling enhancements with respect to all longer-tenor options.

Daily OTC Indicative Quotes

OCC states that, in general, the market for listed longer-tenor options is less liquid than the market for other options, with less volume and therefore less price information. In order to supplement OCC's pricing data derived from the listed markets, and to improve the valuation process for longer-tenor options, OCC proposes to include in the daily dataset of market prices used by STANS to value each portfolio indicative daily quotations obtained through a third-party service provider that obtains these quotations through a daily poll of OTC derivatives dealers. A third-party service provider was selected to provide this data in lieu of having the data provided directly by the OTC derivatives dealers in order to avoid unnecessarily duplicating reporting that is already done in the OTC markets.

Variations in Implied Volatility

OCC states that, to date, the STANS methodology has assumed that implied volatilities of option contracts do not change during the two-day risk horizon used by OCC in the STANS methodology. According to OCC, back testing of its margin models has identified few instances in which this assumption would have, as a result of sudden changes in implied volatility, resulted in margin deposits insufficient to liquidate clearing member accounts without loss. However, as OCC expects to begin clearing more substantial volumes of longer-tenor options, including OTC Options, OCC believes that implied volatility shocks may become more relevant due to the greater sensitivity of longer-tenor options to implied volatility. OCC therefore proposes to introduce variations in implied volatility in the modeling of all longer-tenor options under STANS. OCC states that this will be achieved by incorporating, into the set of risk factors whose behavior is included in the econometric models underlying STANS, time series of proportional changes in implied volatilities for a range of tenors and in-the-money and out-of-the-money amounts representative of the dataset provided by OCC's third-party service provider.

OCC states that it has reviewed individual S&P 500 Index put and call options positions with varying in-the-money amounts and with four to nine years of residual tenor and that such review indicates that the inclusion of modeled implied volatilities tends to result in less margin being held against short call positions and more margin being held against short put positions. OCC states that these results are consistent with what would be expected given the strong negative correlation that exists between changes in implied volatility and market returns.

OCC states that the description of the Monte Carlo simulations performed within STANS in Rule 601 references revaluations of assets and liabilities in an account under numerous price scenarios for "underlying interests." In order to accommodate the proposed implied volatility enhancements, OCC is proposing to amend this portion of Rule 601 to provide that the scenarios used may also involve projected levels of other variables influencing prices of cleared contracts and modeled collateral. Accordingly, the references to "underlying interests" are proposed to be deleted.

Valuation Adjustment

OCC states that historically it has not cleared a significant volume of longer-tenor options, but that it anticipates that there will be growth in the volume of longer-tenor options, including OTC Options, being cleared with three to five year tenors. According to OCC, longer-tenor options may represent a larger portion of any clearing member's portfolio in the future, and OCC has therefore identified a need to model anticipated changes in the value of longer-tenor options on a portfolio basis in order to address OCC's exposure to longer-tenor options that may have illiquid characteristics. OCC proposes to introduce a valuation adjustment into the portfolio net asset value used by STANS based upon the aggregate sensitivity of any longer-tenor options in a portfolio to the overall level of implied volatilities at three years and five years and to the relationship between implied volatility and exercise prices at both the three- and five-year tenors in order to allow for the anticipated market impact of unwinding a portfolio of longer-tenor options, as well as for any differences in the quality of data in OCC's third party service provider's dataset, given that month-end data may be subjected to more extensive validation by the service provider than daily data. In order to accommodate the planned valuation adjustment for longer-tenor options, OCC proposes to add language to Rule 601 to indicate that the projected portfolio values under the Monte Carlo simulations may be adjusted to account for bid-ask spreads, illiquidity, or other factors.

Clarification of Pricing Model Reference in Rule 601

Rule 601 currently refers to the use of "options pricing models" to predict the impact of changes in values on positions in OCC-cleared contracts. OCC is proposing to amend this description to reflect that OCC currently uses non-options related models to price certain instruments, such as futures contracts and U.S. Treasury securities. OCC states that this change is not intended to be substantive and simply clarifies the description in Rule 601.

Effect on Clearing Members

OCC states that the proposed change will affect clearing members who engage in transactions in longer-tenor options, and indirectly their customers, by enhancing the STANS margin calculation methodology for these options. The STANS enhancements could increase margin requirements with respect to these positions. However, OCC states that it does not believe that the enhancements will result in significantly increased margin requirements for any particular clearing member, and therefore is not aware of any significant problems that clearing members are likely to have in complying with the proposed rule change.

OCC states that the proposed rule change is consistent with the purposes and requirements of Section 17A(b)(3)(F) of the Exchange Act[8] and the rules and regulations thereunder, including Rule 17Ad-22(b)(2)[9] and Rule 17Ad-22(d)(2)[10] because by providing additional clarity to clearing members and others concerning the current

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8 15 USC 78q-1(b)(3)(F).

9 17 CFR 240.17Ad-22(b)(2).

10 17 CFR 240.17Ad-22(d)(2).

calculation of margin requirements under OCC's Rules, while also enhancing the calculation of margin with respect to longer-tenor options, the proposed modifications would help remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, ensure that OCC's rules are reasonably designed to have participation requirements that are objective and publicly disclosed and permit fair and open access, and provide for a well-founded, transparent, and enforceable legal framework. OCC states that the proposed rule change is not inconsistent with any rules of OCC, including any other rules proposed to be amended.

(B) Clearing Agency's Statement on Comments on the Advance Notice Received from Members, Participants, or Others

Written comments were not and are not intended to be solicited by OCC with respect to the advance notice and none have been received.

(C) Advance Notices Filed Pursuant to Section 806(e) of the Clearing Supervision Act

OCC is filing this proposed change as an advance notice pursuant to Section 806(e)(2) of the Clearing Supervision Act because the proposed change could be deemed to materially affect the nature or level of risks presented by OCC. However, OCC believes that the Rule changes and changes in OCC's system for calculating margin on longer-tenor options will represent enhancements to OCC's ability to manage the risks presented to it, particularly as OCC begins clearing OTC Options.

According to OCC, OTC Options are nearly identical to listed FLEX options on the S&P 500 that OCC has cleared for many years. OTC Options have the same degree of customization as FLEX options except that OTC Options are limited to a maximum tenor of five years whereas FLEX options can have tenors of up to fifteen years. In this respect, OCC states that OTC Options pose less of a challenge from a risk management perspective than do FLEX options. However, OCC believes, based on activity in the existing OTC markets for uncleared, bilateral options, that there may be greater open interest in OTC Options with tenors exceeding three years as compared to FLEX options, in which open interest is more concentrated in shorter term options. In addition, it is inherent in the nature of the OTC option markets that there are no market makers with affirmative duties to create liquidity by standing ready to buy and sell OTC Options in response to market interest as in the listed options markets, including the FLEX options market.

In order to address the potentially greater open interest in longer-tenor options, OCC is proposing to supplement its existing risk management procedures by enhancing its STANS margining system by:

(i) including in the daily dataset of market prices used by STANS to value each portfolio indicative daily quotations obtained through a third-party service provider that obtains these quotations through a daily poll of OTC derivatives dealers;

(ii) incorporating, into the set of risk factors whose behavior is included in the econometric models underlying STANS, time series of proportional changes in implied volatilities, for a range of tenors and in-the-money and out-of-the-money amounts representative of the foregoing dataset; and

(iii) introducing a valuation adjustment into the portfolio net asset value used by STANS, based upon the aggregate sensitivity of any longer-tenor options in a portfolio to the overall level of implied volatilities at three years and five years and to the relationship between implied volatility and exercise prices at both the three- and five-year tenors in order to allow for the market impact of unwinding a portfolio of longer-tenor options, as well as for any differences in the quality of data provided by OCC's third party service provider's dataset, given that month-end data may be subjected to more extensive validation by the service provider than daily data.

These proposed changes are described in more detail above. As noted above, OCC will not commence clearing of OTC Options unless and until the Commission has approved the modeling enhancements described herein.

III. Date of Effectiveness of the Advance Notice and Timing for Commission Action

OCC may implement the proposed change pursuant to Section 806(e)(1)(G) of the Clearing Supervision Act[11] if it has not received an objection to the proposed change within 60 days of the later of (i) the date that the Commission received the advance notice or (ii) the date the Commission receives any further information it requested for consideration of the notice. The clearing agency shall not implement the proposed change if the Commission has any objection to the proposed change.

The Commission may extend the period for review by an additional 60 days if the proposed change raises novel or complex issues, subject to the Commission providing the clearing agency with prompt written notice of the extension. A proposed change may be implemented in less than 60 days from the date of receipt of the advance notice, or the date the Commission receives any further information it requested, if the Commission notifies the

[11] 12 U.S.C. 5465(e)(1)(G).

clearing agency in writing that it does not object to the proposed change and authorizes the clearing agency to implement the proposed change on an earlier date, subject to any conditions imposed by the Commission.

The clearing agency shall post notice on its website of proposed changes that are implemented.

The proposal shall not take effect until all regulatory actions required with respect to the proposal are completed.[12]

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-OCC-2013-803 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-OCC-2013-803. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The

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12 OCC also filed the proposals contained in this advance notice as a proposed rule change under Section 19(b)(1) of the Exchange Act and Rule 19b-4 thereunder. See supra note 3.

Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the advance notice that are filed with the Commission, and all written communications relating to the advance notice between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 am and 3:00 pm. Copies of the filing also will be available for inspection and copying at the principal office of OCC and on OCC's website (http://www.theocc.com/about/publications/bylaws.jsp). All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-OCC-2013-803 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

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. 69939 / July 5, 2013

Admin. Proc. File No. 3-14999

In the Matter of ANGELICA AGUILERA	ORDER GRANTING EXTENSION

I.

Chief Administrative Law Judge Brenda P. Murray has moved, pursuant to Commission Rule of Practice 360(a)(3),[1] for an extension of time to file an initial decision in this proceeding.[2] For the reasons set forth below, we have determined to grant the law judge's motion.

On August 29, 2012, we issued an Order Instituting Proceedings against Angelica Aguilera, a former shareholder, financial and operations principal, and president of LatAm Investments Inc., a broker-dealer formerly registered with the Commission, alleging that she failed reasonably to supervise two LatAm employees who engaged in a fraudulent markup and markdown scheme to defraud two Brazilian public pension funds and another foreign institutional customer in the offer, purchase, and sale of structured notes.[3] The OIP directs the presiding law judge to file an initial decision no later than 300 days from the date of service of the OIP. On June 6, 2013, Chief Law Judge Murray filed a motion stating that the initial decision is due on July 1, 2013, and requesting a thirty-day extension.

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1 17 C.F.R. § 201.360(a)(3).

2 The motion seeks extensions with respect to two pending matters. We address the motion regarding the other matter in a separate order.

3 The OIP seeks to determine whether to impose sanctions for Aguilera's supervisory failure under Exchange Act Sections 15(b) and 21B, 15 U.S.C. §§ 8o(b), 78u-2.

II.

Rules of Practice 360(a)(2) and 360(a)(3) are intended to enhance the timely and efficient adjudication and disposition of Commission administrative proceedings by setting deadlines for administrative hearings.[4] The rules further provide, however, for extensions under certain circumstances, if supported by a motion from the Chief Administrative Law Judge and we determine that "additional time is necessary or appropriate in the public interest."[5]

In the motion, Chief Judge Murray states that she "expect[s] that *Aguilera* will be completed at, or very close to the due date." She "request[s] a thirty-day extension out of an abundance of caution." Under the circumstances, it appears appropriate in the public interest to grant the Chief Administrative Law Judge's request and to extend the initial decision deadline.

Accordingly, IT IS ORDERED that the deadline for filing the initial decision in *Angelica Aguilera* is extended to July 31, 2013.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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4 *See Adopting Release*, Securities Act Rel. No. 8240, 2003 SEC LEXIS 1404, at *5-7 (June 11, 2008).

5 17 C.F.R. § 201.360(a)(3).

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9413 / July 5, 2013

SECURITIES EXCHANGE ACT OF 1934
Release No. 69940 / July 5, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3621 / July 5, 2013

INVESTMENT COMPANY ACT OF 1940
Release No. 30591 / July 5, 2013

Admin. Proc. File No. 3-15015

In the Matter of MICHAEL BRESNER, RALPH CALABRO, JASON KONNER, and DIMITRIOS KOUTSOUBOS	ORDER GRANTING EXTENSION

I.

Chief Administrative Law Judge Brenda P. Murray has moved, pursuant to Commission Rule of Practice 360(a)(3),[1] for an extension of time to file an initial decision in this proceeding.[2] For the reasons set forth below, we have determined to grant the law judge's motion.

On September 10, 2012, we issued an Order Instituting Administrative and Cease-and-Desist Proceedings against Michael Bresner, an Executive Vice President and Head of Supervision at JP Turner & Company, LLC ("JP Turner"), a registered broker-dealer, and a person associated with JP Turner & Company Capital Management, LLC ("JP Turner Capital"), a registered investment adviser; and Ralph Calabro, Jason Konner, and Dimitrios Koutsoubos, each a former registered representative of JP Turner. The OIP alleges that, between January 1,

1 17 C.F.R. § 201.360(a)(3).

2 The motion seeks extensions with respect to two pending matters. We address the motion regarding the other matter in a separate order.

2008 and December 31, 2009, Calabro, Konner, and Koutsoubos churned the accounts of seven customers, without regard to the customers' conservative investment objectives and low or moderate risk tolerances, in violation of the antifraud provisions.[3] The OIP further alleges that Bresner failed reasonably to supervise Konner and Koutsoubos with a view to preventing and detecting their antifraud violations.[4]

The OIP directs the presiding law judge to file an initial decision no later than 300 days from the date of service of the OIP. On June 6, 2013, Chief Law Judge Murray filed a motion stating that the initial decision is due on July 11, 2013 and requesting a ninety-day extension.

II.

Rules of Practice 360(a)(2) and 360(a)(3) are intended to enhance the timely and efficient adjudication and disposition of Commission administrative proceedings by setting deadlines for administrative hearings.[5] The rules further provide, however, for deadline extensions under certain circumstances, if supported by a motion from the Chief Administrative Law Judge and we determine that "additional time is necessary or appropriate in the public interest."[6]

In her motion, Chief Judge Murray states that "[i]t is certain that [the presiding law judge], who expects to begin a lengthy hearing on July 8, will need an additional ninety days to issue an Initial Decision in *Bresner*." Under the circumstances, it appears appropriate in the public interest to grant the Chief Administrative Law Judge's request and to extend the initial decision deadline.

Accordingly, IT IS ORDERED that the deadline for filing the initial decision in *Michael Bresner* is extended to October 9, 2013.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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3 Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a); Section 10(b) of the Securities Exchange Act of 1934, *Id.* § 78j(b); and Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5.

4 The OIP seeks to determine whether to impose sanctions for Bresner's supervisory failure under Exchange Act Sections 15(b) and 21B, 15 U.S.C. §§ 78o(b), 78u-2, and Sections 203(f) and (k) of the Investment Advisers Act of 1940, *Id.* §§ 80b-3(f) and (k).

5 *See Adopting Release*, Securities Act Rel. No. 8240, 2003 SEC LEXIS 1404, at *5-7 (June 11, 2008).

6 17 C.F.R. § 201.360(a)(3).

SECURITIES AND EXCHANGE COMMISSION

[Release No. PA-50; File No. S7-05-13]

Privacy Act of 1974: Systems of Records.

AGENCY: Securities and Exchange Commission.

ACTION: Notice to revise two existing systems of records.

SUMMARY: In accordance with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. 552a, the Securities and Exchange Commission ("Commission" or "SEC") proposes to revise two existing systems of records: "Freedom of Information and Privacy Act Requests (SEC-24)" and "Backup Care Employee and Family Records (SEC-66)", both of which were last published in the Federal Register Volume 77, Number 211 on Wednesday, October 31, 2012.

DATES: The proposed systems will become effective [insert date that is 40 days after publication in the Federal Register] unless further notice is given. The Commission will publish a new notice if the effective date is delayed to review comments or if changes are made based on comments received. To be assured of consideration, comments should be received on or before [insert date that is 30 days after publication in the Federal Register].

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/other.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-05-13 on the subject line.

Paper Comments:

Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. All submissions should refer to File Number S7-05-13. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet 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 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Todd Scharf, Associate Director and Acting Chief Privacy Officer, Office of Information Technology, 202-551-8800.

SUPPLEMENTARY INFORMATION:

The Commission proposes to revise two existing systems of records, "Freedom of Information and Privacy Act Requests (SEC-24)" and "Backup Care Employee and Family Records (SEC-66)".

The Freedom of Information and Privacy Act Requests (SEC-24) system of records consists of records used by Commission staff to process FOIA and Privacy Act requests and appeals, and to prepare reports to the Department of Justice, the Office of Management and Budget, and other oversight entities on the Commission's FOIA and PA activities. A substantive change to SEC-24 has been incorporated to expand routine use No. 15 to include the National Archives and Records Administration, Office of Government Information Services (OGIS) second statutory mission of reviewing administrative agency policies, procedures and compliance with FOIA.

The Backup Care Employee and Family Records (SEC-66) system of records contains records of current SEC employees who voluntarily sign up for backup care benefits and their family members for whom care is needed. A substantive change to SEC-66 has been made to the Categories of Records, deleting "physician's medical form" and "medical identification number", and updating other types of records maintained in the system.

The Commission has submitted a report of the amended systems of records to the appropriate Congressional Committees and to the Director of the Office of Management and Budget ("OMB") as required by 5 U.S.C. 552a(r) (Privacy Act of 1974) and guidelines issued by OMB on December 12, 2000 (65 FR 77677).

Accordingly, the Commission is proposing to revise two existing systems of records to read as follows:

SEC-24

SYSTEM NAME:

Freedom of Information and Privacy Act Requests.

SYSTEM LOCATION:

Securities and Exchange Commission, Office of Freedom of Information Act (FOIA) Services, 100 F Street, NE, Washington, DC 20549. Other offices involved in the processing of requests may also maintain copies of the requests and related internal administrative records.

CATEGORIES OF INDIVIDUALS COVERED BY THE SYSTEM:

Records are maintained on persons requesting information from the Commission pursuant to provisions of the Freedom of Information Act; persons who are the subject of Freedom of Information Act requests; individuals who have submitted requests for information about themselves or on behalf of an individual under the provisions of the Privacy Act of 1974; and individuals filing an administrative appeal of a denial, in whole or part, of any such request.

CATEGORIES OF RECORDS IN THE SYSTEM:

Records received, created or compiled in processing FOIA and PA requests or appeals, including internal memoranda, correspondence to or from other Federal agencies, correspondence and response letters, appeal of denials under the FOIA, request for amendment of records under the Privacy Act, appeal for denials under the Privacy Act, appeal determinations, and electronic tracking data. These records may contain personal information retrieved in response to a request including requesters' and their attorneys' or representatives' names, addresses, e-mail, telephone numbers, and FOIA and PA case numbers; office telephone numbers of SEC employees and contractors; Names, telephone numbers, and addresses of the submitter of the information requested; Unique case identifier; Social security number; or other identifier assigned to the request or appeal.

AUTHORITY FOR MAINTENANCE OF THE SYSTEM:

5 U.S.C. 552, and 552a; Executive Order 9397.

PURPOSE(S):

The records are used by Commission staff to process FOIA and Privacy Act requests and appeals, and to prepare reports to the Department of Justice, the Office of Management and Budget, and other oversight entities on the Commission's FOIA and PA activities.

ROUTINE USES OF RECORDS MAINTAINED IN THE SYSTEM, INCLUDING CATEGORIES OF USERS AND THE PURPOSES OF SUCH USES:

In addition to those disclosures generally permitted under 5 U.S.C. 552a(b) of the Privacy Act, these records or information contained therein may specifically be disclosed outside the Commission as a routine use pursuant to 5 U.S.C. 552a(b)(3) as follows:

1. To appropriate agencies, entities, and persons when (a) it is suspected or confirmed that the security or confidentiality of information in the system of records has been compromised; (b) the SEC has determined that, as a result of the suspected or confirmed compromise, there is a risk of harm to economic or property interests, identity theft or fraud, or harm to the security or integrity of this system or other systems or programs (whether maintained by the SEC or another agency or entity) that rely upon the compromised information; and (c) the disclosure made to such agencies, entities, and persons is reasonably necessary to assist in connection with the SEC's efforts to respond to the suspected or confirmed compromise and prevent, minimize, or remedy such harm.
2. To other federal, state, local, or foreign law enforcement agencies; securities self-regulatory organizations; and foreign financial regulatory authorities to assist in or coordinate regulatory or law enforcement activities with the SEC.
3. To national securities exchanges and national securities associations that are registered with the SEC, the Municipal Securities Rulemaking Board; the Securities Investor Protection Corporation; the Public Company Accounting Oversight Board; the federal banking authorities, including, but not limited to, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation; state securities regulatory agencies or organizations; or regulatory authorities of a foreign government in connection with their regulatory or enforcement responsibilities.

4. In any proceeding where the federal securities laws are in issue or in which the Commission, or past or present members of its staff, is a party or otherwise involved in an official capacity.
5. To a federal, state, local, tribal, foreign, or international agency in response to its request for information concerning the hiring or retention of an employee; the issuance of a security clearance; the reporting of an investigation of an employee; the letting of a contract; or the issuance of a license, grant, or other benefit by the requesting agency, to the extent that the information is relevant and necessary to the requesting agency's decision on the matter.
6. To any persons during the course of any inquiry, examination, or investigation conducted by the SEC's staff, or in connection with civil litigation, if the staff has reason to believe that the person to whom the record is disclosed may have further information about the matters related therein, and those matters appeared to be relevant at the time to the subject matter of the inquiry.
7. To interns, grantees, experts, contractors, and others who have been engaged by the Commission to assist in the performance of a service related to this system of records and who need access to the records for the purpose of assisting the Commission in the efficient administration of its programs, including by performing clerical, stenographic, or data analysis functions, or by reproduction of records by electronic or other means. Recipients of these records shall be required to comply with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. 552a.
8. To members of advisory committees that are created by the Commission or by Congress to render advice and recommendations to the Commission or to Congress, to be used solely in connection with their official designated functions.
9. To respond to subpoenas in any litigation or other proceeding.

10. To a third party authorized in writing to receive such information by the individual about whom the information pertains.

11. To another Federal agency to (a) permit a decision as to access, amendment or correction of records to be made in consultation with or by that agency, (b) verify the identity of an individual or the accuracy of information submitted by an individual who has requested access to or amendment or correction of records, or (c) to process payment of fees associated with FOIA/PA requests.

12. To the Department of Justice (DOJ) in order to obtain that department's advice on FOIA matters or regarding the agency's FOIA disclosure obligations.

13. To the Office of Management and Budget for the purpose of obtaining its advice on Privacy Act matters.

14. To the public pursuant to the provisions of the FOIA, 5 U.S.C. 552.

15. To the National Archives and Records Administration, Office of Government Information Services (OGIS), to the extent necessary to fulfill its responsibilities in 5 U.S.C. 552(h), to review administrative agency policies, procedures and compliance with the Freedom of Information Act (FOIA), and to facilitate OGIS' offering of mediation services to resolve disputes between persons making FOIA requests and administrative agencies.

16. To members of Congress, the Government Accountability Office, or others charged with monitoring the work of the Commission or conducting records management inspections.

17. To produce summary descriptive statistics and analytical studies, as a data source for management information, in support of the function for which the records are collected and maintained or for related personnel management functions or manpower studies; may also be

used to respond to general requests for statistical information (without personal identification of individuals) under the Freedom of Information Act.

18. To any person who is or has agreed to be subject to the Commission's Rules of Conduct, 17 CFR 200.735-1 to 200.735-18, and who assists in the investigation by the Commission of possible violations of the federal securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(47)), in the preparation or conduct of enforcement actions brought by the Commission for such violations, or otherwise in connection with the Commission's enforcement or regulatory functions under the federal securities laws.

19. To a Congressional office from the record of an individual in response to an inquiry from the Congressional office made at the request of that individual.

20. In connection with any litigation challenging or seeking to enjoin actions by the Commission under the Freedom of Information Act, as amended.

POLICIES AND PRACTICES FOR STORING, RETRIEVING, ACCESSING, RETAINING, AND DISPOSING OF RECORDS IN THE SYSTEM:

STORAGE:

Records are maintained in electronic and paper format. Electronic records are stored in computerized databases and/or on computer disc. Paper records and records on computer disc are stored in locked file rooms and/or file cabinets.

RETRIEVABILITY:

Electronic files and paper format records are indexed and retrieved by a unique case number assigned to the request. Records may also be retrieved by the requestor name and/or the subject of the request.

SAFEGUARDS:

Records are safeguarded in a secured environment. Buildings where records are stored have security cameras and 24 hour security guard service. The records are kept in limited access areas during duty hours and in locked file cabinets and/or locked offices or file rooms at all other times. Access is limited to those personnel whose official duties require access. Computerized records are safeguarded through use of access codes and information technology security. Contractors and other recipients providing services to the Commission shall be required to maintain equivalent safeguards.

RETENTION AND DISPOSAL:

These records are maintained in accordance with general records schedules of the National Archives and Records Administration, General Records Schedule 14.

SYSTEM MANAGER(S) AND ADDRESS:

FOIA/PA Officer, Office of FOIA Services, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-2736.

NOTIFICATION PROCEDURE:

All requests to determine whether this system of records contains a record pertaining to the requesting individual may be directed to the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-2736.

RECORD ACCESS PROCEDURE:

Persons wishing to obtain information on the procedures for gaining access to or contesting the contents of these records may contact the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-2736.

CONTESTING RECORD PROCEDURE:

See Record access procedures above.

RECORD SOURCE CATEGORIES:

Persons requesting information from the Commission pursuant to the Freedom of Information Act and the Privacy Act; agency employees assigned to handle processing the requests; agency records searched and identified as responsive in the process of responding to such requests; other agencies or entities that have referred to SEC requests concerning SEC records, or that have consulted with SEC regarding handling of particular requests; and submitters or subjects of records or information that have provided assistance to SEC in making access or amendment determinations.

EXEMPTIONS CLAIMED FOR THE SYSTEM:

None.

SEC-66

SYSTEM NAME:

Backup Care Employee and Family Records.

SYSTEM LOCATION:

Bright Horizons Family Solutions, 200 Talcott Avenue, Watertown, MA 02472. Records may also be maintained at subcontracted childcare center locations. Electronic Reports of SEC employees' registrations and uses are maintained at the Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

CATEGORIES OF INDIVIDUALS COVERED BY THE SYSTEM:

Current SEC employees who voluntarily sign up for backup care benefits and their family members for whom care is needed.

CATEGORIES OF RECORDS IN THE SYSTEM:

Records may contain employee's name, work address, work phone number, work email address, home address and home phone number; family member's name, gender, home address, and date of birth; and Caregiver's name.

AUTHORITY FOR MAINTENANCE OF THE SYSTEM:

40 U.S.C 590

PURPOSE(S):

The records are used to determine an employee's eligibility to request backup care benefits for family members.

ROUTINE USES OF RECORDS MAINTAINED IN THE SYSTEM, INCLUDING CATEGORIES OF USERS AND THE PURPOSES OF SUCH USES:

In addition to those disclosures generally permitted under 5 U.S.C. 552a(b) of the Privacy Act, these records or information contained therein may specifically be disclosed outside the Commission as a routine use pursuant to 5 U.S.C. 552 a(b)(3) as follows:

1. To appropriate agencies, entities, and persons when (a) it is suspected or confirmed that the security or confidentiality of information in the system of records has been compromised; (b) the SEC has determined that, as a result of the suspected or confirmed compromise, there is a risk of harm to economic or property interests, identity theft or fraud, or harm to the security or integrity of this system or other systems or programs (whether maintained by the SEC or another agency or entity) that rely upon the compromised information; and (c) the disclosure made to such agencies, entities, and persons is reasonably necessary to assist in connection with the SEC's efforts to respond to the suspected or confirmed compromise and prevent, minimize, or remedy such harm.

2. To produce summary descriptive statistics and analytical studies, as a data source for management information, in support of the function for which the records are collected and maintained or for related personnel management functions or manpower studies; may also be used to respond to general requests for statistical information (without personal identification of individuals) under the Freedom of Information Act.
3. To interns, grantees, experts, contractors, and others who have been engaged by the Commission to assist in the performance of a service related to this system of records and who need access to the records for the purpose of assisting the Commission in the efficient administration of its programs, including by performing clerical, stenographic, or data analysis functions, or by reproduction of records by electronic or other means. Recipients of these records shall be required to comply with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. 552a.
4. To a Congressional office from the record of an individual in response to an inquiry from the Congressional office made at the request of that individual.
5. To members of Congress, the Government Accountability Office, or others charged with monitoring the work of the Commission or conducting records management inspections.
6. To a commercial contractor in connection with benefit programs administered by the contractor on the Commission's behalf, including, but not limited to, supplemental health, dental, disability, life and other benefit programs. Recipients of these records shall be required to comply with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. 552a.

POLICIES AND PRACTICES FOR STORING, RETRIEVING, ACCESSING, RETAINING, AND DISPOSING OF RECORDS IN THE SYSTEM:

STORAGE:

Records are maintained in electronic format. Electronic records are stored in computerized databases and/or on computer disc. Paper records and records on computer disc are stored in locked file rooms and/or file cabinets.

RETRIEVABILITY:

Records are retrieved by the individual's name.

SAFEGUARDS:

Records are safeguarded in a secured environment. The records are kept in limited access areas and/or locked offices or file rooms at all other times. Computerized records are safeguarded through use of access codes and information technology security. Access is limited to those personnel whose official duties require access. Contractors and other recipients providing services to the Commission shall be required to maintain equivalent safeguards.

RETENTION AND DISPOSAL:

These records will be maintained until they become inactive, at which time they will be retired or destroyed in accordance with records schedules of the United States Securities and Exchange Commission and as approved by the National Archives and Records Administration.

SYSTEM MANAGER(S) AND ADDRESS:

Associate Executive Director, Office of Human Resources, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3901.

NOTIFICATION PROCEDURE:

All requests to determine whether this system of records contains a record pertaining to the requesting individual may be directed to the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-2736.

RECORD ACCESS PROCEDURE:

Persons wishing to obtain information on the procedures for gaining access to or contesting the contents of these records may contact the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-2736.

CONTESTING RECORD PROCEDURE:

See Record access procedures above.

RECORD SOURCE CATEGORIES:

All information is provided by SEC employees registering for the services.

EXEMPTION CLAIMED FOR THE SYSTEM:

None.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Date: July 8, 2013

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 69945 / July 8, 2013

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3472 / July 8, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15370

In the Matter of **AICHUN LI, 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 Aichun Li ("Respondent" or "Li") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

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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.

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.B.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. Li, age 39, is and has been a certified public accountant licensed to practice in the State of North Carolina. She served as Chief Financial Officer of Keyuan Petrochemicals, Inc. ("Keyuan") from May 2010 until her resignation in October 2011.

2. Keyuan was, at all relevant times, a Nevada corporation with its principal place of business in Ningbo, China. Keyuan is a manufacturer and supplier of petrochemical products. At all relevant times, Keyuan' s common stock was registered with the Commission pursuant to Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act"), and traded on the NASDAQ Stock Market LLC.

3. On February 28, 2013, the Commission filed a complaint against Li in SEC v. Keyuan Petrochemicals, Inc., Civil Action No. 13-cv-00263 (D.D.C.). On July 2, 2013, the court entered an order permanently enjoining Li, by consent, from future violations of Section 13(b)(5) of the Exchange Act and from aiding and abetting violations of Section 13(a) and 13(b)(2)(A) of the Exchange Act and Exchange Act Rules 12b-20 and 13a-13 thereunder. Li was also ordered to pay a $25,000 civil money penalty.

4. The Commission's complaint alleged, among other things, that between May 2010 and January 2011, Keyuan failed to disclose material related party transactions between and among the company and its chief executive officer and controlling shareholders as well as entities controlled by or affiliated with those persons. The related party transactions took the form of loan guarantees, purchases of raw materials, sales of products, and short term cash transfers for financing purposes. Li, who was hired to ensure the company's compliance with U.S. GAAP and oversee the SEC reporting process, received information indicating that the company was engaged in certain related party transactions in the form of loan guarantees. Li also encountered red flags that should have alerted her that the company was not properly identifying or disclosing certain related party transactions. Despite such knowledge, Li signed off on registration statements and periodic reports filed between May 2010 and January 2011 that

failed to disclose material related party transactions, as required by U.S. GAAP and/or Commission regulations.

IV.

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

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

A. Pursuant to Rule 102(e) of the Commission's Rules of Practice, Li is suspended from appearing or practicing before the Commission as an accountant.

B. After two 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

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-69954; File No. SR-NSCC-2013-802)

July 9, 2013

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

On March 21, 2013, National Securities Clearing Corporation ("NSCC") filed with the Securities and Exchange Commission ("Commission") advance notice SR-NSCC-2013-802 ("Advance Notice") pursuant to Section 806(e)(1) of the Payment, Clearing, and Settlement Supervision Act of 2010 ("Clearing Supervision Act")[1] and Rule 19b-4(n)(1)(i)[2] thereunder.[3] On April 19, 2013, NSCC filed with the Commission Amendment No. 1 to the Advance Notice.[4] The Advance Notice, as modified by Amendment No. 1, was published for comment in the

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

2 17 CFR 240.19b-4(n)(1)(i).

3 NSCC also filed the proposal contained in the Advance Notice as proposed rule change SR-NSCC-2013-02 ("Proposed Rule Change") under Section 19(b)(1) of the Securities and Exchange Act of 1934 ("Exchange Act") and Rule 19b-4 thereunder. Release No. 34-69313 (Apr. 4, 2013), 78 FR 21487 (Apr. 10, 2013). On April 19, 2013, NSCC filed Amendment No. 1 to the Proposed Rule Change, which, on May 22, 2013, the Commission provided notice of and designated a longer period of review for Commission action on the Proposed Rule Change, as modified by Amendment No. 1. Release No. 34-69620 (May 22, 2013), 78 FR 32292 (May 29, 2013). On June 11, 2013, NSCC filed Amendment No. 2 to the Proposed Rule Change, which the Commission published notice of with an order instituting proceedings to determine whether to approve or disapprove the Proposed Rule Change. Release No. 34-69951 (July 9, 2013). The proposal in the Advance Notice, as amended, and the Proposed Rule Change, as amended, shall not take effect until all regulatory actions required with respect to the proposal are completed.

4 <u>See</u> Release No. 34-69451 (Apr. 25, 2013), 78 FR 25496 (May 1, 2013).

Federal Register on May 1, 2013.[5] On May 20, 2013, the Commission extended the period of review of the Advance Notice, as modified by Amendment No. 1.[6] As of July 9, 2013, the Commission had received fourteen comment letters on the proposal contained in the Advance Notice and its related Proposed Rule Change,[7] including NSCC's response to the comment letters received as of June 10, 2013.[8]

Pursuant to Section 806(e)(1) of the Clearing Supervision Act[9] and Rule 19b-4(n)(1)(i)[10] thereunder, notice is hereby given that on June 11, 2013, NSCC filed with the Commission

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5 Id.

6 Release No. 34-69605 (May 20, 2013), 78 FR 31616 (May 24, 2013). Absent a request by the Commission to NSCC to provide additional information on the Advance Notice pursuant to Section 806(e)(1)(D) of the Clearing Supervision Act, see 12 U.S.C. 5465(e)(1)(D), the Commission shall have until July 19, 2013 to issue an objection or non-objection to the Advance Notice, as amended. See Release No. 34-69605 (May 20, 2013), 78 FR 31616 (May 24, 2013), and see 12 U.S.C. 5465(e)(1)(E) and (G).

7 See Comments Received on File Nos. SR-NSCC-2013-02 (http://sec.gov/comments/sr-nscc-2013-02/nscc201302.shtml) and SR-NSCC-2013-802 (http://sec.gov/comments/sr-nscc-2013-802/nscc2013802.shtml). Since the proposal contained in the Advance Notice was also filed as a Proposed Rule Change, see Release No. 34-69313, supra note 3, the Commission is considering all public comments received on the proposal regardless of whether the comments are submitted to the Advance Notice, as amended, or the Proposed Rule Change, as amended.

8 NSCC also received a comment letter directly prior to filing the Advance Notice and related Proposed Rule Change with the Commission, which NSCC provided to the Commission in Amendment No. 1 to the filings. See Exhibit 2 to File No. SR-NSCC-2013-802 (http://sec.gov/rules/sro/nscc/2013/34-69451-ex2.pdf).

9 12 U.S.C. 5465(e)(1).

10 17 CFR 240.19b-4(n)(1)(i).

Amendment No. 2 to the Advance Notice, as previously modified by Amendment No. 1.[11] The Commission is publishing this notice to solicit comments on the Advance Notice, as modified by Amendment No. 2, from interested persons.

I. Clearing Agency's Statement of the Terms of Substance of the Advance Notice

The Advance Notice, as modified by Amendment No. 2, is a proposal by NSCC to amend its Rules and Procedures ("Rules") to provide for a supplemental liquidity funding obligation ("SLD Proposal"), as described below. NSCC filed Amendment No. 2 to the Advance Notice, as previously modified by Amendment No. 1, in order to mitigate potential cash outlay burdens, respond to transparency concerns raised by NSCC members ("Members"), clarify the implementation timeframe, and describe the reports that would be provided to Members so that they can anticipate their supplemental liquidity obligations to NSCC under the SLD Proposal ("Supplemental Liquidity Obligations").

II. Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Advance Notice

11 Defined terms that are not defined in this notice are defined in Amended Exhibit 5 to the Advance Notice, available at http://sec.gov/rules/sro/nscc.shtml, under File No. SR-NSCC-2013-802, Additional Materials.

In its filing with the Commission, NSCC included statements concerning the purpose of and basis for the Advance Notice, as modified by Amendment No. 2, and discussed any comments it received on the Advance Notice, as amended. The text of these statements may be examined at the places specified in Item IV below. NSCC has prepared summaries, set forth in sections (A), (B), and (C) immediately below, of the most significant aspects of these statements.[12]

(A) Advance Notices Filed Pursuant to Section 806(e) of the Payment, Clearing and Settlement Supervision Act

1. Description of Change

Original SLD Proposal

The original proposal contained in the Advance Notice, as modified by Amendment No. 1 ("Original SLD Proposal"), would change the Rules to add a new Rule 4A, in order to establish a supplemental liquidity funding obligation designed to cover the liquidity exposure attributable to those Members and families of affiliated Members ("Affiliated Families") that regularly incur the largest gross settlement debits over a settlement cycle during both times of normal trading activity ("Regular Activity Periods") and times of increased trading and settlement activity that arise around quarterly triple options expiration dates ("Quarterly Options Expiration Activity Periods").

The Supplemental Liquidity Obligation of a Member or Affiliated Family with respect to a Regular Activity Period ("Regular Activity Liquidity Obligation") or a Quarterly Options Expiration Activity Period ("Special Activity Liquidity Obligation") would be imposed on the 30

12 The Commission has modified the text of the summaries prepared by NSCC to primarily focus on the Advance Notice.

Members or Affiliated Families who generate the largest aggregate liquidity needs over a settlement cycle that would apply in the event of a closeout (i.e., over a period from date of default through the following three settlement days), based upon a historical look-back period.

NSCC states that the calculations for both the Regular Activity Liquidity Obligation and the Special Activity Liquidity Obligation are designed so that NSCC has adequate liquidity resources to enable it to settle transactions, notwithstanding the default of the Member or Affiliated Family presenting the largest liquidity need during Regular Activity Periods, as well as during Quarterly Options Expiration Activity Periods. The Supplemental Liquidity Obligations imposed on Members of Affiliated Families would be apportioned among the Members in that Affiliated Family in proportion to the liquidity risk (or peak exposure) they present to NSCC.

NSCC states that the SLD Proposal is designed to supplement NSCC's liquidity resources and work in tandem with NSCC's committed credit facility ("Credit Facility"), which it maintains as a liquidity resource (in addition to the NSCC Clearing Fund) should a Member or Affiliated Family default. The Regular Activity Liquidity Obligations would be calculated and imposed semi-annually, the first of which would be made to coincide with the annual renewal of the Credit Facility and the second of which would be made six months thereafter. NSCC states that the SLD Proposal seeks to strike a balance between reliance on the Credit Facility to reduce the burden on Members or Affiliated Families for cash outlay, while at the same time obligating those Members or Affiliated Families who expose NSCC to the largest liquidity risks to fund their fair share of the liquidity "differential."

NSCC states that the SLD Proposal contains both obligations and incentives. For example, a cash deposit in respect of a Regular Activity Liquidity Obligation (e.g., in the Original SLD Proposal, the obligation of a Member or Affiliated Family to make a "Regular

Activity Supplemental Deposit") would be reduced by any liquidity such Members or their affiliates provided as commitments under the Credit Facility. To the extent that NSCC is successful in raising significant amounts of its needed liquidity though the Credit Facility – whether from Members, their affiliates making commitments on their behalf, or non-affiliated lenders – NSCC states that a diversified lender facility serves to mitigate the liquidity risk of NSCC and its membership as a whole, while reducing the cash outlay obligations of the top 30 Members and Affiliated Families.

NSCC states that the cash deposit in respect of a Special Activity Liquidity Obligation ("Special Activity Supplemental Deposit") was structured in the Original SLD Proposal to address any additional liquidity shortfalls (i.e., over and above NCSS's other available liquidity resources) that arose during the heightened trading activity around the Quarterly Options Expiration Period. As such, these additional Special Activity Supplemental Deposits would be required to be maintained on deposit with NSCC only through the completion of the related settlement cycle and for a few days thereafter.

Both prior to the submission of the Advance Notice, and since, NSCC states that it has engaged in significant outreach to its Members to discuss the SLD Proposal, which outreach, NSCC believes, has been key to the development and evolution of the SLD Proposal over the past 18 months. NSCC is cognizant of the concerns raised by Members who have submitted comments regarding the Advance Notice and related Proposed Rule Change, and, according to NSCC, this Amendment No. 2 seeks to address those concerns.

Proposed Enhancements to the Original SLD Proposal

NSCC is proposing to amend the Original SLD Proposal with enhancements that NSCC believes are collectively designed to mitigate potential cash outlay burdens, as well as respond to transparency concerns raised by Members, by clarifying the implementation timeframe of the proposed change and the reporting that would be provided to Members under this revised SLD Proposal ("Revised SLD Proposal").

First, NSCC would allow its Members to designate a commercial lender – whether or not affiliated with that Member – to commit as a lender to the Credit Facility as a designee of the Member, subject to satisfaction of reasonable lender criteria.[13] NSCC states that this commitment would reduce the Member's Regular Activity Liquidity Obligation cash requirement by the amount of any such commitment. Therefore, under the Revised SLD Proposal, NSCC states that all Members, whether or not they have affiliated banks, are equally incentivized to seek lenders to maximize the size of the Credit Facility. NSCC states that this change effectively eliminates any perceived discrimination in the Original SLD Proposal between those Members that have bank affiliates and those that do not. This change is reflected in the proposed Rule 4A by the inclusion of a new definition for "Designated Lender," and corresponding adjustments to the calculation formula.

Second, any "excess" Credit Facility commitments made by Members directly or through their Designated Lenders (i.e., the amount of any commitment by a Member or its Designated Lender that exceeds the Member's calculated Regular Activity Liquidity Obligation) would be allocated ratably among all Regular Activity Liquidity Providers, which NSCC states would reduce their cash Regular Activity Supplemental Deposit requirements, in the same way that commitments of non-affiliated lenders are applied under the Original SLD Proposal. This change

13 NSSC states that such criteria would be designed to cover issues such as credit risk, concentration risk, and lender diversity, so as to ensure the continued robust viability of the line of credit.

is reflected in adjustments to the calculation formula in Sections 5 and 9 of the proposed Rule 4A.

Third, under the Revised SLD Proposal, the seasonal/peak facility that NSCC believes currently addresses NSCC's liquidity needs over Quarterly Options Expiration Activity Periods would be extended to cover monthly options expiration periods and would be calculated and collected 12 times a year instead of four ("Monthly Options Expiration Activity Period"). NSCC states, based on its review of available historical quantitative information, that the effect of this change would be to reduce the size of the Regular Activity Liquidity Obligations under the Revised SLD Proposal. Additionally, NSCC states that by treating all liquidity obligations derived from Monthly Options Expiration Activity Periods (where there is greater activity fluctuation than during other periods) as Special Activity Liquidity Obligations, the Revised SLD Proposal would provide greater stability and predictability to the size of the Regular Activity Liquidity Obligations. NSCC's analyses based upon historical data estimates that expanding this seasonal/peak facility to cover all Monthly Options Expiration Activity Periods could reduce the size of the aggregate Regular Activity Liquidity Obligations by up to 20 percent. NSCC also states that recalibrating the Special Activity Liquidity Obligations on a monthly basis results in allocating the liquidity burdens among those Members and Affiliated Families more equitably, since only those Members whose monthly options-related activity generate liquidity needs in excess of NSCC's then available liquidity resources would be obligated to fund such additional amounts.[14] NSCC states that this change is reflected in a revised definition of "Options

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14 NSCC states that since the allocation formula ratably applies the excess amount needed due to activity during Special Activity Periods based upon the affected Member's Special Activity Peak Liquidity Exposure, then to the extent that a Member's Special Activity

Expiration Activity Period," and clarifications to the calculation formula of the Special Activity Liquidity Obligations, as well as to related definitions to ensure the formula – and the allocation among affected Members – operates as intended.

Fourth, the Revised SLD Proposal includes a new definition for "Other Qualifying Liquid Resources." NSCC states that this new defined term would permit NSCC to take any such additional or alternative liquidity resources that it may obtain in the future into account when calculating Regular Activity Liquidity Obligations and to use them to reduce the amount of cash, if any, that Members would otherwise be obligated to deposit as Regular Activity Supplemental Deposits. This change is reflected both with the inclusion of the new definition of "Other Qualifying Liquid Resources," and with corresponding modifications to the calculation formula.

Fifth, as regards Members' voluntarily prefunding Regular Activity Liquidity Obligations and Special Activity Liquidity Obligations, NSCC would monitor Members' prefunding activity to understand the impact such prefunded amounts have on the amount of its committed liquidity resources. NSCC states that the Revised SLD Proposal provides NSCC with some discretion when including prefunded deposits within its calculated liquidity resources, so as to provide some flexibility in the event it becomes too reliant on voluntary prefunding to meet its minimum liquidity needs. NSCC states that this change to the Original SLD Proposal would address any concern that NSCC would not have sufficient liquid resources to effect settlement if prefunding is unavailable when actually needed.

Additional Revisions to the Original SLD Proposal

Peak Liquidity Exposure (as defined) is less than or equal to NSCC's other available resources, that Member's share of the Special Activity Peak Liquidity Need will be zero.

<u>Reporting</u>. NSCC states that it understands and agrees that Members have to be able to evaluate risks of their membership and be able to plan for their liquidity obligations. NSCC also states that it is critical that Members understand the risks that their own activity presents to NSCC and be prepared to monitor their own activity and alter their behavior if they want to minimize the liquidity risk they present to NSCC. While NSCC states that robust reporting has always been a key element of the Original SLD Proposal, the Revised SLD Proposal clarifies in a new Section 31 of proposed Rule 4A the information that NSCC would provide to Members. Such information would be provided to all Members, not just the top 30 Members and Affiliated Families, at least monthly. NSCC states that these reports would show Members the liquidity exposure they present to NSCC to enable them to monitor their activity and the "Regular Activity Peak Liquidity Exposure" that results from their activity. Information provided in these reports would include:

- the Regular Activity Peak Liquidity Exposure of the Member on each Business Day of the preceding month;
- NSCC's largest Regular Activity Peak Liquidity Need for the preceding month;
- in the case of an Unaffiliated Member, for each Business Day of the preceding month, the percentage that the Regular Activity Peak Liquidity Exposure of the Member bears to the aggregate Regular Activity Peak Liquidity Exposures of all Regular Activity Liquidity Providers (the percentage for a Member that is not a Regular Activity Liquidity Provider for that month would be zero); and
- in the case of an Affiliated Family, for each Business Day of the preceding month, the percentage that the aggregate Regular Activity Peak Liquidity Exposures of all Members of that Affiliated Family bears to the aggregate Regular Activity Peak

Liquidity Exposures of all Regular Activity Liquidity Providers (Affiliated Families that are not Regular Activity Liquidity Providers for that month would be zero percentage).

Technical Clarifications and Changes. The Revised SLD Proposal includes certain technical changes and clarifications that NSCC states it designed to align notice, payment, and cash return timeframes, and to clarify the operation of the calculation formulas to ensure they operate as intended.

Implementation Timeframe and Funding Notice. While the SLD Proposal would be effective upon the completion of all required regulatory approvals, Members would not be obligated to fund their Regular Activity Liquidity Obligations or Special Activity Liquidity Obligations until the Monthly Options Expiration Activity Period in September 2013. Moreover, Members would be provided with notice of their initial Regular Activity Liquidity Obligations no later than 30 days prior to the date on which that amount must be deposited with NSCC. At that time, NSCC's risk management staff would also provide to affected Members their Special Activity Peak Liquidity Exposure within the look-back period. Specific implementation dates would be provided by NSCC by Important Notice.

NSCC states that its risk management staff would continue to work with Members to help them understand the Revised SLD Proposal and to develop tools that NSCC believes would enable Members to forecast the liquidity exposure they present to NSCC. NSCC states that its risk management staff would also use the reports that would be provided under new Section 31 or proposed Rule 4A to guide ongoing discussions with Members regarding the types of actions that could mitigate those Members' peak liquidity exposure. In addition, under the Revised SLD Proposal (as in the Original SLD Proposal), NSCC states that Members would be able to manage their exposures by making prefund deposits where they project their own activity would increase their liquidity exposure. For example, if a Member that would be a Special Activity Liquidity Provider anticipates that its Special Activity Peak Liquidity Exposure at any time during a particular Options Expiration Activity Period would be greater than the amount calculated by NSCC, then it could make an additional cash deposit to the Clearing Fund (in excess of its Required Deposit) that it designates as a "Special Activity Prefund Deposit."

In order to give Members sufficient time to plan for annual Credit Facilities renewals and to line up designated liquidity providers for the Credit Facility, NSCC states that its risk staff would provide Members with an impact analysis of their projected Supplemental Liquidity Obligations beginning on November 31 of each year.[15] NSCC states that the information provided would show the potential impact on affected Members based on different Credit Facility funding levels.

In response to the more general concern regarding refinancing risk and NSCC's reliance on the Credit Facility, NSCC states that it would continue to explore additional financing sources. NSCC states that it would review and evaluate the financing options available to it and the related costs of those options, and would expect to present the findings of that review to the NSCC Board prior to the next renewal of the Credit Facility in May 2014. When sizing and approving the fee and costs structure of the renewal Credit Facility, NSCC states that the NSCC Board would be able to take into account those potential additional financing sources and consider the consequent impact on Members' cash Regular Activity Supplemental Deposit and

15 NSCC states that given the timing of the calculation look-back periods, information provided in November will necessarily be estimates.

Special Activity Supplemental Deposit obligations. The items that would be included in this review are:

- analysis of the availability, size, cost, and credit risk necessary to obtain the additional commitments under the Credit Facility likely to reduce the Regular Activity Supplemental Deposit requirements to zero;
- analysis of the availability, size, cost, and credit risk to obtain a new multi-year committed facility to replace the existing Credit Facility;
- an understanding of the aggregate costs, if any, for Members to designate commercial lenders to commit to the Credit Facility as their designees;
- analysis of the availability, size, cost, and potential depth of a capital markets funding among Members and/or third parties as an additional liquidity resource, including the viability of offering the funding to Members or mandating their participation in such funding; and
- a summary of the steps that Members have taken to reduce their NSCC liquidity profile, and whether this should be factored into the historical analysis used to determine NSCC's Regular Activity Period liquidity needs and Members' share of that need.

NSCC states that it would update its Members on the results of this review and the determination of the NSCC Board. NSCC states that it would also update its Members with information regarding future liquidity initiatives designed to increase NSCC's liquidity resources and potentially reduce supplemental deposit requirements, including the rationale behind these initiatives, how these initiatives fit within NSCC's liquidity risk tolerance, and the likely impact of the initiatives.

NSCC states that the Revised SLD Proposal contributes to NSCC's goal of ensuring that NSCC has adequate liquidity resources to meet its settlement obligations, notwithstanding the default of its Members or Affiliated Families that pose the largest aggregate liquidity exposure over the relevant settlement cycle, as required by Commission Rule 17Ad-22(b)(3).[16]

2. Anticipated Effect on Management of Risk

As described above, NSCC is proposing to amend the Advance Notice, as modified by Amendment No. 1, in order to mitigate potential cash outlay burdens, and respond to transparency concerns raised by Members by clarifying the implementation timeframe of the SLD Proposal and the reporting that would be provided to Members under the SLD Proposal. NSCC believes that the SLD Proposal, as amended hereby, has been designed to ameliorate any unintended impact on competition that may be perceived, and it does not believe that the proposed amendments change the anticipated effect on and management of risk, as described in the original Advance Notice filed by NSCC on March 21, 2013.[17]

(B) Comments on Competition

1. Competition Concerns Raised by Commenters

Bank Affiliates. NSCC states that some commenters raised concerns on competition grounds that the Original SLD Proposal permitted Members and Affiliated Families with bank affiliates to reduce or potentially eliminate their required cash Required Activity Supplemental Deposits by the amounts of the commitments of such bank affiliates under the Credit Facility while Members and Affiliated Families without bank affiliates could not do so. As indicated

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16 See 17 CFR 240.17Ad-22(b)(3).

17 See Release No. 34-69451 (Apr. 25, 2013), 78 FR 25496 (May 1, 2013).

above, NSCC states that this limitation to bank affiliates has been eliminated from the SLD Proposal. NSCC states that any Member or Affiliated Family could designate a Designated Lender and receive an offset for the commitment of such Designated Lender.

The Top 30 Cut-Off. NSCC states that some commenters raised concerns on competition grounds that Supplemental Liquidity Obligations are only imposed on the 30 largest Members and Affiliated Families rather than on the entire membership. NSCC states that, based on an analysis of Members, NSCC made a business determination that the top 30 Members or Affiliated Families would most appropriately capture the liquidity exposure over and above available NSCC Clearing Fund liquidity. NSCC states that its liquidity analyses show that the liquidity requirements attributable to the top 30 Members and Affiliated Families account for the vast majority of NSCC's liquidity needs. According to NSCC, as of the end of February 2013, the top 30 Members and Affiliated Families represented approximately 85% of the total membership by peak liquidity needs over the prior six-month period. NSCC states that the analyses also show that the remaining membership's peak liquidity demands are covered by the required deposits to the NSCC Clearing Fund. Therefore, NSCC states the SLD Proposal appropriately places the burden of providing liquidity on those Members and Affiliated Families who present the largest liquidity risk. While NSCC does not believe it would be appropriate to require the entire membership to bear the burden of the liquidity needs that are generated by NSCC's largest trading firms, it does note that all Members currently do bear the cost of the Credit Facility as an operating expense that NSCC factors into its overall fee structure, as well as their share of the NSCC Clearing Fund. NSCC states that as a whole, NSCC believes this collective liquidity funding approach represents a fair apportionment of NSCC's aggregate liquidity needs amongst its membership.

Impact on a Sector of the Market. NSCC states that some commenters raised concerns on competition grounds that the SLD Proposal may cause increased concentration of clearing activity by requiring smaller firms to clear through larger financial institutions. NSCC states that implicit in these comments is a concern that smaller, less well-capitalized firms have less access to funding than do larger, well capitalized firms. NSCC states, however, that no Member, because of its low capital business model or limited access to funding, should have the right to impose on NSCC (and the rest of the membership) the burden of bearing the risks of that Member's clearing activities. Moreover, NSCC states that the SLD Proposal provides incentives for Members to manage the liquidity risks of their business; by doing so they could reduce the share of their obligation under the SLD Proposal.

NSCC also states that some commenters claim that the risk posed by brokers with business in mostly agency-based transactions was overstated by NSCC in crafting the SLD Proposal because those firms settle transactions on a delivery-versus-payment ("DVP") basis. NSCC states, however, that agency brokers that execute market transactions that clear at NSCC are obligated, as principals, to settle those transactions at NSCC irrespective of whether their institutional customers complete the institutional delivery DVP side of the transaction (which occurs outside of NSCC). According to NSCC, it, as the central counterparty, remains obligated to complete the other side of the market transaction if the agency broker fails. NSCC states that institutional customers of the agency brokers are not NSCC Members and have no contractual obligation with NSCC to complete those trades if the agency broker fails. Therefore, NSCC states that if an agency broker fails, NSCC (and its other Members) face the risk that the institutional customer will take its own market action, and NSCC will incur the liquidity obligation of completing the market settlement. NSCC states that it must consider this risk in crafting its risk management strategies, and agency brokers are not immune from the risk of failure, as recent events have shown that they, like other firms, remain subject to market events, as well as technology and other risks.

NSCC states that these comments raise a concern that Members are being asked share the burden of funding the liquidity needs that are dependent on the actions, including trading levels, of other Members, and thus the amounts are not within the contributing Member's control. NSCC states that from a fairness perspective, however, that proportionate share of the affected Member's liquidity burden (whether it be an agency broker or otherwise) would always be less than the Member's own peak liquidity needs, and each Member is in the best position to monitor and manage the liquidity risks presented by its own activity.

2. Modifications to the Proposed Change Address Competition Concerns

NSCC is an operating subsidiary of The Depository Trust & Clearing Corporation ("DTCC"), which NSCC states is a user-owned, user-governed holding company for NSCC, two other registered clearing agencies, a derivatives clearing organization joint venture, and a number of other companies that provide a variety of post-trade processing and information services. NSCC states that it and the other registered clearing agencies in the DTCC group provide the critical infrastructure for the clearance and settlement of securities transactions in the United States. These registered clearing agencies operate as utilities for their users, allowing such users to compete against each other (for the benefit of their retail and institutional customers) on the basis of performance and price and not on the basis of any relative advantage with respect to clearing and settlement services.

As a clearinghouse for securities transactions and a central counterparty, NSCC states that it has no reason, interest, or intent to discriminate among its Members – certainly not to give any of its Members a competitive advantage or impose on any of its Members a competitive disadvantage in their operations. NSCC states that although it strives for complete neutrality in its interface with Members, it may be that clearing agency rules of general application to all Members could have a disparate effect on Members with diverse business models and strategies. NSCC states that any such disparate effects arising out of choices made by individual Members in terms of their business models and strategies (including their relative levels of capitalization) should not be seen as due to action by the clearing agency having an impact or imposing a burden on competition.

Although NSCC states that it is always mindful of the effect that its Rules may have on individual Members, NSCC states that it must also be concerned with (i) the interests of its membership as a whole, (ii) its general obligations under Section 17A(b)(3) of the Exchange Act "to facilitate the prompt and accurate clearance and settlement of securities transactions and derivatives agreements, contracts, and transactions" and "to safeguard securities and funds in its custody or control," and (iii) the particular requirements of Rule 17Ad-22(b)(3) relating to the financial resources that a clearing agency which is a central counterparty (like NSCC) must maintain to cover the default of the participant family presenting the largest exposure to the clearing agency in extreme but plausible market conditions.

NSCC states that these concerns and the interests of its Members, including their interests relating to issues of competition and the effect of the proposed change on competition among Members and between Members and other financial market participants, can be reconciled. But, NSCC states that individual Members that may be affected by the proposed change – designed to assure that NSCC has the liquidity it needs to safely operate a clearing and settlement business and meet its obligations as a registered clearing agency and central counterparty under the Exchange Act – must also recognize that some accommodation may be required on their part.

Nevertheless, in response to comments submitted on the proposed change in the form in which it was originally filed in the Advance Notice, and dialogue with a number of other Members who did not submit comments but otherwise provided their input to NSCC, NSCC states that it has revised the proposed change in a number of respects that bear upon the issue of competition and whether the proposed change would have an impact or impose any burden on competition.

First, the Original SLD Proposal provided that a Regular Activity Liquidity Provider would receive an offset against its Regular Activity Liquidity Obligation for the amount of its commitment and the commitment of any affiliate of the Regular Activity Liquidity Provider under the Credit Facility. The Revised SLD Proposal provides that a Regular Activity Liquidity Provider would receive an offset against its Regular Activity Liquidity Obligation for the amount of its commitment, the commitment of any affiliate, and the commitment of any Designated Lender of the Regular Activity Liquidity Provider under the Credit Facility. As a result, NSCC states that any distinction between Members with bank affiliates and Members without bank affiliates, and any perceived advantage for Members with bank affiliates over Members without bank affiliates, has been eliminated.

Second, the SLD Proposal has been refined to provide that a Regular Activity Liquidity Provider would receive an offset against its Regular Activity Liquidity Obligation for both (i) its pro rata share of the commitments of lenders under the Credit Facility that are not Members or their Designated Lenders and (ii) its pro rata share of the commitments of Members and their Designated Lenders above the amounts of their Regular Activity Liquidity Obligations. As a result of this change, NSCC states that the obligation of Regular Activity Liquidity Providers to provide Regular Activity Supplemental Deposits will be ratably reduced by the amount of such "excess."

Third, the Options Expiration Activity Period has been redefined to mean the days around all monthly options expiration dates (12 per year) rather than just triple options expiration dates (four per year). As a result of this change, NSCC states that more periods of increased activity would be excluded by NSCC from the calculation of its Regular Activity Peak Liquidity Need, thereby reducing the Regular Activity Liquidity Obligations of Regular Activity Liquidity Providers.

NSCC states that participation in the Credit Facility is available to financial institutions that have the resources and operational capabilities to be lenders under the Credit Facility, subject to satisfaction of reasonable lender criteria. Although the Credit Facility was renewed on May 14, 2013 for an additional term of 364 days, NSCC states that there are mechanisms in the Credit Facility to increase the commitments of existing lenders and admit new lenders at any time during the term. Accordingly, NSCC states that at the time when the SLD Proposal becomes effective and before the time that any Member may have to satisfy a Regular Activity Liquidity Obligation, such Member would have an opportunity to either join the Credit Facility itself as a lender (if it has the authority to be a lender) or enter into arrangements with a bank to be its Designated Lender – in either case thereby reducing or eliminating the need for it to make a cash Regular Activity Supplemental Deposit to the Clearing Fund.

3. Impact on Competition

NSCC states that for the reasons stated above, it believes the changes that have been made to the Original SLD Proposal eliminate or substantially ameliorate the impact that the SLD Proposal might have on competition.

(C) Clearing Agency's Statement on Comments on the Advance Notice Received from Members, Participants, or Others

While written comments on the Advance Notice, as modified by Amendment No. 2, were not solicited, as noted above, NSCC engaged significant outreach and discussion with affected Members in developing the SLD Proposal.

Written comments on the Advance Notice, as amended, have been filed with the Commission and are available on the Commission's website. NSCC states that this Amendment No. 2 addresses some of the issues raised by those comments. NSCC's formal response to the written comments has been submitted separately to the Commission in accordance with the process for submitting comments.

III. Date of Effectiveness of the Advance Notice and Timing for Commission Action

The clearing agency may implement the proposed change pursuant to Section 806(e)(1)(G) of the Clearing Supervision Act[18] if it has not received an objection to the proposed change within 60 days of the later of (i) the date that the Commission received the advance notice or (ii) the date the Commission receives any further information it requested for consideration of the notice. The clearing agency shall not implement the proposed change if the Commission has any objection to the proposed change.

The Commission may extend the period for review by an additional 60 days if the proposed change raises novel or complex issues, subject to the Commission providing the

18 12 U.S.C. 5465(e)(1)(G).

clearing agency with prompt written notice of the extension. A proposed change may be implemented in less than 60 days from the date of receipt of the advance notice, or the date the Commission receives any further information it requested, if the Commission notifies the clearing agency in writing that it does not object to the proposed change and authorizes the clearing agency to implement the proposed change on an earlier date, subject to any conditions imposed by the Commission. The clearing agency shall post notice on its website of proposed changes that are implemented.

The proposal shall not take effect until all regulatory actions required with respect to the proposal are completed.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the Advance Notice, as amended, is consistent with the Clearing Supervision Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File No. SR-NSCC-2013-802 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 No. SR-NSCC-2013-802. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the Advance Notice, as amended, that are filed with the Commission, and all written communications relating to the Advance Notice, as amended, between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filings also will be available for inspection and copying at the principal office of NSCC and on NSCC's website at http://dtcc.com/legal/rule_filings/nscc/2013.php. 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 No. SR-NSCC-2013-802 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

By the Commission.

Kevin M. O'Neill

Kevin M. O'Neill
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 69946 / July 9, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15371

In the Matter of	
Gadzoox Networks, Inc. (n/k/a West Coast Venture Capital, Inc.), Gateway Data Sciences Corp., Gem International USA, Inc., Genus International Corp., and GenuTec Business Solutions, Inc.,	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**
Respondents.	

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 Gadzoox Networks, Inc. (n/k/a West Coast Venture Capital, Inc.), Gateway Data Sciences Corp., Gem International USA, Inc., Genus International Corp., and GenuTec Business Solutions, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Gadzoox Networks, Inc. (n/k/a West Coast Venture Capital, Inc.) (CIK No. 1084722) is a void Delaware corporation located San Jose, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Gadzoox Networks is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended March 31, 2002, which reported a net loss of over $46.9 million for the prior twelve months. On January 2, 2004, Gadzoox Networks changed its name to West Coast Venture Capital, Inc., but

failed to report this change in the Commission's EDGAR database as required by Commission rules. On August 22, 2002, Gadzoox Networks filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Northern District of California, which was closed on October 21, 2004.

2. Gateway Data Sciences Corp. (CIK No. 1002917) is a dissolved Arizona corporation located in Phoenix, Arizona with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Gateway Data Sciences is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended October 31, 1997, which reported a net loss of over $7.4 million for the prior nine months. On February 23, 1998, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Arizona, and the case was closed on July 9, 2004.

3. Gem International USA, Inc. (CIK No. 1116561) is a permanently revoked Nevada corporation located in Port Cosquitlam, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Gem International USA 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 $114,704 since its December 21, 1998 inception.

4. Genus International Corp. (CIK No. 1089905) is a dissolved Wyoming corporation located in Chandler, Arizona with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Genus 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, 2000, which reported a net loss of $243,095 for the prior nine months.

5. GenuTec Business Solutions, Inc. (CIK No. 1372352) is a dissolved Montana corporation located in Laguna Niguel, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GenuTec is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10 registration statement on October 6, 2006, which reported a net loss of over $1.95 million for the period ended September 30, 2005.

B. DELINQUENT PERIODIC FILINGS

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

7. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration

is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports.

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

III.

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

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

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 69950 / July 9, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3623 / July 9, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15373

In the Matter of

JOSEPH J. HENNESSY,

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 Joseph J. Hennessy ("Respondent" or "Respondent Hennessy").

II.

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

III.

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

1. Respondent Hennessy is the co-principal of Resources Planning Group, Inc. ("RPG"), an investment adviser registered with the Commission. Hennessy is also a co-owner and registered representative of HLM Securities, Inc., a broker-dealer registered with the Commission. Hennessy, age 52, is a resident of Western Springs, Illinois.

2. On May 7, 2013, a judgment was entered by consent against Respondent Hennessy, permanently enjoining him from future violations of Sections 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8(a)(1), in the civil action entitled Securities and Exchange Commission v. Resources Planning Group, Inc. and Joseph J. Hennessy, Civil Action Number 12-CV-9509, in the United States District Court for the Northern District of Illinois.

3. The Commission's complaint alleged that between at least February 2007 and April 2012, in connection with the sale of promissory notes and units in the Midwest Opportunity Fund, LLC ("MOF"), a private equity fund that Hennessy co-founded in 2004, Hennessy made misrepresentations about the nature and prospects of the MOF investment and failed to inform investors about the existence of MOF promissory notes that Hennessy had personally guaranteed. The complaint also alleged that Hennessy misappropriated investor funds to make MOF debt payments, 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 Hennessy'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 Hennessy be, and hereby is:

barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and

barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

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

By the Commission.

Elizabeth M. Murphy
Secretary

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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 69949 / July 9, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3622 / July 9, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15372

In the Matter of

MATTHEW M. TAYLOR,

Respondent.

ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Matthew M. Taylor ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, Respondent consents to the Commission's jurisdiction over him and the subject matter of these proceedings and to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of

1934 and Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Taylor, age 34, is a resident of Florida. From 2005 to 2007, Taylor was a registered representative associated with Goldman, Sachs & Co. ("Goldman"), a registered broker-dealer and investment adviser. From 2001 to 2005 and 2008 to 2012, Taylor was a registered representative associated with another registered broker-dealer and investment adviser.

2. On April 3, 2013, Taylor pled guilty to one count of wire fraud in violation of Title 18 United States Code, Section 1343 before the United States District Court for the Southern District of New York, in United States v. Matthew Taylor, Crim. Information No. 1:13-CR-00251 (WHP). Taylor is scheduled to be sentenced on July 26, 2013.

3. The count of the criminal information to which Taylor pled guilty alleged, inter alia, that in December 2007, Taylor willfully and knowingly devised and executed a scheme to accumulate and then conceal an unauthorized $8.3 billion position in a trading account he managed while working at Goldman's New York office. Taylor's unauthorized trading resulted in significant losses to Goldman. In order to conceal those trading loses, Taylor fabricated trades to Goldman's internal systems. Taylor devised and executed this scheme in order to restore his professional reputation and increase his performance-based compensation at Goldman.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Taylor'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 Taylor be, and hereby is barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization and barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Aguilar
Disapproved

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 230, 239 and 242

Release No. 33-9415; No. 34-69959; No. IA-3624; File No. S7-07-12

RIN 3235-AL34

Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings

AGENCY: Securities and Exchange Commission.

ACTION: Final rules.

SUMMARY: We are adopting amendments to Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933 to implement Section 201(a) of the Jumpstart Our Business Startups Act. The amendment to Rule 506 permits an issuer to engage in general solicitation or general advertising in offering and selling securities pursuant to Rule 506, provided that all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that such purchasers are accredited investors. The amendment to Rule 506 also includes a non-exclusive list of methods that issuers may use to satisfy the verification requirement for purchasers who are natural persons. The amendment to Rule 144A provides that securities may be offered pursuant to Rule 144A to persons other than qualified institutional buyers, provided that the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are qualified institutional buyers. We are also revising Form D to require issuers to indicate whether they are relying on the provision that permits general solicitation or general advertising in a Rule 506 offering.

Also today, in a separate release, to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, we are adopting amendments to Rule

506 to disqualify issuers and other market participants from relying on Rule 506 if "felons and other 'bad actors'" are participating in the Rule 506 offering. We are also today, in a separate release, publishing for comment a number of proposed amendments to Regulation D, Form D and Rule 156 under the Securities Act that are intended to enhance the Commission's ability to evaluate the development of market practices in Rule 506 offerings and address certain comments made in connection with implementing Section 201(a)(1) of the Jumpstart Our Business Startups Act.

DATES: The final rule and form amendments are effective on [insert date 60 days after publication in the Federal Register].

FOR FURTHER INFORMATION CONTACT: Charles Kwon, Special Counsel, or Ted Yu, Senior Special Counsel, Office of Chief Counsel, Division of Corporation Finance, at (202) 551-3500, or, with respect to private funds, Holly Hunter-Ceci, Senior Counsel, Chief Counsel's Office, or Alpa Patel, Senior Counsel, Investment Adviser Regulation Office, Division of Investment Management, at (202) 551-6825 or (202) 551-6787, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are adopting amendments to Rule 144A,[1] Form D,[2] and Rules 500,[3] 501,[4] 502[5] and 506[6] of Regulation D[7] under the Securities Act

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[1] 17 CFR 230.144A.

[2] 17 CFR 239.500.

[3] 17 CFR 230.500.

[4] 17 CFR 230.501.

[5] 17 CFR 230.502.

[6] 17 CFR 230.506.

[7] 17 CFR 230.500 through 230.508.

of 1933,[8] and to Rules 101,[9] 102[10] and 104[11] of Regulation M[12] under the Securities Exchange Act of 1934.[13]

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[8] 15 U.S.C. 77a et seq.

[9] 17 CFR 242.101.

[10] 17 CFR 242.102.

[11] 17 CFR 242.104.

[12] 17 CFR 242.100 through 242.105.

[13] 15 U.S.C. 78a et seq.

I. INTRODUCTION

On August 29, 2012, we proposed rule and form amendments[14] to implement Section 201(a) of the Jumpstart Our Business Startups Act (the "JOBS Act").[15] Section 201(a)(1) of the JOBS Act directs the Commission, not later than 90 days after the date of

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[14] See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9354 (Aug. 29, 2012) [77 FR 54464 (Sept. 5, 2012)] (the "Proposing Release").

[15] Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313 (Apr. 5, 2012).

enactment, to amend Rule 506 of Regulation D[16] under the Securities Act of 1933 (the "Securities Act") to permit general solicitation or general advertising in offerings made under Rule 506, provided that all purchasers of the securities are accredited investors.[17] Section 201(a)(1) also states that "[s]uch rules shall require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission." Section 201(a)(2) of the JOBS Act directs the Commission, not later than 90 days after the date of enactment, to revise Rule 144A(d)(1) under the Securities Act[18] to permit offers of securities pursuant to Rule 144A to persons other than qualified institutional buyers ("QIBs"),[19] including by means

[16] The Commission adopted Regulation D in 1982 as a result of the Commission's evaluation of the impact of its rules on the ability of small businesses to raise capital. See Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Release No. 33-6389 (Mar. 8, 1982) [47 FR 11251 (Mar. 16, 1982)]. Over the years, the Commission has revised various provisions of Regulation D in order to address, among other things, specific concerns relating to facilitating capital-raising as well as abuses that have arisen under Regulation D. See, e.g., Additional Small Business Initiatives, Release No. 33-6996 (Apr. 28, 1993) [58 FR 26509 (May 4, 1993)] and Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Release No. 33-7644 (Feb. 25, 1999) [64 FR 11090 (Mar. 8, 1999)].

[17] The definition of the term "accredited investor" that is applicable to Rule 506 is set forth in Rule 501(a) of Regulation D [17 CFR 230.501(a)] and includes any person who comes within one of the definition's enumerated categories of persons, or whom the issuer "reasonably believes" comes within any of the enumerated categories, at the time of the sale of the securities to that person. For natural persons, Rule 502(a) defines an accredited investor as a person: (1) whose individual net worth, or joint net worth with that person's spouse, exceeds $1 million, excluding the value of the person's primary residence (the "net worth test"); or (2) who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year (the "income test").

Although the Dodd-Frank Act did not change the amount of the $1 million net worth test, it did change how that amount is calculated – by excluding the value of a person's primary residence. This change took effect upon the enactment of the Dodd-Frank Act. In December 2011, we amended Rule 501 to incorporate this change into the definition of accredited investor. See Net Worth Standard for Accredited Investors, Release No. 33-9287 (Dec. 21, 2011) [76 FR 81793 (Dec. 29, 2011)].

[18] 17 CFR 230.144A(d)(1).

[19] The term "qualified institutional buyer" is defined in Rule 144A(a)(1) [17 CFR 230.144A(a)(1)] and includes specified institutions that, in the aggregate, own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with such institutions. Banks and other specified financial institutions must also have a net worth of at least $25 million. A registered broker-dealer qualifies as a QIB if it, in the aggregate, owns and invests on a discretionary basis at least $10 million in securities of issuers that are not affiliated with the broker-dealer.

of general solicitation or general advertising, provided that the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs.

The Commission originally adopted Rule 506 as a non-exclusive safe harbor under Section 4(a)(2) (formerly Section 4(2)) of the Securities Act,[20] which exempts transactions by an issuer "not involving any public offering" from the registration requirements of Section 5 of the Securities Act.[21] Under existing Rule 506, an issuer may sell securities, without any limitation on the offering amount, to an unlimited number of "accredited investors," as defined in Rule 501(a) of Regulation D, and to no more than 35 non-accredited investors who meet certain "sophistication" requirements.[22] The availability of Rule 506 is subject to a number of requirements[23] and is currently conditioned on the issuer, or any person acting on its behalf, not offering or selling securities through any form of "general solicitation or general advertising."[24] Although the terms "general solicitation" and "general advertising" are not defined in Regulation D, Rule 502(c) does provide examples of general solicitation and general advertising, including advertisements published in newspapers and magazines, communications broadcast over television and radio, and seminars where attendees have been invited by

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[20] 15 U.S.C. 77d(a)(2).

[21] 15 U.S.C. 77e.

[22] Under Rule 506(b)(2)(ii) [17 CFR 230.506(b)(2)(ii)], each purchaser in a Rule 506 offering who is not an accredited investor must possess, or the issuer must reasonably believe immediately before the sale of securities that such purchaser possesses, either alone or with his or her purchaser representative, "such knowledge and experience in financial and business matters that he [or she] is capable of evaluating the merits and risks of the prospective investment."

[23] Offerings under Rule 506 are subject to all the terms and conditions of Rules 501 and 502. If securities are sold to any non-accredited investors, specified information requirements apply. See Rule 502(b) [17 CFR 230.502(b)].

[24] Rule 502(c) of Regulation D [17 CFR 230.502(c)].

general solicitation or general advertising.[25] By interpretation, the Commission has confirmed that other uses of publicly available media, such as unrestricted websites, also constitute general solicitation and general advertising.[26] In this release, we refer to both general solicitation and general advertising as "general solicitation."

Rule 144A is a non-exclusive safe harbor exemption from the registration requirements of the Securities Act for resales of certain "restricted securities"[27] to QIBs. Resales to QIBs in accordance with the conditions of Rule 144A[28] are exempt from registration pursuant to Section 4(a)(1) (formerly Section 4(1)) of the Securities Act,[29] which exempts transactions by any person "other than an issuer, underwriter, or dealer." Although Rule 144A does not include an express prohibition against general solicitation, offers of securities under Rule 144A currently must be limited to QIBs, which has the same practical effect. By its terms, Rule 144A is available solely for resale transactions; however, since its adoption by the Commission in 1990,[30] market participants have used

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[25] Id.

[26] See Use of Electronic Media for Delivery Purposes, Release No. 33-7233 (Oct. 6, 1995) [60 FR 53458, 53463-64 (Oct. 13, 1995)]; Use of Electronic Media, Release No. 33-7856 (Apr. 28, 2000) [65 FR 25843, 25851-52 (May 4, 2000)].

[27] "Restricted securities" are defined in Securities Act Rule 144(a)(3) [17 CFR 230.144(a)(3)] to include, in part, "[s]ecurities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering."

[28] In order for a transaction to come within existing Rule 144A, a seller must have a reasonable basis for believing that the offeree or purchaser is a QIB and must take reasonable steps to ensure that the purchaser is aware that the seller may rely on Rule 144A. Further, only securities that were not, when issued, of the same class as securities listed on a U.S. securities exchange or quoted on a U.S. automated interdealer quotation system are eligible for resale under Rule 144A. Also, the seller and a prospective purchaser designated by the seller must have the right to obtain from the issuer, upon request, certain information on the issuer, unless the issuer falls within specified categories as to which this condition does not apply.

[29] 15 U.S.C. 77d(a)(1).

[30] See Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Release No. 33-6862 (Apr. 23, 1990) [55 FR 17933 (Apr. 30, 1990)].

Rule 144A to facilitate capital-raising by issuers.[31] The term "Rule 144A offering" in this release refers to a primary offering of securities by an issuer to one or more financial intermediaries – commonly known as the "initial purchasers" – in a transaction that is exempt from registration pursuant to Section 4(a)(2) or Regulation S under the Securities Act,[32] followed by the resale of those securities by the initial purchasers to QIBs in reliance on Rule 144A.

Rule 506 offerings and Rule 144A offerings are widely used by U.S. and non-U.S. issuers to raise capital. In 2012, the estimated amount of capital (including both equity and debt) reported as being raised in Rule 506 offerings and non-asset-backed securities ("non-ABS") Rule 144A offerings by operating companies was $173 billion and $636 billion, respectively, and by pooled investment funds, such as venture capital funds, private equity funds and hedge funds, was $725 billion and $4 billion, respectively, compared to $1.2 trillion raised in registered offerings.[33] In 2011, the

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[31] While Rule 144A applies to resales of securities of both U.S. and non-U.S. issuers, one of the objectives of Rule 144A was to make primary offerings of non-U.S. issuers' securities available to U.S. institutions in the U.S. market through intermediaries (rather than compelling such investors to go to overseas markets) by making the private offering market in the United States more attractive to non-U.S. issuers. See Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Release No. 33-6806 (Oct. 25, 1988) [53 FR 44016 (Nov. 1, 1988)].

[32] Regulation S under the Securities Act [17 CFR 230.901 through 230.905] was adopted in 1990 as a safe harbor from the registration requirements of the Securities Act for any offer or sale of securities made outside the United States. It provides that any "offer," "offer to sell," "sell," "sale" or "offer to buy" that occurs outside the United States is not subject to the registration requirements of Section 5. Regulation S does not affect the scope or availability of the antifraud or other provisions of the Securities Act to offers and sales made in reliance on Regulation S.

[33] These statistics are based on a review of Form D electronic filings with the Commission – specifically, the "total amount sold" as reported in the filings – and data regarding other types of offerings (e.g., public debt offerings and Rule 144A offerings) from Securities Data Corporation's New Issues database (Thomson Financial). See Vladimir Ivanov and Scott Bauguess, Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009-2012 (July 2013) (the "Ivanov/Bauguess Study"), available at: http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf. For non-ABS Rule 144A offerings, since the databases we used to obtain the Rule 144A data do not distinguish between operating companies and funds, we classified issuers with SIC codes between 6200 and 6299 as funds, and the rest as operating companies.

estimated amount of capital (including both equity and debt) reported as being raised in Rule 506 offerings and non-ABS Rule 144A offerings by operating companies was $71 billion and $438 billion, respectively, and by pooled investment funds was $778 billion and $4 billion, respectively, compared to $985 billion raised in registered offerings.[34] These data points underscore the importance of the Rule 506 and Rule 144A exemptions for issuers seeking access to the U.S. capital markets.

To implement Section 201(a) of the JOBS Act, we proposed amending Rule 506 to add new paragraph (c), under which the prohibition against general solicitation contained in Rule 502(c) would not apply, provided that all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that such purchasers are accredited investors. In addition, we proposed amending Form D, which is a notice required to be filed with the Commission by each issuer claiming a Regulation D exemption, to add a check box to indicate whether an issuer is claiming an exemption under Rule 506(c). We also proposed an amendment to Rule 144A to provide that securities sold pursuant to Rule 144A may be offered to persons other than QIBs, including by means of general solicitation, provided that the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs.

The amount of capital raised through offerings under Regulation D may be larger than what is reported in Form D filings because, although the filing of a Form D is a requirement of Rule 503(a) of Regulation D [17 CFR 230.503(a)], it is not a condition to the availability of the exemptions under Regulation D. Further, once a Form D is filed, the issuer is not required to file an amendment to the filing to reflect a change that occurs after the offering terminates or a change that occurs solely with respect to certain information, such as the amount sold in the offering. For example, if the amount sold does not result in an increase in the total offering amount of more than 10% or the offering closes within a year, the filing of an amendment to the initial Form D is not required. Therefore, a Form D filed for a particular offering may not reflect the total amount of securities sold in the offering in reliance on the exemption.

[34] See id.

The comment period for the proposed rule and form amendments closed on October 5, 2012. We received over 225 comment letters on the Proposing Release, including from professional and trade associations, investor organizations, law firms, investment companies and investment advisers, members of Congress, the Commission's Investor Advisory Committee,[35] state securities regulators, issuers, individuals and other interested parties. Most of the comment letters focused on the proposed amendments to Rule 506. As discussed below, commenters were sharply divided in their views on the proposed amendments to Rule 506, whereas commenters generally supported the proposed amendments to Rule 144A and Form D.

We have reviewed and considered all of the comments that we received on the proposed rule and form amendments and on Section 201(a) of the JOBS Act.[36] We are adopting new paragraph (c) to Rule 506 as proposed, with one modification, and the amendments to Form D and to Rule 144A as proposed. We are also adopting the technical and conforming rule amendments as proposed. We discuss these amendments in detail below.

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[35] The SEC Investor Advisory Committee ("Investor Advisory Committee") was established in April 2012 pursuant to Section 911 of the Dodd-Frank Wall Street Reform and Consumer Protection Act [Pub. L. No. 111-203, § 911, 124 Stat. 1376, 1822 (July 21, 2010)] (the "Dodd-Frank Act") to advise the Commission on regulatory priorities, the regulation of securities products, trading strategies, fee structures, the effectiveness of disclosure, initiatives to protect investor interests and to promote investor confidence and the integrity of the securities marketplace. The Dodd-Frank Act authorizes the Investor Advisory Committee to submit findings and recommendations for review and consideration by the Commission.

[36] To facilitate public input on JOBS Act rulemaking before the issuance of rule proposals, the Commission invited members of the public to make their views known on various JOBS Act initiatives in advance of any rulemaking by submitting comment letters to the Commission's website at http://www.sec.gov/spotlight/jobsactcomments.shtml. The comment letters relating to Section 201(a) of the JOBS Act submitted in response to this invitation are located at http://www.sec.gov/comments/jobs-title-ii/jobs-title-ii.shtml. The comment letters submitted in response to the Proposing Release are located at http://www.sec.gov/comments/s7-07-12/s70712.shtml. Many commenters submitted comment letters both before and after the issuance of the Proposing Release. Dated comment letters refer to those submitted before the issuance of the Proposing Release or by commenters that submitted multiple letters.

We acknowledge the concerns of some commenters that the elimination of the prohibition against general solicitation for a subset of Rule 506 offerings may affect the behavior of issuers and other market participants in ways they believe could compromise investor protection.[37] Preserving the integrity of the Rule 506(c) market and minimizing the incidence of fraud are critical objectives for the Commission in implementing Section 201(a) of the JOBS Act. We are adopting today the bad actor disqualification for Rule 506 offerings mandated by the Dodd-Frank Act, which may address some of those concerns.[38] We are also issuing a proposing release to amend Regulation D and Form D to enhance the Commission's ability to analyze the Rule 506 market and to amend Rule 156 under the Securities Act to provide guidance to private funds on the application of the antifraud provisions of the federal securities laws to their sales literature.[39] Upon the effectiveness of Rule 506(c), the Commission staff will monitor developments in the market for Rule 506(c) offerings so as to be able to undertake a review of market practices in Rule 506(c) offerings, including the steps taken by issuers and other market participants to verify that the purchasers of the offered securities are accredited investors, as well as the impact of the amendments to Rule 506 on capital formation.

II. FINAL AMENDMENTS TO RULE 506 AND FORM D

A. Eliminating the Prohibition Against General Solicitation

Section 4(a)(2) of the Securities Act exempts transactions by an issuer "not

[37] See, e.g., letters from Investor Advisory Committee; North American Securities Administrators Association, Inc. ("NASAA"); Consumer Federation of America ("Consumer Federation").

[38] Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Release No. 33-9414 (July 10, 2013) (the "Bad Actor Release").

[39] See Amendments to Regulation D, Form D and Rule 156 under the Securities Act, Release No. 33-9416 (July 10, 2013).

involving any public offering." An issuer relying on Section 4(a)(2) is restricted in its ability to make public communications to attract investors for its offering because public advertising is incompatible with a claim of exemption under Section 4(a)(2).[40] As noted above, Rule 506 currently conditions the availability of the safe harbor under Section 4(a)(2) on the issuer, or any person acting on its behalf, not offering or selling securities through any form of general solicitation.[41] Section 201(a)(1) of the JOBS Act directs the Commission to amend Rule 506 to provide that the prohibition against general solicitation contained in Rule 502(c) shall not apply to offers and sales of securities made pursuant to Rule 506, as so amended, provided that all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify their status as accredited investors.

This mandate affects only Rule 506, and not Section 4(a)(2) offerings in general,[42] which means that even after the effective date of Rule 506(c), an issuer relying on Section 4(a)(2) outside of the Rule 506(c) exemption will be restricted in its ability to make public communications to solicit investors for its offering because public advertising will continue to be incompatible with a claim of exemption under Section

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[40] See Non-Public Offering Exemption, Release No. 33-4552 (Nov. 6, 1962) [27 FR 11316 (Nov. 16, 1962)].

[41] See Rule 502(c) and Rule 506(b)(1) of Regulation D [17 CFR 230.506(b)(1)]. The failure to comply with Rule 502(c) is deemed to be significant to the offering as a whole, which means that an issuer cannot rely on the "insignificant deviation" relief in Rule 508 of Regulation D for violations of Rule 502(c). See Rule 508(a)(2) [17 CFR 230.508(a)(2)].

[42] In this regard, we also note that bills that would have amended Section 4(a)(2) directly, rather than requiring the Commission to amend Rule 506, to permit the use of general solicitation were introduced and considered by Congress, but were not enacted. See Access to Capital for Job Creators, H.R. 2940, 112th Cong., 1st Sess. (2011) (proposing to amend Section 4(a)(2) by adding the phrase "whether or not such transactions involve general solicitation or general advertising"); Access to Capital for Job Creators, S.1831, 112th Cong., 1st Sess. (2011) (same).

4(a)(2). We are amending Rule 500(c) of Regulation D accordingly to make this clear.[43] Congress' directive in Section 201(a)(1) of the JOBS Act, and not Section 4(a)(2) of the Securities Act or our interpretation of Section 4(a)(2), is the reason that Rule 506, "as revised pursuant to [Section 201(a)(1)], shall continue to be treated as a regulation issued under section 4[(a)](2) of the Securities Act of 1933" (emphasis added).[44] Similarly, securities issued in Rule 506(c) offerings are deemed to be "covered securities" for purposes of Section 18(b)(4)(E) of the Securities Act,[45] only by virtue of Section 201(a)(1) of the JOBS Act.

1. Proposed Rule Amendment

To implement the mandated rule change, we proposed new Rule 506(c), which would permit the use of general solicitation to offer and sell securities under Rule 506, provided that the following conditions are satisfied:

- all terms and conditions of Rule 501[46] and Rules 502(a)[47] and 502(d)[48] must be satisfied;

[43] As revised, Rule 500(c) reads as follows: "Attempted compliance with any rule in Regulation D does not act as an exclusive election; the issuer can also claim the availability of any other applicable exemption. For instance, an issuer's failure to satisfy all the terms and conditions of rule 506*(b)* (§230.506*(b)*) shall not raise any presumption that the exemption provided by section 4*(a)*(2) of the Act is not available." (additions italicized).

[44] Section 201(a)(1) of the JOBS Act.

[45] 15 U.S.C. 77r(b)(4)(E). This means that state blue sky registration requirements do not apply to securities offered or sold in Rule 506(c) offerings.

[46] Rule 501 sets forth definitions for the terms used in Regulation D, such as "accredited investor."

[47] Rule 502(a) addresses the question of integration by providing a six-month safe harbor from integration for successive Regulation D offerings and a five-factor framework to apply in cases in which the six-month safe harbor is not available.

[48] Rule 502(d) provides that, for resale purposes, securities acquired in a Regulation D offering, except as provided in Rule 504(b)(1), have the status of securities acquired in a transaction under Section 4(a)(2) of the Securities Act. Rule 144(a)(3)(ii) [17 CFR 230.144(a)(3)(ii)] defines "restricted securities" as securities "acquired from the issuer that are subject to the resale limitations of §230.502(d) under Regulation D...."

- all purchasers of securities must be accredited investors; and
- the issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors.

Offerings under proposed Rule 506(c) would not be subject to the requirement to comply with Rule 502(c), which contains the prohibition against general solicitation. While we proposed Rule 506(c) to enable issuers to use general solicitation in Rule 506 offerings, we also preserved, in current Rule 506(b), the existing ability of issuers to conduct Rule 506 offerings subject to the prohibition against general solicitation.

2. Comments on the Proposed Rule Amendment

Commenters were sharply divided in their views on the proposed amendment to Rule 506. Commenters who supported the proposed amendment to Rule 506 stated that Rule 506(c), if adopted, would assist issuers, particularly early stage and smaller issuers, in raising capital by allowing them to solicit investments from a larger pool of investors.[49] These commenters generally approved of the flexibility afforded by the manner in which we proposed to implement Rule 506(c)'s verification requirement,[50] as

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Separately, Section 201(b) of the JOBS Act added Section 4(b) of the Securities Act, which provides that "[o]ffers and sales exempt under [Rule 506 as amended pursuant to Section 201 of the JOBS Act] shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation." Thus, securities acquired under new Rule 506(c) would also meet the definition of "restricted securities" under Rule 144(a)(3)(i) [17 CFR 230.144(a)(3)(i)] ("[s]ecurities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering").

[49] See, e.g., letters from Biotechnology Industry Organization ("BIO"); National Small Business Association ("NSBA").

[50] See letters from Linklaters LLP ("Linklaters") (stating that a "straightforward, focused rule that provides issuers with the flexibility to continue to adapt to market practice is the best way to realize the spirit and intent of the Jumpstart Our Business Startups Act"); BlackRock (stating that "[o]verall, we believe that the Proposed Rule is in accordance with the intent of Congress and will facilitate the formation of capital"); Securities Regulation Committee, Business Law Section of the New York State Bar Association ("SRC of NYSBA").

further discussed below, and supported retaining, in its current form, the ability of issuers under existing Rule 506(b) to conduct Rule 506 offerings subject to the prohibition against general solicitation.[51] A number of commenters stated that they supported the availability of Rule 506(c) for private funds pursuant to the Commission's guidance in the Proposing Release.[52]

Other commenters opposed the proposed amendment to Rule 506 in its entirety or in part. Many of these commenters expressed concern that the proposed amendment, if adopted, would increase the risk of fraudulent and abusive Rule 506 offerings and asserted that additional investor safeguards are necessary under Rule 506(c).[53] A number of these commenters urged the Commission to adopt rules concerning bad actor disqualifications for Rule 506 offerings, as required by Section 926 of the Dodd-Frank Act.[54] Other commenters recommended that the Commission amend the definition of "accredited investor" by raising the income and net worth thresholds for natural persons

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[51] See, e.g., letters from the Federal Regulation of Securities Committee, Business Law Section of the American Bar Association ("ABA Fed. Reg. Comm."); Angel Capital Association ("ACA") (Sept. 27, 2012); The CrowdFund Intermediary Regulatory Advocates ("CFIRA"); Investment Program Association ("IPA"); Montgomery & Hansen, LLP ("Montgomery & Hansen"); NSBA; Committee on Securities Regulation of the New York City Bar Association ("NYCBA"); Sullivan & Cromwell LLP ("S&C"); Securities Industry and Financial Markets Association ("SIFMA") and The Financial Services Roundtable ("FSR") (Oct. 5, 2012).

[52] See, e.g., letters from BlackRock; Dukas Public Relations ("Dukas"); Forum for U.S. Securities Lawyers in London; Hedge Fund Association ("HFA"); Investment Adviser Association ("IAA"); Managed Funds Association ("MFA") (Sept. 28, 2012); NYCBA; SRC of NYSBA. In the Proposing Release, we stated that private funds that engage in general solicitation under proposed Rule 506(c) would not be precluded from relying on the exclusions from the definition of "investment company" set forth in Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act of 1940.

[53] See, e.g., letters from AARP; AFL-CIO and Americans for Financial Reform ("AFR"); Sen. Levin; CFA Institute; Council of Institutional Investors ("CII"); Consumer Federation; Fund Democracy, Inc. ("Fund Democracy"); Office of the Secretary of the Commonwealth of Massachusetts Securities Division ("Massachusetts Securities Division"); NASAA.

[54] Pub. L. No. 111-203, § 926, 124 Stat. 1376, 1851 (July 21, 2010) (to be codified at 15 U.S.C. 77d note). See, e.g., letters from AFL-CIO and AFR; Consumer Federation; Fund Democracy; Commissioner of Securities, State of Hawaii ("Hawaii Commissioner of Securities"); Investor Advisory Committee; Rep. Waters; Commissioner of Securities, State of Missouri ("Missouri Commissioner of Securities"); NASAA.

or by implementing other measures of financial sophistication.[55] Some commenters stated that the Commission should condition the availability of the Rule 506(c) exemption on the filing of Form D or require the advance filing of Form D, or both.[56] Other commenters argued that the Commission should adopt specific standards or requirements that would govern the content and/or manner of general solicitations in Rule 506(c) offerings, particularly with respect to advertising by private funds.[57] A number of commenters urged the Commission to require that the materials used to generally solicit investors in Rule 506(c) offerings be filed with or furnished to either the Commission or to FINRA.[58]

A number of commenters requested that the Commission provide transitional guidance with respect to ongoing offerings under existing Rule 506 that commenced before the effectiveness of Rule 506(c).[59] For example, in some situations, the initial closings in these offerings may have already occurred, and could have included non-accredited investors pursuant to offering procedures that would not have involved any form of general solicitation.[60] Several commenters suggested that the Commission clarify that an issuer would be entitled to conduct the portion of the offering following

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[55] See, e.g., letters from AARP; AFL-CIO and AFR; BetterInvesting; CFA Institute; Consumer Federation; Investor Advisory Committee; Investment Company Institute ("ICI"); Rep. Waters; Massachusetts Securities Division (July 2, 2012).

[56] See, e.g., letters from AARP; AFL-CIO and AFR; Consumer Federation; Hawaii Commissioner of Securities; Investor Advisory Committee; Massachusetts Securities Division (July 2, 2012); Missouri Commissioner of Securities; Commissioner of Securities and Insurance, State of Montana ("Montana Commissioner of Securities"); NASAA; Ohio Division of Securities.

[57] See, e.g., letters from Sen. Levin; Consumer Federation; ICI; Independent Directors Council ("IDC"); Rep. Waters; Montana Commissioner of Securities; NASAA.

[58] See, e.g., letters from AFL-CIO and AFR; Investor Advisory Committee; ICI; Massachusetts Securities Division (July 2, 2012).

[59] See letters from ABA Fed. Reg. Comm.; Forum for U.S. Securities Lawyers in London; S&C; IPA.

[60] See letter from ABA Fed. Reg. Comm.

the effectiveness of Rule 506(c) in accordance with the requirements of new Rule 506(c), without the portion of the offering occurring after the rule's effectiveness affecting the portion of the offering that was completed prior to the rule's effectiveness.[61]

3. Final Rule Amendment

After considering the comments, we are adopting Rule 506(c) as proposed, with one modification. Under new Rule 506(c), issuers can offer securities through means of general solicitation, provided that they satisfy all of the conditions of the exemption.[62] These conditions are:

- all terms and conditions of Rule 501 and Rules 502(a) and 502(d) must be satisfied;[63]
- all purchasers of securities must be accredited investors;[64] and
- the issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors.[65]

Issuers relying on Rule 506(c) for their offerings will not be subject to the prohibition against general solicitation found in Rule 502(c).[66] In addition and as further discussed

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[61] See letters from ABA Fed. Reg. Comm.; S&C (stating that "[w]e believe that such issuers should be allowed, upon effectiveness of the final rule, to use the new Rule 506(c) exemption and use general solicitation for the remaining portion of their offerings, provided that they satisfy the requirements of Rule 506(c) going forward.").

[62] We also note that broker-dealers participating in offerings in conjunction with issuers relying on Rule 506(c) would continue to be subject to FINRA rules regarding communications with the public, which, among other things, (1) generally require all member communications to be based on principles of fair dealing and good faith, to be fair and balanced, and to provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry or service; and (2) prohibit broker-dealers from making false, exaggerated, unwarranted, promissory or misleading statements or claims in any communications. See FINRA Rule 2210.

[63] New Rule 506(c)(1).

[64] New Rule 506(c)(2)(i).

[65] New Rule 506(c)(2)(ii).

below, in response to comments from a wide range of commenters asking for greater certainty with respect to satisfying the verification requirement, we are also including in Rule 506(c) a non-exclusive list of methods that issuers may use to verify the accredited investor status of natural persons.

Issuers will continue to have the ability under Rule 506(b) to conduct Rule 506 offerings subject to the prohibition against general solicitation. As we noted in the Proposing Release, offerings under existing Rule 506(b) represent an important source of capital for issuers of all sizes, and we believe that the continued availability of existing Rule 506(b) will be important for those issuers that either do not wish to engage in general solicitation in their Rule 506 offerings (and become subject to the requirement to take reasonable steps to verify the accredited investor status of purchasers) or wish to sell privately to non-accredited investors who meet Rule 506(b)'s sophistication requirements. Retaining the safe harbor under existing Rule 506(b) may also be beneficial to investors with whom an issuer has a pre-existing substantive relationship.[67] In this regard, we do not believe that Section 201(a) requires the Commission to modify Rule 506 to impose any new requirements on offers and sales of securities that do not involve general solicitation. Therefore, the amendment to Rule 506 we are adopting today does not amend or modify the requirements relating to existing Rule 506(b).

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[66] Offerings under Rule 506(c) will also not be subject to the information requirements in Rule 502(b) for non-accredited investors, because all purchasers in Rule 506(c) offerings are required to be accredited investors.

[67] See Release No. 33-7856, at 25852 (noting that "one method of ensuring that general solicitation is not involved is to establish the existence of a 'pre-existing, substantive relationship'" and that "there may be facts and circumstances in which a third party, other than a registered broker-dealer, could established a 'pre-existing, substantive relationship' sufficient to avoid a 'general solicitation'").

Finally, with respect to transition matters, for an ongoing offering under Rule 506 that commenced before the effective date of Rule 506(c), the issuer may choose to continue the offering after the effective date in accordance with the requirements of either Rule 506(b) or Rule 506(c). If an issuer chooses to continue the offering in accordance with the requirements of Rule 506(c), any general solicitation that occurs after the effective date will not affect the exempt status of offers and sales of securities that occurred prior to the effective date in reliance on Rule 506(b).

B. Reasonable Steps to Verify Accredited Investor Status

Section 201(a)(1) of the JOBS Act mandates that our amendment to Rule 506 require issuers using general solicitation in Rule 506 offerings "to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission." As noted in the Proposing Release, we believe that the purpose of the verification mandate is to address concerns, and reduce the risk, that the use of general solicitation in Rule 506 offerings could result in sales of securities to investors who are not, in fact, accredited investors.[68]

1. Proposed Rule Amendment

To implement the verification mandate of Section 201(a)(1), we proposed to condition the Rule 506(c) exemption on the requirement that issuers using general solicitation "take reasonable steps to verify" that the purchasers of the offered securities are accredited investors. As proposed, whether the steps taken are "reasonable" would be

[68] See, e.g., Markup of H.R. 2940, Access to Capital for Job Creators Act, Subcommittee on Capital Markets and Government Sponsored Enterprises, House Financial Services Committee, 112th Cong. (Oct. 5, 2011) (remarks of Rep. Waters, explaining that she is introducing the amendment that requires issuers to take reasonable steps to verify accredited investor status because "we must take steps to ensure that those folks are indeed sophisticated"); 157 Cong. Rec. H7291 (daily ed. Nov. 3, 2011) (remarks of Rep. Maloney (same)); 157 Cong. Rec. H7294 (daily ed. Nov. 3, 2011) (remarks of Rep. Lee (same)).

an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction. Under this principles-based approach, issuers would consider a number of factors when determining the reasonableness of the steps to verify that a purchaser is an accredited investor, such as:

- the nature of the purchaser and the type of accredited investor that the purchaser claims to be;
- the amount and type of information that the issuer has about the purchaser; and
- the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.

These factors would be interconnected, and the information gained by looking at these factors would help an issuer assess the reasonable likelihood that a potential purchaser is an accredited investor, which would, in turn, affect the types of steps that would be reasonable to take to verify a purchaser's accredited investor status.

In the Proposing Release, we considered providing a list of specified methods for satisfying the verification requirement, which was suggested by some commenters on Section 201(a) prior to the issuance of the Proposing Release.[69] We expressed concern

[69] See letters from MFA (June 26, 2012) (suggesting that the Commission publish a non-exclusive list of the types of third-party evidence that an investor could provide to establish accredited investor status, in conjunction with certifying that he or she is an accredited investor); NASAA (July 3, 2012) (recommending that the Commission set forth non-exclusive safe harbors to specify the types of actions that would be deemed "reasonable steps to verify" for three types of accredited investors: natural persons who purport to satisfy the income test; natural persons who purport to satisfy the net worth test; and entities who purport to meet one of the other tests set forth in Rule 501(a)).

that, in designating such a list – for example, by setting forth particular types of information that issuers may rely upon as conclusive means of verifying accredited investor status – there may be circumstances where such information will not actually verify accredited investor status or where issuers may unreasonably overlook or disregard other information indicating that a purchaser is not, in fact, an accredited investor. Also, we were concerned that requiring issuers to use specified methods of verification would be impractical, burdensome and potentially ineffective in light of the numerous ways in which a purchaser can qualify as an accredited investor, as well as the potentially wide range of verification issues that may arise, depending on the nature of the purchaser and the facts and circumstances of a particular Rule 506(c) offering. Even if the list of specified methods was not mandatory, but rather, constituted a non-exclusive list, we were concerned that a non-exclusive list of specified methods could be viewed by market participants as, in effect, required methods, in which compliance with at least one of the enumerated methods could be viewed as necessary in all circumstances to demonstrate that the verification requirement has been satisfied, thereby eliminating the flexibility that proposed Rule 506(c) was intended to provide.

We requested comment in the Proposing Release on our proposed principles-based method and its effectiveness in limiting sales of securities in Rule 506(c) offerings to only accredited investors. We also requested comment on possible alternative approaches for implementing the verification mandate of Section 201(a)(1), such as a rule that specifies mandatory methods for verifying accredited investor status or a non-exclusive list of verification methods that would function as a safe harbor for compliance with the verification requirement.

2. Comments on the Proposed Rule Amendment

Commenters expressed a wide range of views on the proposed approach to the verification requirement in Rule 506(c). Some commenters commended the Commission for proposing a flexible, principles-based standard for verification.[70] For example, one commenter stated that the Commission's proposed approach would provide issuers with the flexibility to develop tailored, reliable and cost-effective procedures for verification.[71] A number of commenters stated that the discussion in the Proposing Release of the factors that issuers may take into account in verifying accredited investor status would assist issuers in assessing the reasonableness of their verification processes.[72] Other commenters asserted that not requiring issuers to use certain specified methods to verify a purchaser's accredited investor status would permit advancements in verification methods over time.[73] Some commenters expressed support for the Commission's proposal that accredited investor status may be verified through an attestation or certification by a third party, provided that the issuer has a reasonable basis to rely on such third-party verification.[74]

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[70] See, e.g., letters from HFA; MFA (Sept. 28, 2012); BIO; ABA Fed. Reg. Comm.; IAA; Linklaters; NYCBA; SRC of NYSBA; SIFMA and FSR (Oct. 5, 2012); Artivest Holdings, Inc. ("Artivest").

[71] See letter from SIFMA and FSR (Oct. 5, 2012).

[72] See, e.g., letters from SRC of NYSBA; S&C; SIFMA and FSR (Oct. 5, 2012); IAA.

[73] See letters from ACA (Sept. 27, 2012); CFIRA.

[74] See, e.g., letters from IAA; SIFMA and FSR (Oct. 5, 2012); Tannenbaum Helpern Syracuse & Hirschtritt LLP ("Tannenbaum Helpern"). A number of commenters noted that the availability of third-party verification could address investors' privacy and security concerns in providing information to an issuer. See, e.g., letters from L. Neumann; NSBA. One commenter urged the Commission not to limit third-party verification providers to certain types of entities. See letter from Tannenbaum Helpern. One commenter suggested the possibility of requiring investors to self-certify as to accredited investor status under penalty of perjury. See letter from NSBA.

Other commenters opposed the Commission's proposed approach, for various reasons. A number of these commenters opposed the proposed verification standard because, in their view, self-certification by itself should be sufficient to satisfy the verification requirement.[75] Some commenters opposed the proposed verification standard because it did not prescribe specific verification methods, which they believed is required in order to satisfy the verification mandate in Section 201(a).[76] One commenter stated that the Commission should deem the verification requirement to be satisfied if all purchasers in a Rule 506(c) offering are in fact accredited investors.[77] Another commenter stated that verification of accredited investor status should not be a condition of the Rule 506(c) exemption when the purchaser is actually an accredited investor.[78]

Commenters expressed differing views on whether the Commission should include a non-exclusive list of methods in proposed Rule 506(c) for satisfying the verification requirement. Many commenters, encompassing a wide range of perspectives (e.g., state government officials, law firms, investor organizations, professional and trade associations, and individuals), urged the Commission to provide such a non-exclusive list.[79] A number of these commenters cited the lack of legal certainty that the verification

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[75] See, e.g., letters from C. Hague; G. Brooks; Golenbock Eiseman Assor Bell & Peskoe LLP; P. Christenson; W. Johnson.

[76] See, e.g., letters from AFL-CIO and AFR; Sen. Levin; Consumer Federation; Fund Democracy; Rep. Waters; Massachusetts Securities Division; The Options Clearing Corporation ("OCC"); Ohio Division of Securities.

[77] See letter from IPA.

[78] See letter from S. Keller.

[79] See, e.g., letters from ACA (Sept. 27, 2012 and Dec. 11, 2012); BIO; CFIRA; HFA; Hawaii Commissioner of Securities; IAA; Investor Advisory Committee (stating that the "facts and circumstances" based approach proposed by the Commission does not do enough either to ensure only accredited investors purchase in the offering or to provide issuers with the certainty they need to develop appropriate procedures); J. McLaughlin; MFA (Sept. 28, 2012); Montana Commissioner of Securities; NASAA; Tufts

requirement has been satisfied in any given situation as the reason why, in their view, the Commission should include a non-exclusive list of verification methods in Rule 506(c).[80] In contrast, other commenters stated that the Commission should not include a non-exclusive list of verification methods in Rule 506(c), arguing that such a list could be viewed by market participants as the required verification methods, which would thereby undermine the flexibility of the Commission's proposed approach.[81]

If there were to be a non-exclusive list of verification methods, commenters expressed a range of views on what should be included in such a list, such as verification by certain third parties or through tax returns and third-party documentary proof such as Forms W-2, Forms 1099, bank statements, brokerage account statements, tax assessment valuations and appraisal reports.[82] With respect to the types of third parties that could provide verification services, commenters named registered brokers-dealers,[83] banks and other financial institutions,[84] registered investment advisers,[85] certified financial planners,[86] attorneys,[87] and accountants.[88] Other commenters suggested including in a

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Stephenson & Kasper, LLP; Nevada Securities Division; OCC; Ohio Division of Securities; Pepper Hamilton LLP ("Pepper Hamilton"); Plexus Consulting Group, LLC ("Plexus Consulting Group"); Small Business Investor Association ("SBIA"); South Carolina Securities Commissioner; Virginia Division of Securities.

80 See, e.g., letters from ACA (Sept. 27, 2012 and Dec. 11, 2012); HFA; Investor Advisory Committee; OCC.

81 See, e.g., letters from ABA Fed. Reg. Comm.; Artivest; BlackRock; S&C; SIFMA and FSR (Oct. 5, 2012).

82 See, e.g., letters from B. Methven; L. Neumann; NASAA.

83 See, e.g., letters from Massachusetts Securities Division (July 2, 2012); J. McLaughlin; NASAA; OCC; Pepper Hamilton; Plexus Consulting Group; SBIA.

84 See letter from Massachusetts Securities Division (July 2, 2012).

85 See, e.g., letters from Plexus Consulting Group; SBIA.

86 See, e.g., letters from Plexus Consulting Group; NSBA (stating that "if there must be some kind of enhanced verification, we recommend that a certification by the investor's attorney, CPA, certified financial advisor or other licensed professional should be sufficient").

non-exclusive list of verification methods self-certification, plus a minimum investment amount such as $25,000,[89] $100,000,[90] $250,000,[91] $500,000[92] or $1,000,000.[93]

In contrast, one commenter argued that the ability to satisfy a minimum investment amount would not necessarily mean a person is an accredited investor, but rather, that the investor could be "over-concentrated in the investment."[94] Another commenter stated that the verification requirement should not be deemed satisfied simply because an issuer possesses general information about the average compensation in the investor's profession or workplace.[95]

Several commenters stated that there should be a "grandfather" provision from the verification mandate for an issuer's existing investors who purchased securities in a Rule 506(b) offering prior to the effective date of Rule 506(c),[96] and one commenter proposed to limit the scope of any grandfather provision to only existing accredited investors.[97]

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87 Id.

88 Id.

89 See letter from Montgomery & Hansen.

90 See letters from B. Methven; SBIA (provided the issuer is a small business investment company ("SBIC") or a fund that has been authorized to apply to be an SBIC by the U.S. Small Business Administration).

91 See letter from J. Joseph (stating that "[s]ome may feel that that number is $25,000, perhaps $100,000 but certainly at $250,000 there should be no question that the investor is properly qualified and accredited").

92 See letter from MFA (Sept. 28, 2012) (stating that "[i]n considering the appropriate minimum investment level, we have previously recommended a minimum investment level of 50% of the accredited investor net worth or total asset thresholds, currently $500,000 for an individual, and $2,500,000 for an entity.").

93 See letter from Pepper Hamilton.

94 Letter from Massachusetts Securities Division (July 2, 2012).

95 See letter from NASAA.

96 See letters from MFA (Sept. 28, 2012); IAA; Tannenbaum Helpern.

97 See letter from Pepper Hamilton.

Two of these commenters reasoned that, as issuers are prohibited from engaging in general solicitation activities in Rule 506(b) offerings, their existing investors did not purchase securities in offerings that used general solicitation, and any future investments by these investors would be based on their pre-existing relationship with the issuers, and not as a result of general solicitation.[98] Therefore, a grandfather provision would be appropriate because the purpose of the verification mandate in Section 201(a) of the JOBS Act is to require the verification of the accredited investor status of only prospective purchasers who come to the issuer "as a result of" the issuer's general solicitation activities.[99] One commenter stated that, for existing investors, a "reaffirmation representation" of accredited investor status received shortly before or simultaneously with any subsequent investment should be sufficient for Rule 506(c) purposes.[100]

3. Final Rule Amendment

After considering the comments and as directed by Section 201(a) of the JOBS Act, we are adopting as a condition of new Rule 506(c) the requirement that issuers take "reasonable steps to verify" that purchasers of the offered securities are accredited investors. This requirement is separate from and independent of the requirement that sales be limited to accredited investors, and must be satisfied even if all purchasers happen to be accredited investors.[101] We are also including in Rule 506(c) a non-

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[98] See letters from MFA (Sept. 28, 2012); Tannenbaum Helpern.

[99] See letter from Tannenbaum Helpern.

[100] See letter from Pepper Hamilton.

[101] This will avoid diminishing the incentive for issuers to undertake the reasonable verification steps envisioned by the statute.

exclusive list of methods that issuers may use to satisfy the verification requirement. As discussed above, a number of commenters urged the Commission to provide greater certainty for issuers that the verification requirement has been satisfied by providing a non-exclusive list of methods for verifying the accredited investor status of purchasers in Rule 506(c) offerings. Upon further consideration, we have concluded that a general requirement that issuers take "reasonable steps to verify" that the purchasers are accredited investors, combined with a non-exclusive list of verification methods that are deemed to meet this requirement, would maintain the flexibility of the verification standard while providing additional clarity and certainty that this requirement has been satisfied if one of the specified methods is used. We have specified methods for verifying the accredited investor status of natural persons because we believe that the potential for uncertainty and the risk of participation by non-accredited investors is highest in offerings involving natural persons as purchasers.

a. Principles-Based Method of Verification

Under Rule 506(c), issuers are required to take reasonable steps to verify the accredited investor status of purchasers. Consistent with the Proposing Release, whether the steps taken are "reasonable" will be an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction. Among the factors that issuers should consider under this facts and circumstances analysis are:

- the nature of the purchaser and the type of accredited investor that the purchaser claims to be;
- the amount and type of information that the issuer has about the purchaser; and

- the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.

As noted in the Proposing Release, these factors are interconnected and are intended to help guide an issuer in assessing the reasonable likelihood that a purchaser is an accredited investor – which would, in turn, affect the types of steps that would be reasonable to take to verify a purchaser's accredited investor status. After consideration of the facts and circumstances of the purchaser and of the transaction, the more likely it appears that a purchaser qualifies as an accredited investor, the fewer steps the issuer would have to take to verify accredited investor status, and vice versa. For example, if the terms of the offering require a high minimum investment amount and a purchaser is able to meet those terms, then the likelihood of that purchaser satisfying the definition of accredited investor may be sufficiently high such that, absent any facts that indicate that the purchaser is not an accredited investor, it may be reasonable for the issuer to take fewer steps to verify or, in certain cases, no additional steps to verify accredited investor status other than to confirm that the purchaser's cash investment is not being financed by a third party.

Regardless of the particular steps taken, because the issuer has the burden of demonstrating that its offering is entitled to an exemption from the registration requirements of Section 5 of the Securities Act,[102] it will be important for issuers and

[102] SEC v. Ralston Purina, 346 U.S. 119, 126 (1953) ("Keeping in mind the broadly remedial purposes of federal securities legislation, imposition of the burden of proof on an issuer who would plead the exemption seems to us fair and reasonable.").

their verification service providers to retain adequate records regarding the steps taken to verify that a purchaser was an accredited investor.

Nature of the Purchaser. In determining the reasonableness of the steps to verify accredited investor status, an issuer should consider the nature of the purchaser of the offered securities. The definition of "accredited investor" in Rule 501(a) includes natural persons and entities that come within any of eight enumerated categories in the rule, or that the issuer reasonably believes come within one of those categories, at the time of the sale of securities to that natural person or entity. Some purchasers may be accredited investors based on their status, such as:

- a broker or dealer registered pursuant to Section 15 of the Securities Exchange Act of 1934 (the "Exchange Act");[103] or
- an investment company registered under the Investment Company Act of 1940 (the "Investment Company Act") or a business development company as defined in Section 2(a)(48) of that Act.[104]

Some purchasers may be accredited investors based on a combination of their status and the amount of their total assets, such as:

- a plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5 million;[105] or

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[103] See 17 CFR 230.501(a)(1).

[104] See id.

[105] See id.

- an Internal Revenue Code ("IRC") Section 501(c)(3) organization, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5 million.[106]

Natural persons may be accredited investors based on either their net worth or their annual income, as follows:

- a natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1 million, excluding the value of the person's primary residence;[107] or
- a natural person who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year.[108]

As Rule 501(a) sets forth different categories of accredited investors, an issuer should recognize that the steps that will be reasonable to verify whether a purchaser is an accredited investor will vary depending on the type of accredited investor that the purchaser claims to be. For example, the steps that may be reasonable to verify that an entity is an accredited investor by virtue of being a registered broker-dealer – such as by going to FINRA's BrokerCheck website[109] – will necessarily differ from the steps that may be reasonable to verify whether a natural person is an accredited investor.

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[106] See 17 CFR 230.501(a)(3).

[107] See 17 CFR 230.501(a)(5).

[108] See 17 CFR 230.501(a)(6).

[109] This website is available at: http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/.

As we stated in the Proposing Release, the verification of natural persons as accredited investors may pose greater practical difficulties as compared to other categories of accredited investors, particularly for natural persons claiming to be accredited investors based on the net worth test. These practical difficulties likely will be exacerbated by privacy concerns about the disclosure of personal financial information. As between the net worth test and the income test for natural persons, we recognize that commenters have suggested that it might be more difficult for an issuer to obtain information about the assets and liabilities that determine a person's net worth – particularly the liabilities – than it would be to obtain information about a person's annual income,[110] although there could be privacy concerns with respect to either test. The question of what type of information would be sufficient to constitute reasonable steps to verify accredited investor status under the particular facts and circumstances will also depend on other factors, as described below.

Information about the Purchaser. The amount and type of information that an issuer has about a purchaser can also be a significant factor in determining what additional steps would be reasonable to take to verify the purchaser's accredited investor status. The more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it may have to take, and vice versa.[111] Examples of the types of information that issuers could review or rely upon – any of which might,

[110] See letters from NASAA (stating that "[v]erification of net worth is more challenging because an individual could provide proof of assets but not liabilities."); P. Sigelman (Sept. 28, 2012).

[111] If an issuer has actual knowledge that the purchaser is an accredited investor, then the issuer will not have to take any steps at all.

depending on the circumstances, in and of themselves constitute reasonable steps to verify a purchaser's accredited investor status – include, without limitation:

- publicly available information in filings with a federal, state or local regulatory body – for example, without limitation:
  - the purchaser is a named executive officer of an Exchange Act registrant, and the registrant's proxy statement discloses the purchaser's compensation; or
  - the purchaser claims to be an IRC Section 501(c)(3) organization with $5 million in assets, and the organization's Form 990 series return filed with the Internal Revenue Service discloses the organization's total assets;[112]
- third-party information that provides reasonably reliable evidence that a person falls within one of the enumerated categories in the accredited investor definition – for example, without limitation:
  - the purchaser is a natural person and provides copies of pay stubs for the two most recent years and the current year; or
  - specific information about the average compensation earned at the purchaser's workplace by persons at the level of the purchaser's seniority is publicly available; or

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[112] Such an organization is required to make the Form 990 series returns available for public inspection. See Internal Revenue Service, Public Disclosure and Availability of Exempt Organizations Returns and Applications: Documents Subject to Public Disclosure, available at: http://www.irs.gov/Charities-&-Non-Profits/Public-Disclosure-and-Availability-of-Exempt-Organizations-Returns-and-Applications:-Documents-Subject-to-Public-Disclosure (last reviewed or updated April 28, 2013).

- verification of a person's status as an accredited investor by a third party, provided that the issuer has a reasonable basis to rely on such third-party verification.[113]

Nature and Terms of the Offering. The nature of the offering – such as the means through which the issuer publicly solicits purchasers – may be relevant in determining the reasonableness of the steps taken to verify accredited investor status. An issuer that solicits new investors through a website accessible to the general public, through a widely disseminated email or social media solicitation, or through print media, such as a newspaper, will likely be obligated to take greater measures to verify accredited investor status than an issuer that solicits new investors from a database of pre-screened accredited investors created and maintained by a reasonably reliable third party. We believe that an issuer will be entitled to rely on a third party that has verified a person's status as an accredited investor, provided that the issuer has a reasonable basis to rely on such third-party verification. We do not believe that an issuer will have taken reasonable steps to verify accredited investor status if it, or those acting on its behalf, required only

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[113] For example, in the future, services may develop that verify a person's accredited investor status for purposes of new Rule 506(c) and permit issuers to check the accredited investor status of possible investors, particularly for web-based Rule 506 offering portals that include offerings for multiple issuers. This third-party service, as opposed to the issuer itself, could obtain appropriate documentation or otherwise take reasonable steps to verify accredited investor status. Several commenters, in fact, have recommended that the Commission take action to facilitate the ability of issuers to rely on third parties to perform the necessary verification. See letters from NASAA (July 3, 2012) (recommending that the Commission allow an issuer to obtain the necessary verification through registered broker-dealers, provided that there are independent liability provisions for failure to adequately perform the verification); Massachusetts Securities Division (July 2, 2012) (urging the Commission to adopt as a safe harbor or best practice the use of an independent party, such as a broker-dealer, bank, or other financial institution, that would verify the accredited investor status of purchasers). One commenter, however, expressed concerns that some of the websites that currently offer lists of accredited investors could be used to facilitate fraud, noting that some offer lists based on "ethnicity, gender, and lifestyle – presumably to make [it] easier for scammers to relate to marks – and ominously, 'seniors.'" Letter from I. Moscovitz and J. Maxfield (June 27, 2012).

that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status.

The terms of the offering will also affect whether the verification methods used by the issuer are reasonable. We continue to believe that there is merit to the view that a purchaser's ability to meet a high minimum investment amount could be a relevant factor to the issuer's evaluation of the types of steps that would be reasonable to take in order to verify that purchaser's status as an accredited investor. By way of example, the ability of a purchaser to satisfy a minimum investment amount requirement that is sufficiently high such that only accredited investors could reasonably be expected to meet it, with a direct cash investment that is not financed by the issuer or by any third party, could be taken into consideration in verifying accredited investor status.

Commenters suggested a number of alternative approaches to implementing the verification mandate. Some commenters urged us to adopt a requirement that prescribes specific methods of verification that issuers must use, either because they believed such methods are needed for issuers seeking clarity on how to comply with this condition of Rule 506(c)[114] or because they believed that such methods are needed to maintain investor protection.[115] We have decided not to take such an approach. As we stated in the Proposing Release, we believe that, at present, requiring issuers to use specified methods of verification will be impractical and potentially ineffective in light of the numerous ways in which a purchaser can qualify as an accredited investor, as well as the potentially wide range of verification issues that may arise, depending on the nature of

[114] See, e.g., letter from Handler Thayer, LLP.

[115] See, e.g., letters from AARP; CII.

the purchaser and the facts and circumstances of a particular Rule 506(c) offering. We are also concerned that a prescriptive rule that specifies required verification methods could be overly burdensome in some cases, by requiring issuers to follow the same steps, regardless of their particular circumstances, and ineffective in others, by requiring steps that, in the particular circumstances, would not actually verify accredited investor status.

We believe that the approach we are adopting appropriately addresses the concerns underlying the verification mandate by obligating issuers to take reasonable steps to verify that the purchasers are accredited investors, but not requiring them to follow uniform verification methods that may be ill-suited or unnecessary to a particular offering or purchaser in light of the facts and circumstances. We also expect that such an approach will give issuers and market participants the flexibility to adopt different approaches to verification depending on the circumstances, to adapt to changing market practices, and to implement innovative approaches to meeting the verification requirement, such as the development of reliable third-party databases of accredited investors and verification services. In addition, we anticipate that many practices currently used by issuers in connection with existing Rule 506 offerings will satisfy the verification requirement for offerings pursuant to Rule 506(c).

b. Non-Exclusive Methods of Verifying Accredited Investor Status

In addition to adopting a principles-based method of verification, we are including in Rule 506(c) four specific non-exclusive methods of verifying accredited investor status for natural persons that, if used, are deemed to satisfy the verification requirement in Rule 506(c); provided, however, that none of these methods will be deemed to satisfy the verification requirement if the issuer or its agent has knowledge that the purchaser is not an accredited investor.[116] While the principles-based method of verification is intended to provide an issuer with the flexibility to address the particular facts and circumstances surrounding its offering, we appreciate the view of some commenters that the final rule should include a non-exclusive list of specific verification methods for natural persons that may be relied upon by those issuers seeking greater certainty that they satisfy the rule's verification requirement.[117] Accordingly, we are adding a non-exclusive list of specific verification methods to supplement our principles-based framework for verifying accredited investor status.[118] Issuers are not required to use any of the methods discussed below, and can apply the reasonableness standard directly to the specific facts and circumstances presented by the offering and the investors.[119]

First, in verifying whether a natural person is an accredited investor on the basis of income, an issuer is deemed to satisfy the verification requirement in Rule 506(c) by reviewing copies of any Internal Revenue Service ("IRS") form that reports income, including, but not limited to, a Form W-2 ("Wage and Tax Statement"), Form 1099 (report of various types of income), Schedule K-1 of Form 1065 ("Partner's Share of Income, Deductions, Credits, etc."), and a copy of a filed Form 1040 ("U.S. Individual

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[116] Because an issuer must have a reasonable belief that the purchaser is an accredited investor, the issuer could not form such reasonable belief if it has knowledge that the purchaser is not an accredited investor. See Section II.C of this release for a discussion of the reasonable belief standard in the definition of accredited investor in Rule 501(a).

[117] See, e.g., letters from ACA (Sept. 27, 2012 and Dec. 11, 2012); Investor Advisory Committee; MFA (Sept. 28, 2012).

[118] Information and documentation collected for these verification purposes may be subject to federal and/or state privacy and data security requirements. See, e.g., Regulation S-P [17 CFR 248.1 - 248.30] (implementing notice requirements and restrictions on a financial institution's ability to disclose nonpublic personal information about customers); Privacy of Consumer Financial Information (Regulation S-P), Release No. 34-42974 (June 22, 2000) [65 FR 40334 (June 29, 2000)].

[119] We expect that many issuers will conduct Rule 506(c) offerings in reliance on the principles-based method of verification, in light of its flexibility and efficiency.

Income Tax Return"),[120] for the two most recent years, along with obtaining a written representation from such person that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year. In the case of a person who qualifies as an accredited investor based on joint income with that person's spouse, an issuer would be deemed to satisfy the verification requirement in Rule 506(c) by reviewing copies of these forms for the two most recent years in regard to, and obtaining written representations from, both the person and the spouse.

Second, in verifying whether a natural person is an accredited investor on the basis of net worth, an issuer is deemed to satisfy the verification requirement in Rule 506(c) by reviewing one or more of the following types of documentation, dated within the prior three months,[121] and by obtaining a written representation from such person that all liabilities necessary to make a determination of net worth have been disclosed. In the case of a person who qualifies as an accredited investor based on joint net worth with that person's spouse, an issuer would be deemed to satisfy the verification requirement in Rule 506(c) by reviewing such documentation in regard to, and obtaining representations from, both the person and the spouse. For assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by independent third parties are deemed to be satisfactory; and

[120] A person could provide a redacted version of an Internal Revenue Service form so as to disclose only information about annual income and to avoid disclosure of personally identifiable information, such as a Social Security number, or other information that would not be relevant to the determination of a person's annual income.

[121] A person could provide redacted versions of these documents so as to disclose only information about the amounts of assets and liabilities and to avoid disclosure of personally identifiable information, such as a Social Security number, or other information that would not be relevant to the determination of a person's net worth.

for liabilities: a consumer report (also known as a credit report) from at least one of the nationwide consumer reporting agencies is required.[122] Commenters did not provide examples of any other type of documentation that would, in our view, adequately evidence liabilities.[123] We recognize that it will be difficult for an issuer to determine whether it has a complete picture of a natural person's liabilities, and therefore, for purposes of this method, consistent with the suggestions of some commenters, we are requiring a consumer report and a written representation from such person that all liabilities necessary to make a determination of net worth have been disclosed.

Third, an issuer is deemed to satisfy the verification requirement in Rule 506(c) by obtaining a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a certified public accountant that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor.[124] While third-party confirmation by one of these parties will be deemed to satisfy the verification requirement in Rule 506(c), depending on the circumstances, an issuer may be entitled to rely on the verification of accredited investor status by a person or entity other than one of these parties, provided that any such third party takes

[122] We note that the Fair Credit Reporting Act ("FCRA") [15 U.S.C. 1681 et seq.] requires each of the nationwide consumer reporting agencies to provide a person with a free copy of his or her consumer report, upon request, once every 12 months. In addition, the FCRA permits third parties to access individual consumer reports with the written permission of the individual.

[123] One commenter suggested that the Commission "require the issuer to obtain a list of liabilities from the investor, which would include a sworn statement that all material liabilities are disclosed." Letter from NASAA. Another commenter noted that liabilities can be cross checked against UCC 1 filings, bankruptcy information on Public Access to Court Electronic Records (PACER), and credit reports. See letter from P. Sigelman (Sept. 28, 2012).

[124] For purposes of this method, a licensed attorney must be in good standing under the laws of the jurisdictions in which the attorney is admitted to practice law, and a certified public accountant must be in good standing under the laws of the place of the accountant's residence or principal office.

reasonable steps to verify that purchasers are accredited investors and has determined that such purchasers are accredited investors, and the issuer has a reasonable basis to rely on such verification.

Fourth, with respect to any natural person who invested in an issuer's Rule 506(b) offering as an accredited investor prior to the effective date of Rule 506(c) and remains an investor of the issuer, for any Rule 506(c) offering conducted by the same issuer, the issuer is deemed to satisfy the verification requirement in Rule 506(c) with respect to any such person by obtaining a certification by such person at the time of sale that he or she qualifies as an accredited investor.

We are including the first three methods in our non-exclusive list of methods that are deemed to satisfy the verification requirement in Rule 506(c) because we believe that there will likely be few instances in which they would not constitute reasonable steps to verify accredited investor status. With respect to the verification method for the income test, there are numerous penalties for falsely reporting information in an Internal Revenue Service form, and these forms are filed with the Internal Revenue Service for purposes independent of investing in a Rule 506(c) offering. Similarly, we believe that the various forms of documentation set forth in the verification method for the net worth test ordinarily are generated for reasons other than to invest in a Rule 506(c) offering (with the possible exception of appraisal reports) and, in combination with a consumer report and a written representation from the investor regarding his or her liabilities, constitute sufficiently reliable evidence that such person's net worth exceeds $1 million, excluding the value of the person's primary residence. With respect to the third-party verification method, we have included written confirmations from certain third parties in our non-exclusive list of verification methods because these third parties are subject to various regulatory and/or licensing requirements. Registered broker-dealers[125] and SEC-registered investment advisers[126] are regulated by the Commission; and in the United States, attorneys and certified public accountants are licensed at the state level and are subject to rules of professional conduct[127] as well as, to the extent they appear or practice before the Commission in any way, to the Commission's Rules of Practice.[128]

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125 Registered broker-dealers are subject to a comprehensive system of oversight by the Commission as well as FINRA. In particular, registered broker-dealers, among other things, must maintain and preserve specified books and records, develop effective supervisory policies and controls, and comply with FINRA rules regarding registration and qualification requirements for their associated persons as well as general and specific conduct rules. In addition, registered broker-dealers are subject to examinations by both FINRA and Commission staff.

126 An investment adviser must register with the Commission unless it is prohibited from registering under Section 203A of the Investment Advisers Act of 1940 [15 USC 80b-3a] (the "Advisers Act") or is exempt from registration under Advisers Act Section 203 [15 USC 80b-3]. Investment advisers that are prohibited from registering with the Commission instead may be subject to regulation by the states, but the antifraud provisions of the Advisers Act continue to apply to them. See Advisers Act Sections 203A(b) and 206 [15 USC 80b-3(a), 15 USC 80b-6]. SEC-registered investment advisers are subject to examinations by Commission staff.

127 Attorneys are subject to state standards for professional competence and ethical conduct, such as those based on the American Bar Association ("ABA") Model Rules of Professional Conduct, which have been adopted by most states in the United States. For example, Rule 4.1 of the ABA Model Rules of Professional Conduct prohibits an attorney from knowingly making a false statement of material fact or law to a third person or failing to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client. Accountants are also subject to state standards for professional competence and ethical conduct, such as those based on the AICPA Code of Professional Conduct. See AICPA Code of Professional Conduct ET 201.01, 202.01; see also, e.g., The Uniform Accountancy Act (5th ed. 2007), available at: http://www.aicpa.org/Advocacy/State/StateContactInfo/uaa/DownloadableDocuments/UAA_Fifth_Edition_January_2008.pdf.

The Commission recognizes that there may be particular considerations a certified public accountant would need to take into account to comply with applicable professional standards for attestation engagements to provide a report that constitutes a confirmation in the context of this rule.

128 See Rule 102(e) of the Rules of Practice [17 CFR 201.102(e)] (The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing and practicing before it in any way to any person who is found by the Commission after notice and opportunity for hearing in the matter: (i) Not to possess the requisite qualifications to represent others; or (ii) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct; or (iii) To have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.).

We are including the fourth method in our non-exclusive list of methods that are deemed to satisfy the verification requirement in Rule 506(c) because we acknowledge that existing accredited investors who purchased securities in an issuer's Rule 506(b) offering prior to the effective date of Rule 506(c) would presumably participate in any subsequent offering by the same issuer conducted pursuant to Rule 506(c) based on their pre-existing relationships with the issuer. Accordingly, for these existing investors who were accredited investors in a Rule 506(b) offering prior to the effective date of Rule 506(c), a self-certification at the time of sale that he or she is an accredited investor will be deemed to satisfy the verification requirement in Rule 506(c). This provision does not extend to existing investors in an issuer who were not accredited investors in a Rule 506(b) offering that was conducted prior to the effective date of Rule 506(c).

While we have not adopted the recommendations of commenters who believe that even more prescriptive verification requirements are needed, we do recognize the general concern regarding possible misuse of the new Rule 506(c) exemption to sell securities to those who are not qualified to participate in the offering. We will closely monitor and study the development of verification practices by issuers, securities intermediaries and others by undertaking a review of whether such practices are, in fact, resulting in the exclusion of non-accredited investors from participation in these offerings, and the impact of compliance with this verification requirement on investor protection and capital formation.

C. Reasonable Belief that All Purchasers Are Accredited Investors

In the Proposing Release, we noted that a number of commenters had raised concerns that the language of Section 201(a) of the JOBS Act could be interpreted as precluding the use of the "reasonable belief" standard in the definition of "accredited investor" in Rule 501(a) in determining whether a purchaser is an accredited investor, such that an issuer's determination as to whether a purchaser is an accredited investor is subject to an absolute, rather than a "reasonable belief," standard.[129] In their view, issuers may be more reluctant to use general solicitation in Rule 506 offerings if their determinations as to whether a purchaser is an accredited investor are subject to an absolute standard. Other commenters had interpreted the difference in the statutory language used in Section 201(a)(1) and Section 201(a)(2)[130] as indicating Congress' intent that the Commission "raise the 'reasonable belief' standard for Rule 506 offerings...."[131]

Commenters on the Proposing Release were divided on the Commission's interpretation that the reasonable belief standard in Rule 501(a) applies to offerings under Rule 506(c). Several commenters supported this interpretation;[132] and other commenters opposed this interpretation.[133]

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[129] See, e.g., letters from ABA Fed. Reg. Comm. (Apr. 30, 2012); BlackRock (May 3, 2012); NYCBA (May 4, 2012); W. Sjostrom, Jr. (Apr. 14, 2012).

[130] Section 201(a)(2) of the JOBS Act, which calls for amendments to Rule 144A, specifically refers to a "reasonable belief" standard as to whether a purchaser is a QIB, whereas Section 201(a)(1) does not mention a similar "reasonable belief" standard with respect to the amendments to Rule 506.

[131] Letter from Fund Democracy (May 24, 2012). See also letter from Massachusetts Securities Division (July 2, 2012).

[132] See letters from ABA Fed. Reg. Comm. (stating that it "strongly support[s] the continued inclusion of the reasonable belief standard in the accredited investor definition, whether the offering is conducted under Rule 506(b) without general solicitation, or under Rule 506(c) with general solicitation"); IAA; MFA (Sept. 28, 2012) (stating that "[e]liminating the 'reasonable belief' standard in the definition of accredited investor would preclude issuers from relying on Rule 506(c)" and that, if this were the case, "[i]ssuers would not engage in general solicitation and Section 201 would fail in its intended purposes to modernize the securities laws"); NSBA; NYCBA; P. Rutledge.

[133] See letters from AFL-CIO and AFR (stating that "the legislative record reflects unmistakable congressional intent that securities sold through general solicitation and advertising under Rule 506 be sold only to accredited investors, not individuals issuers reasonably believe to be accredited investors"); Sen. Levin (stating that the "Proposed Rule also creates, with no statutory basis, an alternative to the 'reasonable steps' requirement in the statute by stating that issuers may engage in a general solicitation or advertising so long as they 'reasonably believe' that the investors to be addressed will be accredited"); Consumer

We are reaffirming the view that we expressed on this issue in the Proposing Release. In our view, the difference in the language between Section 201(a)(1) and Section 201(a)(2) reflects only the differing manner in which the reasonable belief standard was included in the respective rules at the time they were adopted, and does not represent a Congressional intent to eliminate the existing reasonable belief standard in Rule 501(a) or for Rule 506 offerings.[134] We note that the definition of accredited investor remains unchanged with the enactment of the JOBS Act and includes persons that come within any of the listed categories of accredited investors, as well as persons that the issuer reasonably believes come within any such category.

Further, as discussed in the Proposing Release, we continue to recognize that a person could provide false information or documentation to an issuer in order to purchase securities in an offering made under new Rule 506(c). Thus, even if an issuer has taken reasonable steps to verify that a purchaser is an accredited investor, it is possible that a person nevertheless could circumvent those measures.[135] If a person who does not meet

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Federation (stating that a reasonable belief standard "is in direct conflict with the statutory mandate that all investors in offerings sold through general solicitation and advertising be accredited investors and that the Commission specify methods issuers must follow to ensure that this is the case"); Fund Democracy (arguing that "Congress intentionally chose not to make such [a reasonable belief] exception to the mandate that Rule 506 purchasers be accredited investors").

[134] Both Rule 506 and Rule 144A currently provide for a reasonable belief standard regarding the eligibility of an investor to participate in an offering under the respective rules, but they reach that result in different ways. For Rule 506, the Commission chose to include the reasonable belief standard within the Rule 501(a) definition of "accredited investor"; for Rule 144A, the Commission chose to include the standard as a condition, in paragraph (d)(1), to the use of the exemption.

[135] We note that several federal courts have been unsympathetic to attempts by investors who represented that they were accredited investors at the time of the sale of securities to subsequently disavow those representations in order to pursue a cause of action under the federal securities laws. See, e.g., Wright v. Nat'l Warranty Co., 953 F.2d 256 (6th Cir. 1991) (rejecting the plaintiffs' argument that Rule 505 was unavailable because the plaintiffs "specifically warranted and represented in the subscription agreement … that they were accredited investors"); Goodwin Properties, LLC v. Acadia Group, Inc., No. 01-49-P-C, 2001 U.S. Dist. LEXIS 9975 (D. Me. 2001) (noting that the plaintiffs "provided the defendants with reason to believe that they were accredited investors as defined by 17 C.F.R. § 230.501(a)" and stating that

the criteria for any category of accredited investor purchases securities in a Rule 506(c) offering, we believe that the issuer will not lose the ability to rely on Rule 506(c) for that offering, so long as the issuer took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor at the time of sale.[136]

D. Form D Check Box for Rule 506(c) Offerings

Form D is the notice of an offering of securities conducted without registration under the Securities Act in reliance on Regulation D.[137] Under Rule 503 of Regulation D, an issuer offering or selling securities in reliance on Rule 504, 505 or 506 must file a notice of sales on Form D with the Commission for each new offering of securities no later than 15 calendar days after the first sale of securities in the offering. Form D is currently organized around 16 numbered "items" or categories of information. The information required to be provided in a Form D filing includes basic identifying information, such as the name of the issuer of the securities and the issuer's year and place of incorporation or organization; information about related persons (executive

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therefore "[t]hey cannot now disavow those representations in order to support their claims against the defendants"); Faye L. Roth Revocable Trust v. UBS Painewebber Inc., 323 F. Supp. 2d 1279 (S.D. Fla. 2004) (stating that the plaintiffs "cannot disavow their representations that they were accredited investors" and concluding that there was no material dispute that the offering complied with Regulation D).

[136] Our views regarding an issuer's ability to maintain the exemption for a Rule 506(c) offering notwithstanding the fact that not all purchasers meet the criteria for any category of accredited investor are consistent with our views regarding the effect of attempts by prospective investors to circumvent the requirement in Regulation S that offers and sales be made only to non-U.S. persons. See Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore, Release No. 33-7516 (Mar. 23, 1998) [63 FR 14806 (Mar. 27, 1998)] ("In our view, if a U.S. person purchases securities or investment services notwithstanding adequate procedures reasonably designed to prevent the purchase, we would not view the Internet offer after the fact as having been targeted at the United States, absent indications that would put the issuer on notice that the purchaser was a U.S. person.").

[137] Form D also applies to offerings conducted using the Section 4(a)(5) exemption. The Commission adopted Form D when it adopted Regulation D in 1982. Release No. 33-6389 (adopting Form D as a replacement for Forms 4(6), 146, 240 and 242).

officers, directors, and promoters); the exemption or exemptions being claimed for the offering; and factual information about the offering, such as the duration of the offering, the type of securities offered and the total offering amount.

1. Proposed Form Amendment

We proposed revising Form D to add a separate field or check box for issuers to indicate whether they are claiming an exemption under Rule 506(c). Item 6 of Form D currently requires the issuer to identify the claimed exemption or exemptions for the offering from among Rule 504's paragraphs and subparagraphs, Rule 505, Rule 506 and former Section 4(5), as applicable. Under the proposal, a new check box in Item 6 of Form D would require issuers to indicate specifically whether they are relying on the Rule 506(c) exemption. In addition, the current check box for "Rule 506" would be renamed "Rule 506(b)," and the current check box for "Section 4(5)" would be renamed "Section 4(a)(5)" to update the reference to former Section 4(5) of the Securities Act.

We explained in the Proposing Release that this revision would provide additional information needed to assist our efforts to analyze the use of general solicitation in Rule 506(c) offerings and the size of this offering market. The information would also help us to look into the practices that may develop to satisfy the verification requirement, which would assist us in assessing the effectiveness of various verification practices in identifying and excluding non-accredited investors from participation in Rule 506(c) offerings.

2. Comments on the Proposed Form Amendment

Most commenters who expressed a view on the proposed checkbox in Form D supported the addition of this checkbox for issuers to indicate whether they are relying on

Rule 506(c) for their offerings.[138] Only one commenter opposed the proposed checkbox.[139] A number of commenters recommended that the Commission include additional information requirements in Form D for Rule 506(c) offerings, beyond a checkbox to indicate reliance on Rule 506(c).[140] Some commenters asked for confirmation that issuers may check both the Rule 506(b) box and the Rule 506(c) box in a Form D under certain circumstances.[141]

3. Final Form Amendment

We are adopting the revision to Form D as proposed. Issuers conducting Rule 506(c) offerings must indicate that they are relying on the Rule 506(c) exemption by marking the new check box in Item 6 of Form D. Further, as proposed, the current check box for "Rule 506" will be renamed "Rule 506(b)," and the current check box for "Section 4(5)" will be renamed "Section 4(a)(5)."

We are of the view that an issuer will not be permitted to check both boxes at the same time for the same offering. We remind issuers that once a general solicitation has been made to the purchasers in the offering,[142] an issuer is precluded from making a claim of reliance on Rule 506(b), which remains subject to the prohibition against general

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138 See, e.g., letters from MFA (Sept. 28, 2012); BIO; S&C; Tannenbaum Helpern; ABA Fed. Reg. Comm.; IAA; SIFMA and FSR (Oct. 5, 2012); SRC of NYSBA.

139 Letter from J. McLaughlin (stating that "Section 201(a)(1) does not authorize the Commission to impose a separate Form D filing requirement on issuers who choose to engage in general solicitation").

140 See, e.g., letters from AARP; AFL-CIO and AFR; Consumer Federation; Investor Advisory Committee; NASAA; Massachusetts Securities Division (July 2, 2012); Fund Democracy.

141 See letters from J. Gross; NYCBA; IAA.

142 That is, the purchasers became interested in the offering because of, or through, the general solicitation, and not through some means other than the general solicitation, such as through a substantive, pre-existing relationship with the company or direct contact by the company or its agents outside of the general solicitation. See Revisions of Limited Offering Exemptions in Regulation D, Release No. 33-8828 (Aug. 3, 2007) [72 FR 45116, 45129 (Aug. 10, 2007)].

solicitation, for that same offering.

E. Specific Issues for Private Funds

Private funds, such as hedge funds, venture capital funds and private equity funds, typically rely on Section 4(a)(2) and Rule 506 to offer and sell their interests without registration under the Securities Act.[143] In addition, private funds generally rely on one of two exclusions from the definition of "investment company" under the Investment Company Act – Section 3(c)(1)[144] and Section 3(c)(7)[145] – which enables them to be excluded from substantially all of the regulatory provisions of that Act.[146] Private funds are precluded from relying on either of these two exclusions if they make a public offering of their securities.[147] Section 3(c)(1) excludes from the definition of "investment company" any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 beneficial owners,[148] and which is not making and does not presently propose to make a public offering of its securities. Section 3(c)(7) excludes from the definition of "investment company" any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such

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143 See, e.g., Implications of the Growth of Hedge Funds, Staff Report to the Securities and Exchange Commission (Sept. 2003) ("Staff Report on Hedge Funds"), available at: http://www.sec.gov/news/studies/hedgefunds0903.pdf.

144 15 U.S.C. 80a-3(c)(1).

145 15 U.S.C. 80a-3(c)(7).

146 We also refer in this release to "pooled investment funds" because that term is used in Form D. Issuers that rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act are a subset of pooled investment funds.

147 See also Section 202(a)(29) of the Advisers Act [15 U.S.C. 80b-2(a)(29)] (defining a "private fund" as an issuer that would be an investment company under the Investment Company Act, but for Sections 3(c)(1) or 3(c)(7) of that Act). Many ABS issuers also rely on the exclusions contained in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act. These ABS issuers frequently participate in Rule 144A offerings.

148 See also Rule 3c-5 under the Investment Company Act [17 CFR 270.3c-5] (providing that the section's limit of 100 beneficial owners does not include "knowledgeable employees," as defined in the rule).

securities, are "qualified purchasers,"[149] and which is not making and does not at that time propose to make a public offering of its securities.

Section 201(a)(1) of the JOBS Act directs the Commission to eliminate the prohibition against general solicitation for a new category of Rule 506 offerings, and makes no specific reference to private funds. Section 201(b) of the JOBS Act also provides that "[o]ffers and sales exempt under [Rule 506, as revised pursuant to Section 201(a)] shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation." We historically have regarded Rule 506 transactions as non-public offerings for purposes of Sections 3(c)(1) and 3(c)(7).[150] As we stated in the Proposing Release and reaffirm here, the effect of Section 201(b) is to permit private funds to engage in general solicitation in compliance with new Rule 506(c) without losing either of the exclusions under the Investment Company Act.

A few commenters argued that Section 201(b) does not permit private funds to engage in general solicitation under proposed Rule 506(c) without losing their exclusions under the Investment Company Act.[151] In our view, although Section 201(b) does not explicitly reference the meaning of "public offering" under the Investment Company Act, it clearly states that "[o]ffers and sales exempt under [Rule 506, as revised pursuant to

[149] See Section 2(a)(51) of the Investment Company Act [15 U.S.C. 80a-2(a)(51)] and the rules thereunder. See also Rule 3c-5 under the Investment Company Act (excluding "knowledgeable employees" from the determination of whether all of the outstanding securities of the fund relying on Section 3(c)(7) are owned exclusively by qualified purchasers).

[150] See Release No. 33-6389 (noting that the "Commission regards rule 506 transactions as non-public offerings for purposes of the definition of 'investment company' in section 3(c)(1) of the Investment Company Act"); Privately Offered Investment Companies, Release No. IC-22597 (Apr. 3, 1997) [62 FR 17512 (Apr. 9, 1997)], at n. 5 (noting that the "Commission believes that section 3(c)(7)'s public offering limitation should be interpreted in the same manner as the limitation in section 3(c)(1)").

[151] See letter from Fund Democracy (stating that "Section 201(b) refers only to Rule 506; it makes no reference to the meaning of 'public offering' under the Investment Company Act exemptions"). See also letter from AFL-CIO and AFR.

Section 201(a)] shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation" (emphasis added). As the Investment Company Act is a federal securities law, the effect of Section 201(b) is to permit offers and sales of securities under Rule 506(c) by private funds relying on the exclusions from the definition of "investment company" under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act.

Some commenters expressed concerns about private funds engaging in general solicitation under proposed Rule 506(c).[152] Other commenters, however, supported the removal of the prohibition against general solicitation in Rule 506(c) offerings with respect to private funds,[153] with some commenters stating that the removal of the ban would bring greater transparency to the private fund industry and allow managers of private funds to communicate more effectively with the public and prospective investors.[154]

Some commenters who were concerned about private funds engaging in general solicitation recommended that we impose additional conditions on private funds that rely on Rule 506(c). In particular, a number of commenters believed that private funds engaging in general solicitation should be subject to some form of content and/or other restrictions, and suggested potential methods.[155] For example, some believed that, in

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[152] See, e.g., letters from A. La Rosa; A. Pierwola; AFL-CIO and AFR; C. Erickson; Consumer Federation; E. Guthrie; F. Urling; Fund Democracy; J. Clark; K. Pesson; M. Gessford; M. Trail; M. Zartler; R. Dunn; S. Johnston; W. Cunningham.

[153] See, e.g., letters from BlackRock; Dukas; Forum for U.S. Securities Lawyers in London; HFA; IAA; MFA (Sept. 28, 2012); NYCBA; SRC of NYSBA.

[154] See, e.g., letters from Dukas; HFA.

[155] See, e.g., letters from ICI; AFL-CIO and AFR; C. Corn; Sen. Levin (stating that "Congress did not contemplate removing the general solicitation ban – without retaining any limitations on forms of

order to engage in general solicitation, private funds should be held to performance and advertising standards that are analogous to mutual fund standards.[156] One of these commenters suggested that the Commission develop rules tailored to the ways private funds calculate and present investment performance, rather than extending mutual fund performance rules to private funds.[157] Some made other suggestions, such as requiring each private fund relying on Rule 506(c) to disclose that the private fund is not registered with the Commission and should not be confused with a registered fund, such as a mutual fund.[158] With respect to private funds sold through broker-dealers subject to FINRA's rules of conduct, some commenters believed that we should direct FINRA to require the

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solicitation – for private investment vehicles"); Consumer Federation; D. Kronheim; D. Smith; Fund Democracy; G. Lavy; G. Morin; Investor Advisory Committee; IDC; J. Sanders; Rep. Waters; NASAA; P. Turney; Sens. Reed, Levin, Durbin, Harkin, Lautenberg, Franken and Akaka.

[156] See, e.g., letters from C. Corn; Sen. Levin (noting that "[a]lready, the Commission has determined that the manner and substance of solicitation and advertising for investments in registered investment companies deserves significant regulatory oversight. Many of those same concerns apply to investments in private investment vehicles. Accordingly, the Commission should impose analogous protections for investments in private funds."); Consumer Federation (stating that "[s]hort of an outright prohibition on general solicitation and advertising by private funds, the Commission should at the very least adopt clear standards for the reporting of performance and fees by private funds, and delay their eligibility from engaging in general solicitation and advertising until such time as those standards are in place," including a requirement to include in private fund advertisements "a clear, prominent warning that they are not mutual funds and carry special risks."); D. Kronheim; D. Smith; Fund Democracy (noting that an alternative would be to "apply mutual fund advertising and valuation rules to hedge funds that engage in [general solicitation and advertising] (and, in any case, require standardized performance and fee reporting for all hedge funds), and require explicit, large-font disclaimers that hedge funds are not mutual funds and present special risks."); G. Lavy; ICI (recommending content restrictions on private fund advertising at least as extensive as those currently applicable to mutual funds (e.g., disclaimers regarding the performance figures or measures displayed in any advertisement), with a prohibition on use of performance advertising until the Commission can develop a new rule regarding such advertising); IDC; NASAA (stating that "because the investment strategies of private funds are typically more opaque, risky, and illiquid than those of mutual funds, private fund advertisements should be subject to restrictions that are comparable to the rules for mutual funds."); P. Turney.

[157] See letter from ICI (arguing that the antifraud provisions in Section 206(4) of the Advisers Act [15 U.S.C. 80b-6(4)] and Rule 206(4)-8 thereunder [17 CFR 275.206(4)-8] would not be enough to protect investors because these advertisements will be presented before accredited and non-accredited investors at the same time).

[158] See letters from ICI; IDC.

filing and review of private fund advertisements.[159]

Finally, some commenters opposed the imposition of content and/or other restrictions for private funds.[160] They asserted that purchasers of the securities of a private fund that relies on Rule 506(c), must be, at a minimum, accredited investors and thus have met objective criteria demonstrating financial sophistication, which they believed eliminates the risk that other types of investors could be defrauded.[161] A number of commenters pointed out that advertisements of private funds are subject to the antifraud provisions of the federal securities laws and suggested that liability under such provisions provides sufficient investor protections.[162]

We have carefully considered commenters' suggestions and concerns. We are mindful of certain commenters' concerns that private funds engaging in general solicitation may raise certain investor protection issues. We also understand that other commenters believe that additional measures regarding private fund advertising are not necessary because the antifraud provisions of the federal securities laws continue to apply. We will monitor and study the development of private fund advertising and

[159] See letters from AFL-CIO and AFR (stating that "FINRA already pre-reviews broker-dealer advertising; the same requirement should apply to general solicitation and advertising in Rule 506 offerings in light of the significant potential for abuse."); ICI (noting that "FINRA has developed an infrastructure to handle such filings and an expertise to substantively review them, and accordingly is best positioned to handle this task.").

[160] See, e.g., letters from Verrill Dana LLP (stating that "[t]here is no suggestion in Section 201 that the Commission must distinguish between 'issuers that engage in operational businesses' and 'those that are merely investment vehicles'"); Artivest (noting that for private funds managed by a registered commodity pool operator, the National Futures Association Rule 2-29 contains standards regarding marketing materials).

[161] In general, private funds that pay performance fees to their managers are available only to "qualified clients" that have at least $1 million in assets under management or that have a net worth of $2 million (excluding the value of the client's primary residence). See Rule 205-3 under the Advisers Act [17 CFR 275.205-3]. See also letter from BlackRock.

[162] See, e.g., letters from BlackRock; HFA; MFA (Mar. 22, 2013).

undertake a review to determine whether any further action is necessary.

We remind investment advisers to private funds that they are subject to Rule 206(4)-8 under the Advisers Act.[163] Rule 206(4)-8 provides that it shall constitute a fraudulent, deceptive or manipulative act, practice or course of business within the meaning of Section 206(4) of the Advisers Act for any investment adviser to a pooled investment vehicle[164] to "(1) [m]ake any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or (2) otherwise engage in any act, practice or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle."[165]

As was stated by the Commission when it adopted Rule 206-4(8), "[t]he rule clarifies that an adviser's duty to refrain from fraudulent conduct under the federal securities laws extends to the relationship with ultimate investors and that the Commission may bring enforcement actions under the Advisers Act against investment advisers who defraud investors or prospective investors in those pooled investment vehicles."[166] We further stated that we "intend to employ all of the broad authority that Congress provided us in section 206(4) and direct it at adviser conduct affecting an

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163 17 CFR 275.206(4)-8.

164 Rule 206(4)-8 defines a pooled investment vehicle to mean any investment company as defined in Section 3(a) of the Investment Company Act [15 U.S.C. 80a-3(a)] or any company that would be an investment company under Section 3(a) of that Act but for the exclusion provided from that definition by either Section 3(c)(1) or Section 3(c)(7) of that Act [15 U.S.C. 80a-3(c)(1) or (7)].

165 Id.

166 Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Release No. IA-2628 (Aug. 3, 2007) [72 FR 44756 (Aug. 9, 2007)].

investor or potential investor in a pooled investment vehicle."[167] Recently, for example, we have brought enforcement actions against private fund advisers and others for material misrepresentations to investors and prospective investors regarding fund performance, strategy, and investments, among other things.[168]

We believe that investment advisers that have implemented appropriate policies and procedures regarding, among other things, the nature and content of private fund sales literature, including general solicitation materials, are less likely to use materials that materially mislead investors or otherwise violate the federal securities laws. Accordingly, we believe that investment advisers to private funds should carefully review any such policies and procedures that have been implemented to determine whether they are reasonably designed to prevent the use of fraudulent or materially misleading private fund advertising and make appropriate amendments to those policies and procedures, particularly if the private funds intend to engage in general solicitation activity.[169]

F. Technical and Conforming Amendments

We proposed a number of technical and conforming amendments to Rules 502 and 506 of Regulation D. Under the proposal, we would amend various provisions in

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[167] Id.

[168] See, e.g., In the Matter of Oppenheimer Asset Management Inc. and Oppenheimer Alternative Investment Management, LLC, Release No. IA-3566 (Mar. 11, 2013); In the Matter of Sentinel Investment Management Corp., Release No. IA-3530 (Dec. 27, 2012); In the Matter of Weizhan Tang, Release No. IA-3482 (Oct. 5, 2012); In the Matter of Calhoun Asset Management, LLC, et al., Release No. IA-3428 (July 9, 2012); In the Matter of Belal K. Faruki, Release No. IA-3405 (May 17, 2012); In the Matter of GMB Capital Management LLC, et al., Release No. IA-3399 (Apr. 20, 2012).

[169] We remind investment advisers that are registered or required to be registered under Section 203 of the Advisers Act that they must adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act which include, but are not limited to, violations of Section 206 of the Advisers Act and the rules thereunder. They must also review, no less frequently than annually, the adequacy of the written policies and procedures and the effectiveness of the policies and procedures' implementation. See CFR 275.206(4)-7.

Rule 502(b) to clarify that the references to sales to non-accredited investors under Rule 506, and the corresponding informational requirements, would be applicable to offerings under Rule 506(b) and not to offerings under Rule 506(c). We proposed to amend Rule 502(c) to clarify that Rule 502(c)'s prohibition against general solicitation would not apply to offerings under Rule 506(c). In addition, as Section 201(c) of the JOBS Act renumbered Section 4 of the Securities Act, we proposed to amend Regulation D and Rule 144A to update the references to Section 4. Finally, the proposal would update references to Section 2 of the Securities Act in these rules as some of the references have not been updated to reflect the current numbering scheme in Section 2. We received no comments regarding these technical and conforming amendments and are adopting these rule amendments as proposed.

III. FINAL AMENDMENT TO RULE 144A

Section 201(a)(2) of the JOBS Act directs the Commission to revise Rule 144A(d)(1) under the Securities Act to provide that securities sold pursuant to Rule 144A may be offered to persons other than QIBs, including by means of general solicitation, provided that securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe is a QIB. To implement the mandated rule change, we proposed amending Rule 144A(d)(1) to eliminate the references to "offer" and "offeree." All of the commenters that expressed a view on the proposed amendment to Rule 144A(d)(1) stated that they supported the Commission's proposal.[170] We are adopting the amendment as proposed. As amended, Rule 144A(d)(1) will require only that the securities be sold to a QIB or to a purchaser that the seller and any person acting

[170] See letters from IAA; SIFMA and FSR (Oct. 5, 2012); J. Johnson; OTC Markets Group Inc.

on behalf of the seller reasonably believe is a QIB.[171] Under this amendment, resales of securities pursuant to Rule 144A can be conducted using general solicitation, so long as the purchasers are limited in this manner.[172]

As a result of the Section 201(a)(2) mandate and the resulting Rule 144A revisions, we are also making technical and conforming revisions to the exceptions in Regulation M relating to transactions in Rule 144A securities, specifically Regulation M Rules 101(b)(10), 102(b)(7) and 104(j)(2). When adopted in 1996, the exceptions delineated in Rules 101(b)(10)(i), 102(b)(7)(i) and 104(j)(2)(i) were generally intended to permit transactions in securities eligible for resale under Rule 144A during a distribution of securities, provided that offers and sales of such securities were made solely to QIBs or persons reasonably believed to be QIBs in certain transactions exempt from registration.[173]

As explained above, Section 201(a)(2) of the JOBS Act directs the Commission to revise Rule 144A to permit offers of securities to persons other than QIBs. As noted above, Rule 144A is being amended to eliminate references to "offer" and "offeree," so that the amended rule will require only that securities be sold to a QIB or to a purchaser that the seller and any person acting on behalf of the seller reasonably believes is a QIB.

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[171] Rule 144A(d)(1).

[172] The general solicitation that is permitted in Rule 144A resales from the initial purchaser to the QIBs will not affect the availability of the Section 4(a)(2) exemption or Regulation S for the initial sale of securities by the issuer to the initial purchaser.

[173] See Anti-Manipulation Rules Concerning Securities Offerings, Release No. 34-38067 (Dec. 20, 1996) [62 FR 520 (Jan. 3, 1997)] at 530 ("As adopted, the exception permits transactions in Rule 144A securities during a distribution of such securities, provided that sales of such securities within the United States are made solely to: qualified institution buyers ('QIBs'), or persons reasonably believed to be QIBs, in transactions exempt from registration under the Securities Act.... The exception covers both the Rule 144A security being distributed and any reference security.").

form the language in Regulation M to Rule 144A, as amended, we

In ord .egulation M exceptions by similarly eliminating the references to are con ees." We believe that these conforming modifications do not result change to the Regulation M exceptions and are consistent with the ceptions.

isition matter, for an ongoing Rule 144A offering that commenced before te of the amendment to Rule 144A(d)(1), offering participants will be duct the portion of the offering following the effective date of the o Rule 144A(d)(1) using general solicitation, without affecting the ility of Rule 144A for the portion of the offering that occurred prior to the effective date of the amended rule.

IV. INTEGRATION WITH OFFSHORE OFFERINGS

In the Proposing Release, we noted that the mandate in Section 201(a) that the Commission amend Rule 506 and Rule 144A to permit the use of general solicitation in transactions under those rules has raised questions from some commenters[174] regarding the impact of the use of general solicitation on the availability of the Regulation S safe harbors for concurrent unregistered offerings inside and outside the United States.[175] The safe harbors are important when U.S. and non-U.S. companies engage in global

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174 See, e.g., letters from ABA Fed. Reg. Comm. (Apr. 30, 2012); L. Neumann (June 12, 2012); NYCBA (May 4, 2012); SecuritiesLawUSA, PC (June 26, 2012); SIFMA (Apr. 27, 2012).

175 Regulation S provides a safe harbor for offers and sales of securities outside the United States and includes an issuer and a resale safe harbor. Two general conditions apply to both safe harbors: (1) the securities must be sold in an offshore transaction and (2) there can be no "directed selling efforts" in the United States. Rule 902(c)(1) [17 CFR 230.902(c)(1)] broadly defines "directed selling efforts" as: any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities offered in reliance on Regulation S. Such activity includes placing an advertisement in a publication "with a general circulation in the United States" that refers to the offering of securities being made in reliance upon Regulation S.

offerings of securities in which the U.S. portion of the offering is conducted in accordance with Rule 144A or Rule 506 and the offshore portion is conducted in reliance on Regulation S.

We expressed our view on this issue in the Proposing Release, which we are reaffirming in this release.[176] Concurrent offshore offerings that are conducted in compliance with Regulation S will not be integrated with domestic unregistered offerings that are conducted in compliance with Rule 506 or Rule 144A, as amended. As explained in the Proposing Release, we believe that our view is consistent with the historical treatment of concurrent Regulation S and Rule 144A/Rule 506 offerings.[177]

V. PAPERWORK REDUCTION ACT

A. Background

The amendment to Form D contains a "collection of information" requirement within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[178] We published a notice requesting comment on the collection of information requirement in the Proposing Release for the rule and form amendments. We submitted that requirement to the Office

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[176] All of the commenters who expressed a view on our interpretation supported it and encouraged us to reiterate it in this release. See letters from ABA Fed. Reg. Comm; Forum for U.S. Securities Lawyers in London; IAA; IPA; NYCBA.

[177] See Offshore Offers and Sales, Release No. 33-6863 (Apr. 24, 1990) [55 FR 18306 (May 2, 1990)] (stating that "[o]ffshore transactions made in compliance with Regulation S will not be integrated with registered domestic offerings or domestic offerings that satisfy the requirements for an exemption from registration under the Securities Act."). In addressing the offshore transaction component of the Regulation S safe harbor, the Commission also stated, "Offers made in the United States in connection with contemporaneous registered offerings or offerings exempt from registration will not preclude reliance on the safe harbors." Id. at n. 36. Likewise, in addressing directed selling efforts, the Commission stated, "Offering activities in contemporaneous registered offerings or offerings exempt from registration will not preclude reliance on the safe harbors." Id. at n. 47. See also Rule 500(g) of Regulation D [17 CFR 230.500(g)] (formerly Preliminary Note No. 7 to Regulation D) ("Regulation S may be relied upon for such offers and sales even if coincident offers and sales are made in accordance with Regulation D inside the United States.").

[178] 44 U.S.C. 3501 et seq.

of Management and Budget ("OMB") for review and approval in accordance with the PRA and its implementing regulations.[179] The title of this requirement is: "Form D" (OMB Control No. 3235-0076).[180]

We adopted Regulation D and Form D as part of the establishment of a series of exemptions for offerings and sales of securities under the Securities Act. The Form D filing is required to be made by issuers as a notice of sales without registration under the Securities Act based on a claim of exemption under Regulation D or Section 4(a)(5) of the Securities Act. The Form D filing is required to include basic information about the issuer, certain related persons, and the offering. This information is needed for implementing the exemptions and analyzing their use. The information collection requirements related to the filing of Form D with the Commission are mandatory to the extent that an issuer elects to make an offering of securities in reliance on the relevant exemption. Responses are not confidential. The hours and costs associated with preparing and filing forms and retaining records constitute reporting and cost burdens imposed by the collection of information requirements. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information requirement unless it displays a currently valid OMB control number.

As discussed above, we proposed to amend Form D to add a check box to indicate an offering relying on the Rule 506(c) exemption. In the Proposing Release, we requested comment on our PRA burden hour and cost estimates and the analysis used to derive such estimates. One commenter responded to our request for comment on the

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179 44 U.S.C. 3507(d); 5 CFR 1320.11.

180 Form D was adopted under the authority of Sections 2(a)(15), 3(b), 4(a)(2), 19(a) and 19(c)(3) of the Securities Act [15 U.S.C. 77b(a)(15), 77c(b), 77d(a)(2), 77s(a) and 77s(c)(3)].

PRA analysis and stated that it believed that the cost estimates in the PRA and economic analysis are too low.[181]

B. Revisions to PRA Reporting and Cost Burden Estimates

Consistent with the PRA analysis in the Proposing Release, we believe that the addition of a check box on Form D to indicate that an issuer is relying on the Rule 506(c) exemption for its offering will have a negligible effect on the paperwork burden of the form. Form D already contains a check box for each basis of exemption claimed under Regulation D; this change simply conforms the form to the new rule amendment. Accordingly, we estimate that under the amendment to Form D, the burden for responding to the collection of information in Form D will be substantially the same as before the amendment to Form D. We believe, however, that the amendment to Rule 506 could increase the number of Form D filings that are made with the Commission because we expect issuers may conduct more Rule 506 offerings.

The table below shows the current total annual compliance burden, in hours and in costs, of the collection of information pursuant to Form D. For purposes of the PRA, we estimate that, over a three-year period, the average burden estimate will be four hours per Form D filing. Our burden estimate represents the average burden for all issuers. This burden is reflected as a one hour burden of preparation on the issuer and a cost of $1,200 per filing. In deriving these estimates, we assume that 25% of the burden of preparation is carried by the issuer internally and that 75% of the burden of preparation is

[181] See letter from NSBA (stating that "the compliance cost estimates should include the time required by the issuer and their advisors to familiarize themselves with the rule and to comply with the additional verification requirements and the time and costs of investors to comply (for example, with a third-party verification requirement)"). For PRA purposes, we consider only the burden of responding to the collection of information in Form D; we do not consider any of the other costs, direct or indirect, of conducting a Rule 506(c) offering.

carried by outside professionals retained by the issuer 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 issuer internally is reflected in hours.

Table 1. Estimated paperwork burden under Form D, pre-amendment to Rule 506

	Number of responses (A)[182]	Burden hours/form (B)	Total burden hours (C)=(A)*(B)	Internal issuer time (D)	External professional time (E)	Professional costs (F)=(E)*$400
Form D	18,187	4	72,748	18,187	54,561	$21,824,400

According to our Division of Economic and Risk Analysis ("DERA"), in 2012, 16,067 companies made 18,187 new Form D filings. The annual number of new Form D filings rose from 13,764 in 2009 to 18,187 in 2012, an average increase of approximately 1,474 Form D filings per year, or approximately 10%. Assuming that the macroeconomic factors underlying this increase persist and the number of Form D filings continues to increase by 1,474 filings per year for each of the next three years, the average number of Form D filings in each of the next three years, absent the elimination of the prohibition against general solicitation, would be approximately 21,135.

We anticipate that new paragraph (c) of Rule 506 could result in an even greater annual increase in the number of Form D filings than the 10% annual increase estimated above. As a reference point for the potential increase, we use the impact of another past rule change on the market for Regulation D offerings. In 1997, the Commission amended

182 We had previously estimated the number of responses to be 25,000, as reflected in OMB's Inventory of Currently Approved Information Collections (available at: http://www.reginfo.gov/public/do/PRAMain;jsessionid=D37174B5F6F9148DB767D63DF6983A65), but we are revising this estimate to reflect the number of new Form D filings made in 2012.

Rule 144(d) under the Securities Act[183] to reduce the holding period for restricted securities from two years to one year,[184] thereby increasing the attractiveness of Regulation D offerings to investors and to issuers. There were 10,341 Form D filings in 1996. This was followed by a 20% increase in the number of Form D filings in each of the subsequent three calendar years, reaching 17,830 by 1999. Although it is not possible to predict with any degree of accuracy the increase in the number of Rule 506 offerings following the elimination of the prohibition against general solicitation for a new category of Rule 506 offerings, we assume for purposes of this analysis that there could be a similarly significant increase.

For purposes of the PRA and based on our analysis above, we estimate that the amendment to Rule 506 will result in a 20% increase in Form D filings relying on the Rule 506 exemption, or approximately 3,637 filings.[185] We also assume that the number of Form D filings will increase by approximately 3,637 in each year following the adoption of the rule.

Based on this increase, we estimate that the annual compliance burden of the collection of information requirements for the first year in which issuers will make Form D filings after the adoption of Rule 506(c) will be an aggregate of 21,824 hours of issuer personnel time and $26,188,800 for the services of outside professionals per year.

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183 17 CFR 230.144(d).

184 See Revision of Holding Period Requirements in Rules 144 and 145, Release No. 33-7390 (Feb. 20, 1997) [62 FR 9242 (Feb. 28, 1997)].

185 This number is based on the 18,187 new Form D filings that were made in 2012.

Table 2. Estimated paperwork burden under Form D, post-amendment to Rule 506

	Number of responses (A)[186]	Burden hours/form (B)	Total burden hours (C)=(A)*(B)	Internal issuer time (D)	External professional time (E)	Professional costs (F)=(E)*$400
Form D	21,824	4	87,296	21,824	65,472	$26,188,800

VI. ECONOMIC ANALYSIS

A. Background

We are adopting amendments to Rule 506 and Rule 144A to implement the requirements of Section 201(a) of the JOBS Act.[187] Section 201(a)(1) directs the Commission to revise Rule 506 to provide that the prohibition against general solicitation contained in Rule 502(c) shall not apply to offers and sales of securities made pursuant to Rule 506, as amended, provided that all purchasers of the securities are accredited investors. Section 201(a)(1) also provides that "such rules shall require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission." Section 201(a)(2) of the JOBS Act directs the Commission to revise Rule 144A(d)(1) to provide that securities sold pursuant to Rule 144A may be offered to persons other than QIBs, including by means of general solicitation, provided that securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs.

We are mindful of the costs imposed by and the benefits obtained from our rules.

[186] The information in this column is based on the 18,187 new Form D filings that were made in 2012, plus the additional 3,637 filings we estimate would be filed in the first year after the effectiveness of Rule 506(c).

[187] As explained above, the Commission in this release is adopting only those rule and form amendments that are specifically mandated by Section 201(a). Correspondingly, we analyze the economic impacts – including the benefits and costs – only of those rules and form amendments considered within the scope of this release.

The discussion below addresses the economic effects of the amendments to Rule 506, Rule 144A and Form D, including the likely benefits and costs of the amendments as well as the effect of the amendments on efficiency, competition and capital formation.[188] Some of the costs and benefits stem from the statutory mandate of Section 201(a), whereas others are affected by the discretion we have exercised in implementing this mandate. These two types of costs and benefits may not be entirely separable to the extent that our discretion is exercised to realize the benefits that we believe were intended by Section 201(a).

B. Economic Baseline

The baseline analysis that follows is in large part based on information collected from Form D filings submitted by issuers relying on Regulation D to raise capital. As we describe in more detail below, we believe that we do not have a complete view of the Rule 506 market, particularly with respect to the amount of capital raised. Currently, issuers are required to file a Form D within 15 days of the first sale of securities, and are required to report additional sales through amended filings only under certain conditions. In addition, issuers may not report all required information, either due to error or because they do not wish to make the information public. Commenters have suggested and we also have evidence that some issuers do not file a Form D for their offerings in

[188] Section 2(b) of the Securities Act [15 U.S.C. 77b(b)] requires the Commission, when engaging in rulemaking that requires it to consider 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.

compliance with Rule 503.[189] Consequently, the analysis that follows is necessarily subject to these limitations in the current Form D reporting process.

1. Size of the Exempt Offering Market

Exempt offerings play a significant role in capital formation in the United States. Offerings conducted in reliance on Rule 506 account for 99% of the capital reported as being raised under Regulation D from 2009 to 2012, and represent approximately 94% of the number of Regulation D offerings.[190] The significance of Rule 506 offerings is underscored by the comparison to registered offerings. In 2012, the estimated amount of capital reported as being raised in Rule 506 offerings (including both equity and debt) was $898 billion, compared to $1.2 trillion raised in registered offerings.[191] Of this $898 billion, operating companies (issuers that are not pooled investment funds) reported raising $173 billion, while pooled investment funds reported raising $725 billion.[192] The amount reported as being raised by pooled investment funds is comparable to the amount of capital raised by registered investment funds. In 2012, registered investment funds

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[189] Many commenters asserted that non-compliance with Form D filing obligations is widespread. See, e.g., letters from Investor Advisory Committee (stating that "[i]t is generally acknowledged that a significant number of issuers do not currently file Form D..."); AARP (stating that "[s]imply adding a checkbox to a form that too often goes unfiled and then only after the fact is inadequate to the task at hand."); AFL-CIO and AFR (stating that "many issuers today flout the Form D filing requirement for such offerings, further limiting the Commission's ability to provide effective oversight"). See also Securities and Exchange Commission, Office of Inspector General, Regulation D Exemption Process (Mar. 31, 2009) ("OIG Report"), available at: http://www.sec-oig.gov/Reports/AuditsInspections/2009/459.pdf (stating that while the Commission staff "strongly encourage companies to comply with Rule 503, they are aware of instances in which issuers have failed to comply with Rule 503..."). Based on its analysis of the filings required by FINRA Rules 5122 and 5123 during the period of December 3, 2012 to February 5, 2013, DERA estimates that as many as 9% of the offerings represented in the FINRA filings for Regulation D or other private offerings that used a registered broker did not have a corresponding Form D.

[190] See Ivanov/Bauguess Study.

[191] See id.

[192] See id.

(which include money market mutual funds, long-term mutual funds, exchange-traded funds, closed-end funds and unit investment trusts) raised approximately $727 billion.[193]

In 2011, the estimated amount of capital (including both equity and debt) reported as being raised in Rule 506 offerings was $849 billion compared to $985 billion raised in registered offerings.[194] Of the $849 billion, operating companies reported raising $71 billion, while pooled investment funds reported raising $778 billion.[195] More generally, when including offerings pursuant to other exemptions – Rule 144A, Regulation S and Section 4(a)(2) – significantly more capital appears to be raised through exempt offerings than registered offerings (Figure 1).[196]

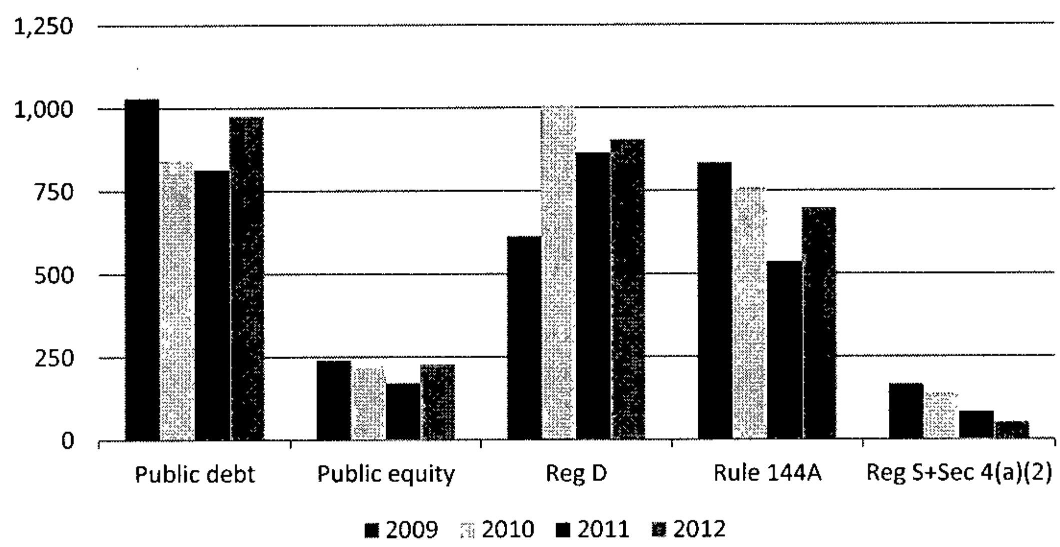
[193] In calculating the amount of capital raised by registered investment funds, we use the net amounts (plus reinvested dividends and reinvested capital gains), which reflect redemptions, and not gross amounts, by open-ended registered investment funds because they face frequent redemptions and do not have redemption restrictions and lock-up periods common among private funds. In addition, we use the new issuances of registered closed-end funds and the new deposits of registered unit investment trusts. See 2013 Investment Company Institute Factbook, available at: http://www.icifactbook.org.

[194] See Ivanov/Bauguess Study.

[195] See id.

[196] See id.

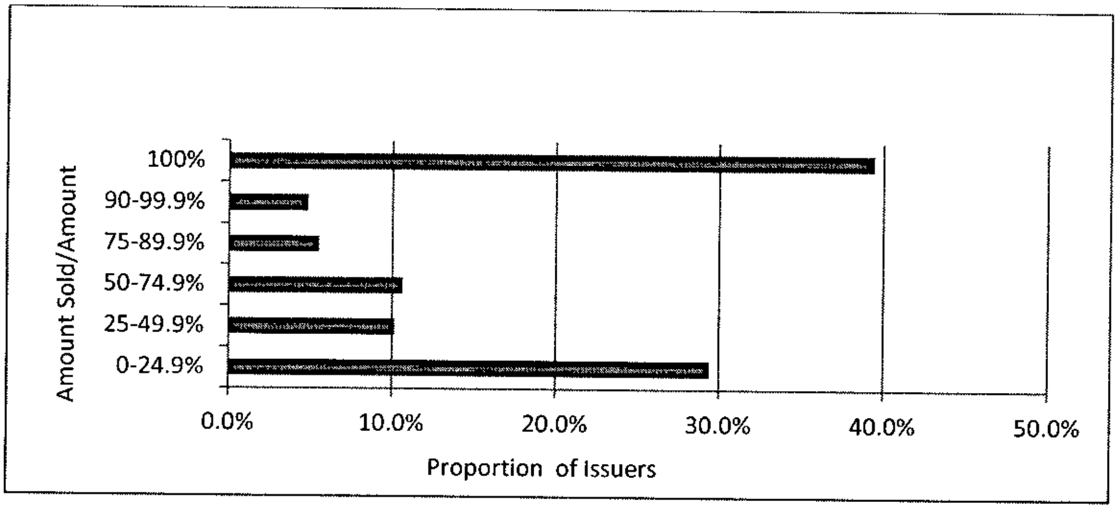
Figure 1: Capital Raised in U.S. Capital Markets during 2009-2012[197]



At present, issuers are required to file a Form D not later than 15 days after the first sale of securities in a Regulation D offering and an amendment to the Form D only under certain circumstances. Since issuers are not required to submit a Form D filing when an offering is completed, and submit amendments only under certain circumstances, we have no definitive information on the final amounts raised. Figure 2, below, illustrates that at the time of the Form D filing, only 39% of offerings by non-pooled investment fund issuers were completed relative to the total amount sought. Separately, 70% of pooled investment funds state their total offering amount to be "Indefinite" in their Form D filings. As a result, the Form D filings of these pooled investment funds likely do not accurately reflect the total amount of securities offered or sold.

[197] The 2012 non-ABS Rule 144A offerings data is based on an extrapolation of currently available data through May 2012 from Sagient Research System's Placement Tracker database. For more detail, see the Ivanov/Bauguess Study.

Figure 2: Amount Sold as Percentage of Total Offering Amount by Non-Pooled Investment Fund Issuers in Regulation D Offerings at the Time of Form D Filing: 2009-2012



2. Affected Market Participants

The amendments to Rule 506 we are adopting today will affect a number of different market participants. Issuers of securities in Rule 506 offerings include both reporting and non-reporting operating companies and pooled investment funds. Investment advisers organize and sponsor pooled investment funds that conduct Rule 506 offerings. Intermediaries that facilitate Rule 506 offerings include registered broker-dealers, finders and placement agents. Investors in Rule 506 offerings include accredited investors (both natural persons and legal entities) and non-accredited investors who meet certain "sophistication" requirements. Each of these market participants is discussed in further detail below.

a. Issuers

Based on the information submitted in 112,467 new and amended Form D filings between 2009 and 2012, there were 67,706 new Regulation D offerings by 49,740 unique issuers during this four-year period.[198] The size of the average Regulation D offering during this period was approximately $30 million, whereas the size of the median offering was approximately $1.5 million.[199] The difference between the average and median offering sizes indicates that the Regulation D market is comprised of many small offerings, which is consistent with the view that many smaller businesses are relying on Regulation D to raise capital, and a smaller number of much larger offerings.

Some information about issuer size is available from Item 5 in Form D, which requires issuers in Regulation D offerings to report their size in terms of revenue ranges or, in the case of certain pooled investment funds, net asset value ranges. All issuers can currently choose not to disclose this size information, however, and a significant majority of issuers that are not pooled investment funds declined to disclose their revenue ranges in the Forms D that they filed between 2009 and 2012. For those that did, most reported a revenue range of less than $1 million (Figure 3).[200] During the 2009-2011 period, approximately 10% of all public companies raised capital in Regulation D offerings; in 2012, approximately 6% of such companies did so.[201] These public companies tended to be smaller and less profitable than their industry peers, which illustrates the significance of the private capital markets to smaller companies, whether public or private.[202]

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198 See Ivanov/Bauguess Study.

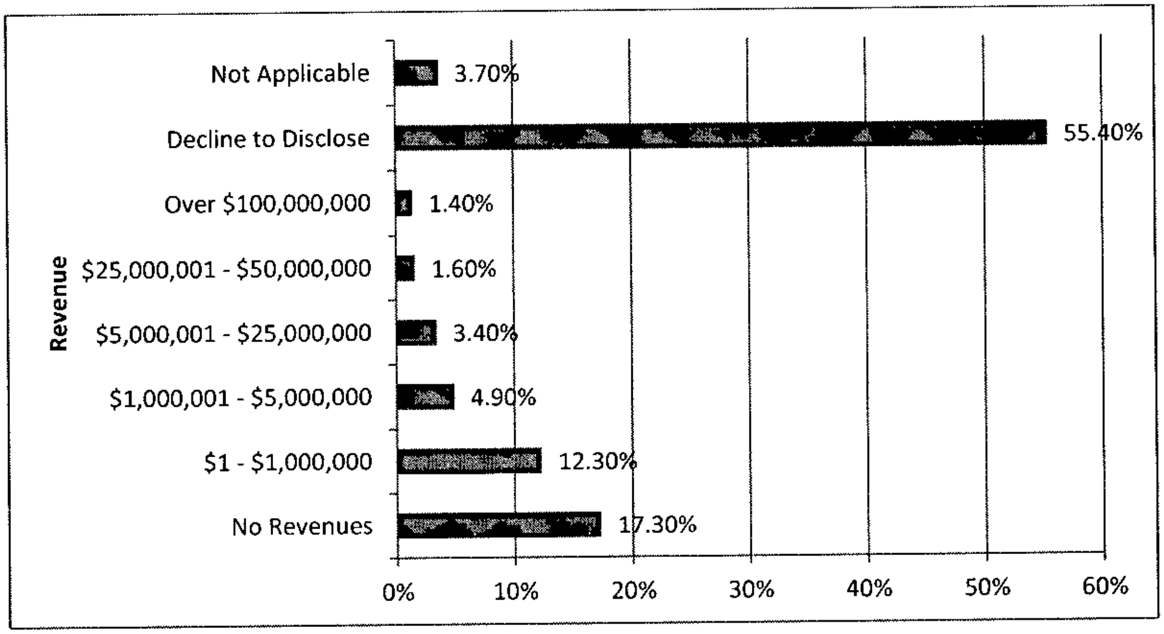
199 See id. A study of unregistered equity offerings by publicly-traded companies over the period 1980-1996 found that the mean offering amount was $12.7 million, whereas the median offering amount was $4.5 million. See Michael Hertzel, Michael Lemmon, James Linck and Lynn Rees, Long-Run Performance Following Private Placements of Equity, 57 Journal of Finance 2595 (2002).

200 See Ivanov/Bauguess Study.

201 Id. (explaining the methodology of using listings in the Standard & Poor's Compustat database and the University of Chicago's Center for Research in Securities Prices database to determine which companies were public companies).

202 Id.

Figure 3: Distribution of Non-Pooled Investment Fund Issuers in Regulation D Market by Revenue: 2009-2012



During this period, pooled investment funds conducted approximately 24% of the total number of Regulation D offerings and raised approximately 81% of the total amount of capital raised in Regulation D offerings.[203] More than 75% of pooled investment funds declined to disclose their net asset value range.

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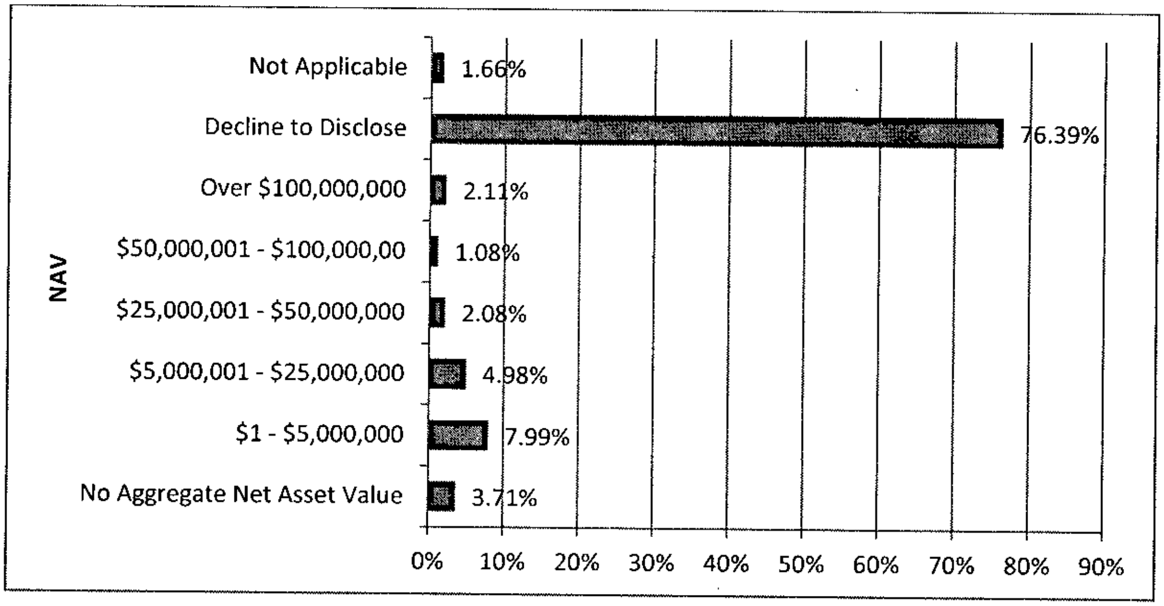
[203] Id.

Figure 4: Distribution of Pooled Investment Fund Issuers in Regulation D Market by Net Asset Value: 2009-2012



Between 2009 and 2012, approximately 66% of Regulation D offerings were of equity securities, and almost two-thirds of these were by issuers other than pooled investment funds.[204] Non-U.S. issuers accounted for approximately 19% of the amount of capital raised in Regulation D offerings, indicating that the U.S. market is a significant source of capital for these issuers.[205]

Unlike in Regulation D offerings, issuers conducting Rule 144A offerings are not required to disclose information about their offerings to the Commission, which limits our ability to measure the size of the Rule 144A market. Based on transaction

[204] Id.

[205] Id.

information collected by third-party data providers,[206] we can broadly characterize the Rule 144A market as being divided between ABS and non-ABS offerings. These sources indicate that, over the four-year period from 2009 to 2012, there were 3,510 non-ABS Rule 144A offerings by 1,965 unique issuers. During this period, the average non-ABS offering size was approximately $526 million, while the median non-ABS offering size was $350 million. These offering sizes are significantly larger than the average and median amounts of Regulation D offerings, as discussed above, indicating that the Rule 144A market, as compared to the Regulation D market, is characterized by much larger issues (which we presume correlate to larger issuers, as well) and, based on the number of Rule 144A offerings, far fewer issuers. Another significant difference from Regulation D offerings is the type of security offered. During this period, over 99% of the non-ABS offerings in the Rule 144A market were debt offerings,[207] compared to 13% of Regulation D offerings.[208]

b. Investors

We have relatively little information on the types and number of investors in Rule 506 offerings. Form D currently requires issuers in Rule 506 offerings to provide information about the total number of investors who have already invested in the offering and the number of persons who do not qualify as accredited investors.[209] In 2012,

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[206] These statistics are based on a review of data from Securities Data Corporation's New Issues database (Thomson Financial) and Sagient Research System's Placement Tracker database.

[207] This statistic is based on a review of data from Securities Data Corporation's New Issues database (Thomson Financial) and Sagient Research System's Placement Tracker database.

[208] See Ivanov/Bauguess Study.

[209] See Item 14 of Form D. Form D does not require any other information on the types of investors, such as whether they are natural persons or legal entities.

approximately 153,000 investors participated in offerings by operating companies, while approximately 81,000 investors invested in offerings by pooled investment funds.[210] Because some investors participate in multiple offerings, these numbers likely overestimate the actual number of unique investors in these reported offerings. In offerings under Rule 506(b), both accredited investors and up to 35 non-accredited investors who meet certain sophistication requirements are eligible to purchase securities. In offerings under new Rule 506(c), only accredited investors will be eligible to purchase securities.

Information collected from Form D filings indicates that most Rule 506 offerings do not involve broad investor participation. More than two-thirds of these offerings have ten or fewer investors, while less than 5% of these offerings have more than 30 investors. Although Rule 506 currently allows for the participation of non-accredited investors who meet certain sophistication requirements, such non-accredited investors reportedly purchased securities in only 11% of the Rule 506 offerings conducted between 2009 and 2012.[211] Only 8% of the offerings by pooled investment funds included non-accredited investors, compared to 12% of the offerings by other issuers.[212]

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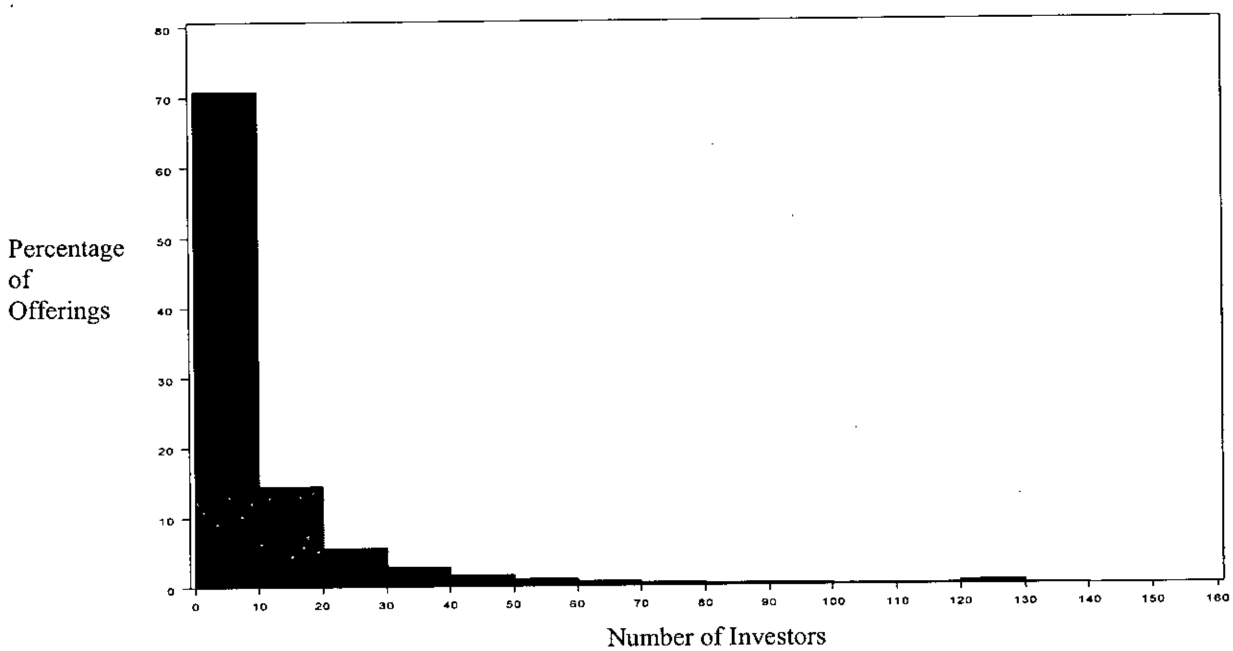
210 These numbers are based on initial Form D filings submitted in 2012.

211 See Ivanov/Bauguess Study.

212 Id.

Figure 5: Distribution of Regulation D Offerings by Number of Investors: 2009-2012



As stated above, between 2009 and 2012, the size of the median Regulation D offering, based on the information in Form D filings, was approximately $1.5 million. The presence of so many relatively small offerings suggests that a sizable number of current investors in Rule 506 offerings are natural persons or legal entities in which all equity owners are natural persons. This is because smaller offerings may not provide sufficient scale for institutional investors to earn a sizable return. Institutional investors typically have a larger investible capital base and more formal screening procedures compared to investors who are natural persons, and the associated costs of identifying potential investments and monitoring their investment portfolio lead them to make larger investments than natural persons.[213] As for whether natural persons investing in these offerings are accredited investors or non-accredited investors, almost 90% of the Regulation D offerings conducted between 2009 and 2012 did not involve any non-accredited investors.[214]

While we do not know what percentage of investors in Rule 506 offerings are natural persons, the vast majority of Regulation D offerings are conducted without the use of an intermediary,[215] suggesting that many of the investors in Regulation D offerings likely have a pre-existing relationship with the issuer or its management because these offerings would not have been conducted using general solicitation. This category of investors is likely to be much smaller than the total number of eligible investors for Rule 506(c) offerings, which is potentially very large. We estimate that at least 8.7 million U.S. households, or 7.4% of all U.S. households, qualified as accredited investors in 2010, based on the net worth standard in the definition of "accredited investor" (Figure 6).[216]

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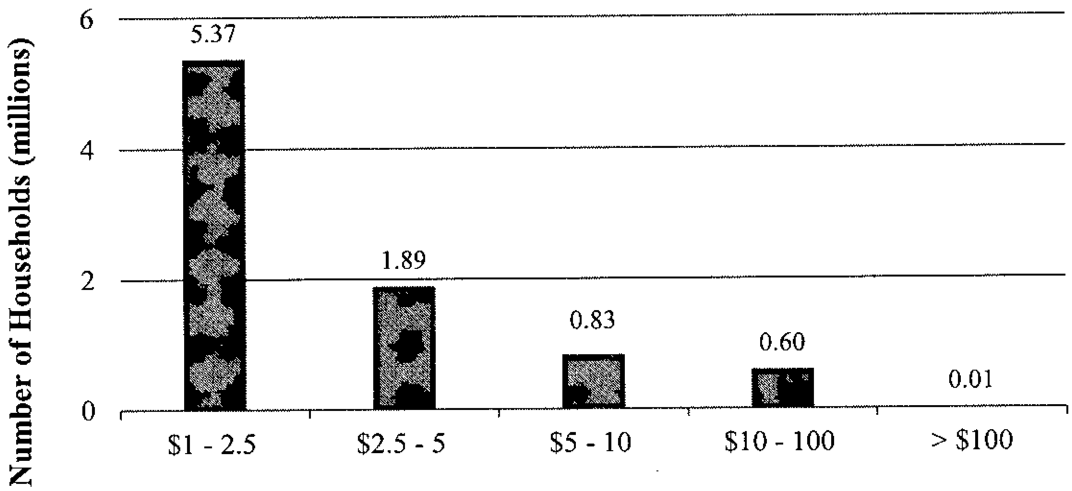
[213] See, e.g., George Fenn, Nellie Liang and Stephen Prowes, The Economics of Private Equity Markets (1998); Steven Kaplan and Per Strömberg, Leveraged Buyouts and Private Equity, 23 Journal of Economic Perspectives 121 (2009).

[214] See Ivanov/Bauguess Study.

[215] An analysis of all Form D filings submitted between 2009 to 2012 shows that approximately 11% of all new offerings reported sales commissions of greater than zero because the issuers used intermediaries. See Ivanov/Bauguess Study. We assume that the lack of a commission indicates the absence of an intermediary.

[216] This estimate is based on net worth and household data from the Federal Reserve Board's Triennial Survey of Consumer Finances 2010. Our calculations are based on all 32,410 observations in the 2010 survey.

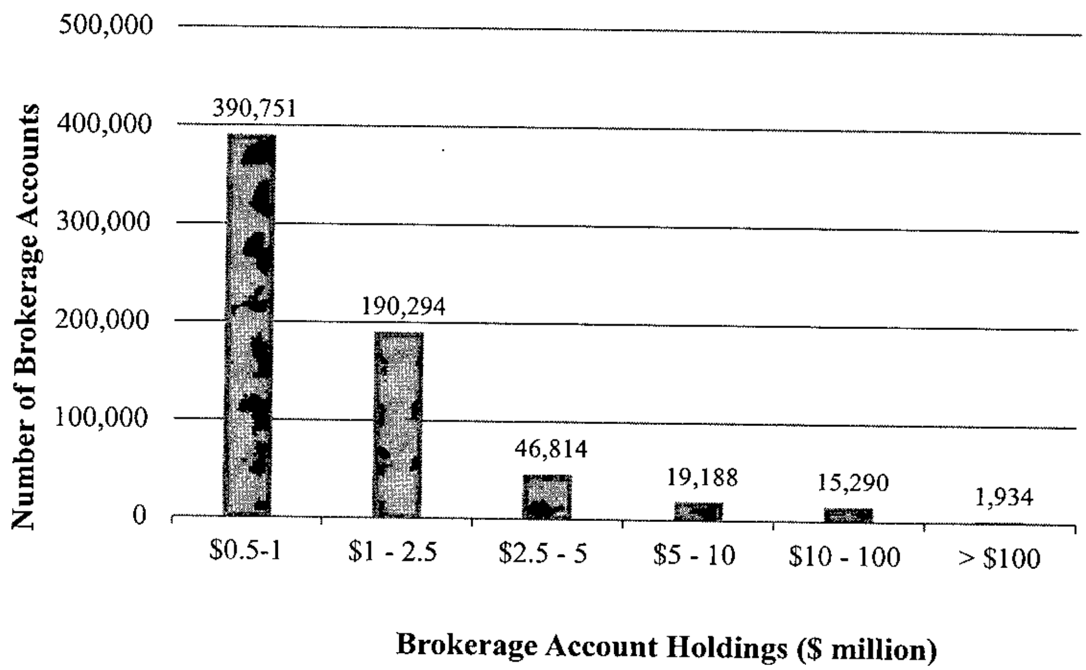
Figure 6: Number of U.S. Households that Qualify as Accredited Investors Based on 2010 Net Worth



Our analysis, however, leads us to believe that only a small percentage of these households are likely to participate in securities offerings, especially exempt offerings. First, as mentioned above, data from Form D filings in 2012 suggests that fewer than 234,000 investors (of which an unknown subset are natural persons) participated in Regulation D offerings, which is small compared to the 8.7 million households that qualify as accredited investors. Second, evidence suggests that only a small fraction of the total accredited investor population has significant levels of direct stockholdings. Based on an analysis of retail stock holding data for 33 million brokerage accounts in 2010, only 3.7 million accounts had at least $100,000 of direct investments in equity securities issued by public companies listed on domestic national securities exchanges, while only 664,000 accounts had at least $500,000 of direct investments in such equity

securities (Figure 7).[217] Assuming that investments in publicly-traded equity securities are a gateway to investments in securities issued in exempt offerings, and accredited investors with investment experience in publicly-traded equity securities are more likely to participate in an exempt offering than accredited investors who do not, the set of accredited investors likely to be interested in investing in Rule 506(c) offerings could be significantly smaller than the total accredited investor population.

Figure 7: Direct Stock Holdings of Retail Investors, 2010



Investors in Rule 144A offerings are QIBs, which comprise a broad range of U.S. entities, including mutual funds, pension funds, banks, savings and loan associations, investment companies, insurance companies and entities whose equity owners are all

[217] This analysis by DERA is based on the stock holdings of retail investors from more than 100 brokerage firms covering more than 33 million accounts during the period June 2010-May 2011.

QIBs.[218] As there is no obligation for issuers in Rule 144A offerings to publicly disclose the characteristics of their investors, the information available on the number and types of QIBs in the Rule 144A market is not broadly known, and is generally available only to those financial intermediaries who act as initial purchasers in the offerings.

c. Investment Advisers

As of December 2012, there were 10,870 Commission-registered investment advisers that filed Form ADV with the Commission, representing approximately $50 trillion total assets under management.[219] The average investment adviser registered with the Commission has assets under management of approximately $4.6 billion; the median size of assets under management for these registered investment advisers is $258 million.

Approximately one-fourth of registered investment advisers (2,842) currently advise (or advised) private funds that filed Form D between 2002 and 2012, while another 1,250 registered investment advisers currently advise (or advised) private funds that did not file Form D during the same period. The registered investment advisers advising private funds that submitted Form D filings during this period had average assets under management of $8.7 billion, while the ones advising private funds that did not submit Form D filings had average assets under management of $8.6 billion. Registered investment advisers that did not advise private funds (6,623) are considerably smaller, with average assets under management of $2.1 billion.

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[218] Non-U.S. investors generally do not participate in Rule 144A offerings; rather, they participate in Regulation S offerings. Issuers will frequently conduct side-by-side Rule 144A and Regulation S offerings.

[219] For the same time period, 2,303 exempt reporting advisers filed a Form ADV with the Commission. Certain investment advisers that are ineligible to register with the Commission may also be exempt from registration with any state.

d. Broker-Dealers

As of December 2012, there were 4,450 broker-dealers registered with the Commission who file on Form X-17A-5, with average total assets of approximately $1.1 billion per broker-dealer. The aggregate total assets of these registered broker-dealers are approximately $4.9 trillion. Of these registered broker-dealers, 410 are dually registered as investment advisers. The dually registered broker-dealers are larger (average total assets of $6.4 billion) than those that are not dually registered. Among the dually registered broker-dealers, we identified 24 that currently have or have had private funds that submitted Form D filings between 2002 and 2012.

3. Current Practices

The extent of the economic impact of the amendments to Rule 506 will depend on the current practices of issuers and market participants in Rule 506 offerings. As issuers in the Regulation D market are not required to disclose in Form D how they formed a reasonable belief that the purchasers in their Rule 506 offerings are accredited investors or sophisticated investors and are not currently required to take reasonable steps to verify the accredited investor status of these purchasers, the Commission does not have any data on current verification practices used in such offerings, if any. Commenters, however, provided examples of current practices of how issuers collect information from a potential purchaser to form a reasonable belief that he or she is an accredited investor. One commenter suggested that a large number of issuers rely on lists of accredited investors created and maintained by a reliable third party, such as registered broker-dealers,[220] which would be consistent with the Commission's view that an issuer would not contravene Rule 502(c)'s prohibition against general solicitation if the issuer or its agent has a pre-existing substantive relationship with the offerees.[221] Other commenters asserted that many issuers rely on the services of placement agents to obtain information about accredited investor status and to complete a Rule 506 transaction.[222] One commenter stated that the most common practice was a combination of an investor suitability questionnaire and investor self-certification.[223] These commenters, however, did not provide data to allow for an estimate of the frequency of usage and the costs associated with these practices.

C. Analysis of the Amendment to Rule 506

Congress has mandated that we eliminate the prohibition against general solicitation for a subset of Rule 506 offerings.[224] Below, we analyze the benefits and costs associated with the amendments to Rule 506 in light of the baseline discussed above. Because existing Rule 506 has always been subject to the prohibition against

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[220] See letter from J. McLaughlin.

[221] See Release No. 33-7856.

[222] See letters from SIFMA and FSR (Oct. 5, 2012); IAA.

[223] See letters from NSBA; MFA (May 4, 2012) (noting that, in the hedge fund industry, a potential hedge fund investor must complete "a subscription document provided by the fund's manager that provides a detailed description of, among other things, the qualification standards that a purchaser must meet under the federal securities laws").

[224] The legislative history of a bill that was introduced (but not adopted) at or around the time of the JOBS Act may be instructive with respect to how Congress viewed the effect of eliminating the prohibition against general solicitation in private offerings. In its report on a bill that would have amended Section 4(a)(2) of the Securities Act to permit the use of general solicitation, the House Committee on Financial Services stated that "regulations such as the prohibition of general solicitation and advertising in Regulation D Rule 506 offerings inhibit capital formation." Access to Capital for Job Creators Act, H.R. Rep. 112-263, at 2 (2011). Accordingly, "[t]he legislation would allow companies greater access to accredited investors and to new sources of capital to grow and create jobs, without putting less sophisticated investors at risk." Id.

general solicitation, there are significant data and informational limitations on our ability to quantify the economic impact of eliminating that prohibition in certain Rule 506 offerings. As discussed above, we do not believe that the Form D filings available on the Commission's Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system present a complete view of the Rule 506 market, as there are some Rule 506 offerings for which a Form D is not filed and the information presented in the Forms D that are filed is not necessarily comprehensive.[225] In addition, as discussed below, we believe that there are sufficient differences between Rule 504, as amended to permit general solicitation from 1992 to 1999, and Rule 506(c) such that it would not be useful to look to the Rule 504 market during that period to make meaningful predictions as to the type or magnitude of the effects of eliminating the prohibition against general solicitation for Rule 506(c) offerings. For example, the amount of capital that could be raised under Rule 504, as amended during this period, was capped at $1 million over a 12-month period; the securities in a Rule 504 offering could be sold to an unlimited number of non-accredited investors; and the securities sold in Rule 504 offerings were not restricted securities for purposes of resale. We provide below a qualitative analysis of the potential costs and benefits of eliminating the prohibition against general solicitation in certain Rule 506 offerings, supplementing that analysis with quantification, where possible, based on existing data.

[225] Because filing a Form D is not a condition for relying on Regulation D, commenters have noted that many issuers do not file a Form D when raising capital under Rule 506. Issuers are currently required to file an initial Form D within 15 days of the first sale of securities, but are required to report additional sales through amended filings only under certain conditions, which means that in many cases, the total amount of capital raised in a Regulation D offering is not reported on Form D. Finally, issuers do not report all required information, either due to error or because they do not wish to make the information public. For example, issuers have the option in Form D to decline to disclose their revenues or net asset values.

1. Benefits to Issuers

The elimination of the prohibition against general solicitation for a subset of Rule 506 offerings will enable issuers to solicit potential investors directly, through both physical (such as mailings, newspaper advertisements and billboards) and electronic (such as the Internet, social media, email and television) means. As a result, we anticipate that issuers will be able to reach a much greater number of potential investors than is currently the case, thereby increasing their access to sources of capital. We note that many commenters, including those representing small businesses, biotechnology companies and angel investors, stated that the elimination of the prohibition against general solicitation will facilitate capital formation by allowing businesses, particularly early-stage companies, to solicit investments from a larger pool of investors.[226] This could increase overall capital formation if issuers that previously did not raise capital from individual investors because it was too costly to solicit them through intermediaries now choose to solicit investors directly using general solicitation in accordance with Rule 506(c). Alternatively, if issuers use new Rule 506(c) in lieu of other methods of raising capital, such as registered offerings or unregistered non-Rule 506(c) offerings, then Rule 506(c) would replace one source of capital for another, thereby potentially improving the efficiency of capital flow through lower issuance costs, but not necessarily increasing the gross amount raised.

We believe that it is reasonable to conclude that allowing issuers to have wider access to accredited investors by eliminating the prohibition against general solicitation for a category of Rule 506 offerings will significantly improve their access to capital and

[226] See, e.g., letters from BIO; NSBA.

potentially enhance capital formation and lower the issuance cost. Although the lack of available data on the economic impact of eliminating the prohibition against general solicitation in Rule 506 offerings precludes us from quantifying the magnitude of this effect, the Commission has some evidence of the effect of the availability of general solicitation on issuers' ability to raise capital based on information about the number of Rule 504 offerings from 1992 to 2001, which covers the period during which the prohibition against general solicitation was lifted for Rule 504,[227] and subsequently reinstated in 1999.[228] In particular, and as shown in the chart below, the number of Rule 504 offerings increased at an average annual rate of 10.6% from 1992 through 1999.[229] In 2000, following the reinstatement of the ban, the number of Rule 504 offerings declined by almost 44%. This decline is coincident with the general market decline in 2000, including the collapse of the Internet bubble, which may have been the cause or at least a significant contributing factor to the rate of decline. During 2000, however, there was not a concurrent decline in either the number of Rule 505 offerings or the number of Rule 506 offerings. To the contrary, the number of Rule 506 offerings increased by about 54% in 2000, while the number of Rule 505 offerings remained largely unchanged (Figure 8). Declines in the numbers of Rule 505 and Rule 506 offerings followed in 2001, when presumably both types of offerings were negatively affected by the general market decline, although Rule 504 offerings experienced a sharper decline (-35%) compared to Rule 506 offerings (-30%). While it is not possible to disentangle the

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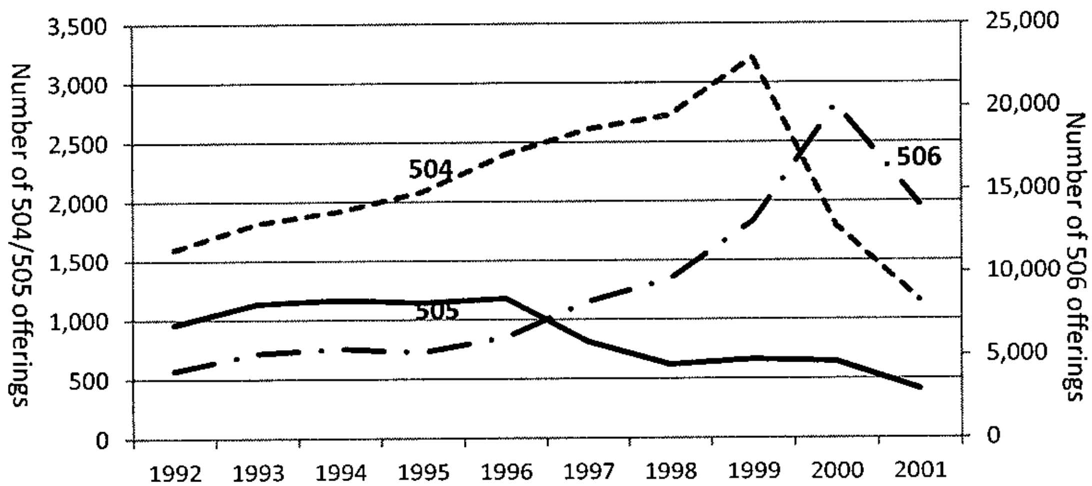
227 See Small Business Initiatives, Release No. 33-6949 (July 30, 1992) [57 FR 36442 (Aug. 13, 1992)].

228 See Release No. 33-7644.

229 This is based on an analysis of Form REGDEX filings on EDGAR.

broader market effects in 2000 from the reinstatement of the prohibition against general solicitation on the number of Rule 504 offerings, the steady increase in the number of Rule 504 offerings during the seven-year period following the elimination, in 1992, of the prohibition against general solicitation and the subsequent sharp decline in the number of Rule 504 offerings is consistent with the view that issuers' ability to generally solicit may enhance their ability to raise capital.

Figure 8: Number of New Regulation D Offerings: 1992-2001



The development of the venture capital (VC) industry in the United States may also be a relevant example to illustrate the potential for enhanced capital formation that may result from allowing issuers to have access to a wider range of investors. Under the Employment Retirement Income Security Act of 1974, pension fund managers are subject to a "prudent man" standard of care in making investments.[230] Prior to 1979, there was uncertainty under the U.S. Department of Labor's then-existing interpretations

[230] 29 U.S.C. 1104(a).

of this standard as to whether pension funds could invest in venture capital and start-up companies. In 1979, the Department clarified its interpretation of this standard by indicating that portfolio diversification is a factor in determining whether an investment is prudent, which indicated that pension funds would not be precluded from making investments in VC funds.[231] Following this regulatory change, the VC industry experienced substantial growth: VC commitments increased from $218 million in 1978 (of which pension funds supplied approximately 15%) to $3 billion in 1988 (of which pension funds supplied approximately 46%).[232]

We also anticipate that allowing issuers to solicit potential investors directly will lower the direct costs of Rule 506 offerings. Although none of the commenters provided data on direct cost savings, and although Form D filings do not present a complete view of the market, we do have estimates of the direct offering costs paid by issuers that use an intermediary to locate investors in Rule 506 offerings. An analysis of all Form D filings submitted between 2009 to 2012 shows that approximately 11% of all new Regulation D offerings reported sales commissions of greater than zero because the issuers used intermediaries.[233] The average commission paid to these intermediaries was 5.9% of the offering size, with the median commission being approximately 5%. Accordingly, for a $5 million offering, which was the median size of a Regulation D offering with a commission during this period, an issuer could potentially save up to $250,000 if it solicits investors directly rather than through an intermediary, minus the cost of its own

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[231] See 29 CFR 2550.404a-1(b)(1)(i).

[232] See Paul A. Gompers and Josh Lerner, The Venture Capital Cycle (2006); Paul Gompers, The Rise and Fall of Venture Capital, 23 Business and Economic History 1 (1994).

[233] See Ivanov/Bauguess Study.

solicitation efforts and the cost associated with verifying accredited investor status.[234] This potential benefit would likely be larger on a percentage basis for smaller offerings. During this four-year period, of the issuers that paid a commission in connection with a Regulation D offering, issuers raising up to $1 million in capital paid on average a 6.5% commission, whereas issuers raising over $50 million in capital paid on average a 1.9% commission.[235]

Even for issuers that do not currently use an intermediary, allowing issuers to generally solicit would likely lower the search costs associated with finding accredited investors who would be interested in a particular offering, thus enhancing economic efficiency.[236] If lower search costs expand the pool of interested investors for offerings, there could be greater competition among investors, thereby lowering the costs of capital for issuers.[237]

The elimination of the prohibition against general solicitation would also reduce the uncertainty for issuers as to whether a Rule 506 offering can be completed in certain situations, and would eliminate the costs of complying with the prohibition.[238] Under existing Rule 506, an inadvertent release of information about an offering to entities or persons with whom the issuer does not have a pre-existing substantive relationship has

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[234] We recognize that intermediaries can provide benefits to issuers in addition to locating investors. For example, an intermediary may be able to help an issuer obtain better pricing and terms or provide access to investors that can provide strategic or other advice to the issuer. An intermediary could also provide accreditation services. Unfortunately, we do not have data to quantify these benefits.

[235] See Ivanov/Bauguess Study.

[236] See, for example, Erik Sirri and Peter Tufano, Costly Search and Mutual Fund Flows, 53 Journal of Finance 1589 (1998), for a similar argument with respect to investors in mutual funds.

[237] For example, a study on offerings involving venture capitalists finds that increased competition among them results in higher valuations for issuers. See Paul Gompers and Josh Lerner, Money Chasing Deals? The Impact of Fund Inflows on Private Equity Valuations, 55 Journal of Financial Economics 281 (2000).

[238] See letter from MFA (May 4, 2012).

been viewed by some as raising questions about the issuer's ability to rely on the exemption for the entire offering.[239] In addition, some private funds have been reluctant to respond to press inquiries or to correct inaccurate reports due to concerns about these discussions being misconstrued as a general solicitation.[240] Under Rule 506(c), any such uncertainty as to the availability of the exemption due to the public disclosure of information will be reduced. Nevertheless, there is no data available to quantify or estimate these effects.

2. Benefits to Investors

The elimination of the prohibition against general solicitation in Rule 506(c) offerings will likely increase the amount and types of information about issuers and offerings that are communicated to investors, which could also lead to more efficient pricing for the offered securities. In addition, accredited investors who previously have found it difficult to find investment opportunities in Rule 506 offerings may be able to find and potentially invest in a larger and more diverse pool of potential investment opportunities, which would result in a more efficient allocation of investments by accredited investors.[241] Thus, Rule 506(c) could increase capital formation and at the

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239 See, e.g., letter from S. Lorne and J. McLaughlin (Aug. 5, 2008) on Release No. 33-8828 (stating that "[o]n occasion, the prohibition forces issuers to delay or even cancel offerings because of communications – sometimes inadvertent – that could be viewed in hindsight as a solicitation. The need to police communications by transaction participants, and to analyze and remedy inadvertent communications, also adds significantly to the cost of effecting private placements.").

240 See, e.g., letters from D.E. Shaw & Co. (Apr. 3, 2006) on Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies, Release No. 33-8666 (Feb. 28, 2006); MFA (May 4, 2012).

241 This benefit may not be applicable with respect to every issuer (e.g., certain private funds that offer their shares continuously at net asset value).

same time improve its allocative efficiency.[242] One commenter argued that we do not provide data to support the statements that accredited investors need new opportunities or cannot find new opportunities under the current rules prohibiting the use of general solicitation in Rule 506 offerings.[243] While we do not have data to test the validity of these statements since general solicitation has heretofore been prohibited in Rule 506 offerings, economic theory suggests that expanding investors' opportunities for investment generally results in more efficient allocation of capital. For example, one seminal study suggests that if some investors have incomplete information and are not aware of all firms in the economy, risk sharing is incomplete and inefficient.[244] Information that makes investors aware of the existence of these firms and enlarges the investor base leads to improved risk sharing and lower cost of capital.

With respect to private funds in particular, in the Proposing Release, we noted that eliminating the prohibition against general solicitation would allow accredited investors to gather information about private funds at relatively lower costs and to allocate their capital more efficiently.[245] Increased information about private fund strategies, management fees and performance information would likely lead to greater competition among private funds for investor capital.

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[242] Allocative efficiency is a condition that is reached when resources are allocated in a way that allows the maximum possible net benefit from their use. In this context, it means the right number of dollars from the right types of investors going to the most suitable investments on efficient terms.

[243] See letter from Consumer Federation.

[244] See Robert Merton, A Simple Model of Capital Market Equilibrium with Incomplete Information, 42 Journal of Finance 483 (1987).

[245] See, e.g., letter from MFA (May 4, 2012); and Managed Funds Association, Petition for Rulemaking on Rule 502 of Regulation D under the Securities Act of 1933, File No. 4-643 (Jan. 9, 2012) ("MFA Petition").

Some commenters noted that greater transparency about private funds' activities would benefit investors in these funds, and communications about these activities would be subject to the antifraud provisions of the federal securities laws and FINRA regulations on the preparation of marketing materials.[246] Other commenters believed that private funds engaging in general solicitation should be subject to form, content and/or other restrictions, such as performance and advertising standards that are analogous to the standards that are applicable to mutual funds in order to engage in general solicitation.[247] One of the commenters suggested that the Commission develop a rule tailored to the ways private funds calculate and present performance, rather than extending mutual fund performance rules to private funds.[248] With respect to private funds sold through broker-dealers subject to FINRA's rules of conduct, some commenters believed that we should direct FINRA to require the filing and review of private fund advertisements.[249]

While the lack of data does not allow us to quantify the costs and benefits of eliminating the prohibition against general solicitation under Rule 506(c) for private funds, we believe that the potential for an increase in fraudulent or deceptive issuer behavior due to the elimination of the prohibition may be limited to some extent by the competitive nature of the private funds industry as well as by the fact that there are often repeat interactions between private funds and their investors.[250]

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246 See letters from IAA; BlackRock; MFA (Sept. 28, 2012).

247 See, e.g., letters from AFL-CIO and AFR; Sen. Levin; Consumer Federation; Fund Democracy; Investor Advisory Committee; ICI; IDC; Rep. Waters; NASAA; P. Turney; and Sens. Reed, Levin, Durbin, Harkin, Lautenberg, Franken and Akaka.

248 See letter from ICI.

249 Letters from AFL-CIO and AFR; ICI.

250 See, e.g., William Fung and David Hsieh, Hedge Fund Benchmarks: Information Content and Biases, 58 Financial Analysts Journal 22 (2002); Rajarishi Nahata, Venture Capital Reputation and Investment

3. Costs

Eliminating the prohibition against general solicitation could result in heightened fraudulent activity in Rule 506(c) offerings because it will be easier for promoters of fraudulent schemes to reach potential investors through general solicitation. An increase in fraud would not only harm those investors who are defrauded, it would undermine investor participation in Rule 506(c) offerings and could negatively affect capital-raising by legitimate issuers – for example, by reducing investor participation in Rule 506(c) offerings – thereby inhibiting capital formation and reducing efficiency. One commenter was concerned that investors may confuse private funds with registered investment companies.[251] In such cases, fraud that occurs with private funds may cause investors to associate the wrongdoing with registered investment companies, and therefore refrain from investing in registered investment companies. In addition, some issuers with publicly-traded securities may use general solicitation for a purported Rule 506(c) offering to generate investor interest in the secondary trading markets, especially in the over-the-counter markets, which could be used by insiders to resell securities at inflated prices. This would impose costs to investors in these secondary markets, as well as investors in Rule 506(c) offerings, and could erode investor participation in Rule 506(c) offerings, thus potentially raising the cost of capital for issuers in this market. As discussed above, we cannot quantify these potential costs because the existence of the prohibition against general solicitation in Rule 506 offerings until now means that data on the economic impact of eliminating the prohibition is not available.

Performance, 90 Journal of Financial Economics 127 (2008); Douglas Cumming and Uwe Walz, Private Equity Returns and Disclosure Around the World, 41 Journal of International Business Studies 727 (2010).

[251] See letters from ICI; ICI re: MFA Petition (Feb. 7, 2012).

Several commenters echoed concerns regarding the potential of fraud related to private funds in the Rule 506(c) market.[252] Empirical evidence on the extent of fraud involving private funds is not readily available. While a few economic studies suggest that certain hedge funds engage in various types of misreporting, such as misrepresenting past performance,[253] delaying disclosure of returns[254] and inflating returns at the end of the fiscal year in order to earn higher fees,[255] these studies do not provide information about the extent or magnitude of any such misreporting activities. In a 2003 report, the Commission staff noted that there was no evidence that hedge funds were disproportionately involved in fraudulent activity and that the charges brought by the Commission in 38 enforcement actions against hedge fund advisers and hedge funds between 1999 and 2003 were similar to the charges against other types of investment advisers.[256] Evidence on the extent of fraud involving other types of pooled investment funds also is sparse. A more recent study has identified 245 lawsuits (both federal and state) involving 200 venture capitalists as defendants between 1975 and 2007, and has shown that VC funds that are older and have a larger presence in terms of size and network are less likely to be sued.[257]

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[252] See letters from Consumer Federation; Fund Democracy; IDC.

[253] See Andrew Patton, Tarun Ramadorai, and Michael Streatfield, Change You Can Believe In? Hedge Fund Data Revisions (Duke University, Working Paper, 2013). But see letter from MFA (June 20, 2013) (questioning the reliability of the underlying data used in the study).

[254] See George Aragon and Vikram Nanda, Strategic Delays and Clustering in Hedge Fund Reported Returns (Arizona State University, Working Paper, 2013).

[255] See Vikas Agarwal, Naveen Daniel, and Naranyan Naik, Do Hedge Funds Manage Their Reported Returns?, 24 Review of Financial Studies 3282 (2011).

[256] See Staff Report on Hedge Funds.

[257] See Vladimir Atanasov, Vladimir Ivanov, and Kate Litvak, Does Reputation Limit Opportunistic Behavior in the VC Industry? Evidence From Litigation Against VCs, 67 Journal of Finance 2215 (2012).

A number of commenters[258] noted the Commission's experience with the elimination of the prohibition against general solicitation for Rule 504 offerings in 1992,[259] and its subsequent reinstatement in 1999 as a result of heightened fraudulent activity.[260] We do not believe that our experience with offerings conducted pursuant to Rule 504, as amended in 1992, is particularly instructive with respect to the potential incidence of fraud resulting from our implementation of Section 201(a) of the JOBS Act, for a number of reasons. In 1992, when we amended Rule 504 to eliminate the prohibition against general solicitation, we also provided that the securities issued in these Rule 504 offerings would not be "restricted securities" for purposes of resale pursuant to Rule 144 under the Securities Act.[261] As a result, a non-reporting company could sell up to $1 million of immediately freely-tradable securities in a 12-month period and be subject only to the antifraud and civil liability provisions of the federal securities laws.

By 1998, we concluded that securities issued in these Rule 504 offerings facilitated a number of fraudulent secondary transactions in the over-the-counter markets, and that these securities were issued by "microcap" companies, characterized by thin capitalization, low share prices and little or no analyst coverage.[262] At that time, we stated that, while "we believe that the scope of abuse is small in relation to the actual

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258 See letters from Consumer Federation; Fund Democracy; Sen. Levin.

259 See Release No. 33-6949.

260 See Release No. 33-7644.

261 17 CFR 230.144.

262 Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Release No. 33-7541 (May 21, 1998) [63 FR 29168 (May 28, 1998)].

usage of the exemption, we also believe that a regulatory response may be necessary."[263] As the freely-tradable nature of the securities facilitated the fraudulent secondary transactions, we proposed to "implement the same resale restrictions on securities issued in a Rule 504 transaction as apply to transactions under the other Regulation D exemptions," in addition to reinstating the prohibition against general solicitation. Although we recognized that resale restrictions would have "some impact upon small businesses trying to raise 'seed capital' in bona fide transactions," we believed that such restrictions were necessary so that "unscrupulous stock promoters will be less likely to use Rule 504 as the source of the freely tradable securities they need to facilitate their fraudulent activities in the secondary markets."[264]

In contrast, issuers using Rule 506(c) can sell only to accredited investors, and the securities issued in these offerings are deemed to be "restricted securities" for purposes of resale under Rule 144. As a result, schemes involving price manipulation to defraud unknowing investors in the immediate resale of securities purchased directly from issuers (colloquially referred to as "pump and dump" schemes)[265] are not the types of fraud we believe are likely to occur in Rule 506(c) offerings, given the holding period requirement in Rule 144(d) and other structural impediments, such as restricted transfer legends on stock certificates.

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[263] Id. at 29169.

[264] Id.

[265] See, e.g., Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, before the Permanent Subcommittee on Investigations, Senate Committee on Governmental Affairs, Sept. 22, 1997; SEC v. Huttoe, Litigation Release No. 15237 (Jan. 31, 1997), 63 SEC Docket 2383 (Mar. 4, 1997); SEC v. Spencer, Litigation Release No. 14856 (Mar. 29, 1996), 61 SEC Docket 1960 (Apr. 30, 1996), and Litigation Release No. 15042 (Sept. 12, 1996), 62 SEC Docket 2409 (Oct. 8, 1996).

The risks to investors of fraudulent offerings conducted under Rule 506(c) may be mitigated to some extent by the requirement that issuers sell only to accredited investors (and take reasonable steps to verify such status), who, by virtue of meeting the requirements of the definition, may be better able to assess their ability to take financial risks and bear the risk of loss than investors who are not accredited investors. Issuers will still be subject to the antifraud provisions under the federal securities laws, and the public nature of these solicitations may also facilitate detection of fraudulent activity in that the fraudulent nature of some offerings may be inferred from particular statements contained in solicitation materials, for example, representations of guaranteed high rates of return.

Several commenters asserted that satisfying the definition of accredited investor does not equate to financial sophistication and that it is questionable whether accredited investors will be better able to identify the financial risks of the offerings and detect fraudulent offerings as compared to non-accredited investors.[266] They also noted that the income test and the net worth test have been significantly eroded by inflation. These commenters also stated that not all general solicitation activities are widely known or accessible, and that fraudulent offerings sold through telemarketing calls and email solicitations, for example, will be difficult if not impossible to detect until after significant damage has occurred.

4. Indirect Effects on Other Markets

Although Rule 506(c) will directly affect the private offering market, it could also have an indirect effect on other markets. The lower search costs associated with finding

[266] See, e.g., letters from Consumer Federation; Fund Democracy.

Rule 506(c) offerings may cause some investors that currently invest in public equity and debt markets or other non-registered offering markets to reallocate capital to offerings made under Rule 506(c). If a significant number of investors make a greater proportion of their investments in Rule 506(c) offerings, such investor behavior may reduce the supply of capital and prices in the public equity and debt markets and in other non-registered offering markets. For example, issuers currently using the exemptions in Regulation A under the Securities Act[267] and in Rules 504(b)(1)(i) through (iii) of Regulation D[268] to solicit investors could prefer to rely on the exemption under Rule 506(c) because they would be able to raise unlimited amounts of capital under Rule 506(c) and state blue sky securities registration requirements do not apply to Rule 506(c) offerings.[269] Although it is difficult to estimate how many of these issuers will choose to rely on Rule 506(c) in lieu of other available exemptions from registration, we believe that it is likely that Rule 506(c) will have a larger impact on issuers using Rule 504 rather than Regulation A because very few issuers have been using the Regulation A exemption in recent years.[270] In addition, to the extent that accredited investors have invested in registered investment companies instead of private funds because of information asymmetry between private funds and registered investment companies, it is possible that registered investment companies' assets may decrease if these investors now transfer

[267] 17 CFR 230.251 through 17 CFR 230.263.

[268] 17 CFR 230.504(b)(1)(i)-(iii).

[269] 17 CFR 230.251 through 17 CFR 230.263.

[270] The Ivanov/Bauguess Study reported that 1,852 issuers relied on the Rule 504 exemption to raise capital between 2009 to 2012, and 20 issuers relied on Regulation A. The number of issuers using Regulation A to raise capital may increase once the Commission adopts rules implementing Title IV of the JOBS Act, which directs the Commission to adopt an exemption based on Regulation A to permit offerings of up to $50 million.

their assets to private funds. Because we cannot predict how issuers will use the various exemptions from registration after the elimination of the prohibition against general solicitation in Rule 506(c) offerings, we cannot quantify these potential effects.

5. Retention of Rule 506(b)

We believe that retaining existing Rule 506(b) will have benefits for both issuers and investors. It will allow issuers that do not wish to generally solicit in their private offerings to avoid the added expense of complying with the rules applicable to Rule 506(c) offerings. It will also allow issuers to continue selling privately to up to 35 non-accredited investors who meet existing Rule 506's sophistication requirements. The continued availability of Rule 506(b) may also be beneficial to investors with whom the issuer has a pre-existing substantive relationship and who do not wish to bear additional verification costs that may be associated with participation in Rule 506(c) offerings. All but one commenter supported the Commission's decision to retain Rule 506(b).[271]

D. Verifying Accredited Investor Status in Rule 506(c) Offerings

As there is no information available to us on the costs currently incurred by issuers to form a reasonable belief that a purchaser in a Rule 506 offering is an accredited investor, we are unable to quantify the estimated costs and benefits of the verification requirement in Rule 506(c). Comments from the public on this issue also did not provide any estimates.

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[271] See, e.g., letters from ABA Fed. Reg. Comm.; ACA (Sept. 27, 2012); CFIRA; IPA; Montgomery & Hansen; NSBA; NYCBA; S&C; SIFMA and FSR (Oct. 5, 2012). Only one commenter opposed retaining it. Letter from J. McLaughlin (stating that "[t]here is no basis in the statute for the Commission to continue to apply the prohibition to a set of offerings exempt under Rule 506, especially since the effect of maintaining a parallel rule may have the effect of discouraging some issuers from using general solicitation….").

The requirement in Rule 506(c) for issuers to take reasonable steps to verify that purchasers are accredited investors will likely make it more difficult for issuers to sell securities to non-accredited investors. This, in turn, may reduce the likelihood that fraudulent offerings would be completed because those who are eligible to purchase are more likely to be able to protect their interests than investors who are not accredited investors. Issuers would also benefit from measures that improve the integrity and reputation of the Rule 506(c) market because the measures would facilitate investor participation, which could result in issuers having greater access to capital.

The verification requirement in Rule 506(c) would impose costs as well. Because the requirement is to take "reasonable" steps to verify, and not every conceivable step to verify, it is possible that some investors in Rule 506(c) will not be accredited investors, even if the issuer takes reasonable steps to verify their status as accredited investors. If so, then these investors will participate in offerings for which they are not qualified and that may not be appropriate for them, thereby resulting in a potentially inefficient allocation of capital for these investors. These investors could also face an additional cost in the form of heightened risk of significant losses on their investments, which they may not be able to manage or diversify in a way that accredited investors could.

In addition, some potential investors likely would have to provide more information to issuers than they currently provide, while issuers may have to apply a stricter and more costly process to determine accredited investor status than what they currently use. While commenters provided us with examples of the methods currently used by issuers in the Rule 506 market to collect information about purchasers, they did not provide any data on the costs of these methods. While it is reasonable to expect that the costs associated with the verification requirement could be offset somewhat by its benefits, it is also reasonable to expect that some accredited investors who would participate in existing Rule 506(b) offerings would decline to participate in Rule 506(c) offerings in light of the verification requirement.

To the extent that issuers require investors to provide personally identifiable information (e.g., Social Security numbers, tax information, bank or brokerage account information) in order to verify their accredited investor status, these investors may be reluctant to do so in the context of making an investment in an issuer, particularly an issuer with which they may have no prior relationship.[272] In addition to concerns about maintaining personal privacy, investors may be concerned that their personally identifiable information could be stolen or accessed by third parties or used by unscrupulous issuers in various ways (e.g., identity theft), which could impose costs to investors that go well beyond the costs typically associated with investing. As a consequence, some potential investors may elect not to participate in Rule 506(c) offerings, thus impeding capital formation to some extent.

Our decision not to specify the verification methods that an issuer must use in taking reasonable steps to verify accredited investor status would provide issuers with the flexibility to use methods that are appropriate in light of the facts and circumstances of each offering and each purchaser. Such flexibility could mitigate the cost to issuers of complying with Rule 506(c) because it would allow them to select the most cost-effective verification method for each offering. We anticipate, however, that issuers or their verification service providers will document the particular verification methods used in

[272] See letter from SecondMarket Holdings, Inc. (May 25, 2012).

the event of any question being raised about the availability of the exemption. Although we do not specify the nature or extent of any such documentation, we acknowledge that it will create some cost.

On the other hand, the greater flexibility of the principles-based "reasonableness" verification method could result in less rigorous verification, thus allowing some unscrupulous issuers to more easily sell securities to purchasers who are not accredited investors and perpetrate fraudulent schemes, or it could create or promote legal uncertainty about the availability of Rule 506(c), which may cause some issuers to interpret "reasonable steps to verify" in a manner that is more burdensome than if specific verification methods were prescribed, thus incurring higher cost. We believe that the non-exclusive list of specific methods of verification we are including in Rule 506(c), as adopted, should help to mitigate the impact of these costs.

Some commenters suggested that using a flexible verification standard is optimal for issuers because it closely resembles current market practices which they believe have worked well in this market.[273] Such flexibility will allow issuers to adopt different approaches based on the types of accredited investors, types of offerings and changing market practices. In contrast, other commenters questioned the benefits of the flexibility provided by the principles-based verification method and criticized the Commission for not quantifying the costs and benefits of currently used verification methods.[274] They argued that the application of the reasonableness standard in the principles-based method

[273] See letters from SIFMA and FSR (Oct. 5, 2012); and IAA.

[274] See letters from Consumer Federation; Fund Democracy.

will lead to lax verification practices by issuers, which would lessen investor protection by allowing sales of securities to non-accredited investors.

Our decision to provide a non-exclusive list of specified methods that issuers can use to verify a purchaser's accredited investor status will provide legal certainty in those circumstances in which there is a question as to whether or not the steps taken are reasonable in light of the facts and circumstances. Using a specified method would reduce issuers' verification costs to the extent that they would otherwise incur costs to analyze whether or not the steps they had taken or proposed to take satisfied the reasonableness standard in Rule 506(c). It could also reduce investors' costs, since the methods for verifying income and net worth rely mostly on documents prepared by third parties at no cost to the investors. On the other hand, some investors may be reluctant to provide the personal financial information required by the income and net worth methods; and with respect to the third-party method, it may be relatively costly to pay for the verification services of a lawyer or accountant as they may be concerned about professional liability. The grandfather method – which permits self-certification by existing investors who purchased securities as accredited investors in an issuer's Rule 506(b) offering before the effective date of Rule 506(c) – could result in investors that do not meet the definition of "accredited investor" participating in Rule 506(c) offerings because issuers conducting Rule 506(b) offerings are not required to take reasonable steps to verify the accredited investor status of their purchasers.

In addition, our non-exclusive list of specified verification methods could be mistakenly viewed by market participants as the required verification methods, in which compliance with at least one of the enumerated methods could be viewed, in the practical application of the verification requirement, as necessary in all circumstances to demonstrate that the verification requirement has been satisfied, thereby eliminating the flexibility that Rule 506(c) is intended to provide.[275] If issuers choose not to use verification methods different from those on the non-exclusive list, then some potential investors may limit their participation in the Rule 506(c) market, which may impede capital formation to some extent. Finally, even if a specified method has been used, thereby satisfying the verification requirement, there may be circumstances in which issuers may unreasonably overlook or disregard other information indicating that a purchaser is not, in fact, an accredited investor. This could lead to sales being made to persons who are not accredited investors. Because, as stated above, the Commission does not have data on current verification practices, we cannot quantify the effect of the new verification requirement in Rule 506(c).

E. Analysis of the Amendment to Rule 144A

We expect the potential benefits of the amendments to Rule 144A to be lower (i.e., less available) for issuers in Rule 144A offerings as compared to issuers in Rule 506(c) offerings because QIBs, which are the only permitted investors in Rule 144A offerings, are generally fewer in number, known by market participants, and better networked than accredited investors. Thus, as we noted in the Proposing Release, we believe that eliminating the prohibition against general solicitation for Rule 144A offerings is unlikely to dramatically increase issuers' access to QIBs in such offerings or to lower the cost of capital in Rule 144A offerings.

[275] The use of any of the specified methods is optional. We expect that many issuers will conduct Rule 506(c) offerings in reliance on the principles-based method of verification, in light of its flexibility and efficiency.

We expect that there would be fewer potential occurrences of general solicitation-induced fraud in Rule 144A offerings, as compared to Rule 506(c) transactions, because Rule 144A offerings involve an intermediary that, as the initial purchaser of the securities, typically performs a due diligence investigation and assists the issuer in preparing the offering materials, thereby adding a layer of protection against fraud. Also, Rule 144A investors are generally large institutions, which are thought to be better able to identify fraudulent activities than smaller institutions and retail investors in general.

We also anticipate that eliminating the prohibition against general solicitation would significantly affect private trading systems by permitting information vendors to provide more information about Rule 144A securities. Indeed, because offers will be able to be made to the public, the information on private trading systems for Rule 144A securities could be made available to all investors, even though sales would be limited to QIBs.[276] In addition, currently there is no public dissemination through Trade Reporting and Compliance Engine ("TRACE") of transactions in Rule 144A securities.[277] Now that Rule 144A is being amended to permit offers to be made to persons other than QIBs, transaction information with respect to Rule 144A securities can be publicly disseminated. Such improvements in the information available to potential investors could enhance efficiency in the Rule 144A market.

[276] Under the PORTAL Trading System developed by the Nasdaq Stock Market for trading Rule 144A securities, access is restricted to QIBs. Other privately developed Rule 144A trading systems, such as Portal Alliance, have similar restrictions.

[277] See FINRA Rule 6750. There is mandatory reporting of over-the-counter trades in fixed income securities. On April 19, 2013, the FINRA Board of Governors announced that it has authorized FINRA to file with the Commission "proposed amendments to FINRA Rules 6750 and 7730 to provide for the dissemination of transactions in TRACE-eligible securities effected pursuant to Securities Act Rule 144A (Rule 144A transactions)." See Letter from Richard G. Ketchum, Chairman and CEO, FINRA (Apr. 19, 2013), available at: http://www.finra.org/Industry/Regulation/Guidance/CommunicationstoFirms/P244913.

F. Additional Information Collection and Disclosures

We are amending Form D to add a new check box in Item 6 of Form D that will require an issuer to indicate whether it is relying on Rule 506(c) in conducting its offering. With this information, the Commission will be able to more effectively analyze the use of Rule 506(c). The marginal cost to issuers of providing this information is likely to be low because Form D already requires issuers to identify the exemption on which they are relying. Commenters generally supported the proposal to have a new check box in Item 6 of Form D as a way to identify Rule 506(c) offerings.[278] One commenter, however, questioned the usefulness of the information provided by the new check box.[279]

Much of what we know about the size and characteristics of the private offering market comes from Form D filings. The information collected to date and described in this release illustrates and underscores the importance of the private offering market to the U.S. economy. The continued collection of this information following the elimination of the prohibition against general solicitation in Rule 506(c) and Rule 144A offerings will be an important tool in assessing the ongoing economic impact of the new rule amendments.

VII. FINAL REGULATORY FLEXIBILITY ANALYSIS

This Final Regulatory Flexibility Analysis ("FRFA") has been prepared in accordance with Section 603 of the Regulatory Flexibility Act.[280] It relates to the

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[278] See letters from MFA (Sept. 28, 2012); SIFMA and FSR (Oct. 5, 2012); IAA.

[279] See letter from Consumer Federation.

[280] See 5 U.S.C. 603.

amendments to Rules 500, 501, 502 and 506 of Regulation D, Form D and Rule 144A that we are adopting in this release. An Initial Regulatory Flexibility Analysis ("IRFA") was prepared in accordance with the Regulatory Flexibility Act and included in the Proposing Release.

A. Reasons for, and Objectives of, the Action

The primary reason for, and objective of, the amendments to Rule 502 and Rule 506 is to implement the statutory requirements of Section 201(a)(1) of the JOBS Act, which directs the Commission to revise Rule 506 to provide that the prohibition against general solicitation in Rule 502(c) shall not apply to offers and sales of securities made pursuant to Rule 506, provided that all purchasers of the securities are accredited investors. Consistent with the language in Section 201(a), the amendment to Rule 506 requires issuers to take reasonable steps to verify that purchasers in any Rule 506 offering using general solicitation are accredited investors. The primary reason for, and objective of, the amendment to Form D is to assist our efforts to analyze the use of general solicitation in Rule 506(c) offerings and the size of this offering market.

The primary reason for, and objective of, the final amendment to Rule 144A is to implement the statutory requirements of Section 201(a)(2) of the JOBS Act, which directs the Commission to revise Rule 144A(d)(1) to provide that securities sold pursuant to Rule 144A may be offered to persons other than QIBs, including by means of general solicitation, provided that securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs.

B. Significant Issues Raised By Public Comments

In the Proposing Release, we requested comment on any aspect of the IRFA, including the number of small entities that would be subject to the proposed rule and form amendments and the nature of the effects of the proposed amendments on small entities. We received one comment addressing the IRFA.[281] This commenter stated that the Commission failed in its IRFA to consider the alternative of eliminating Form D or significantly reducing the scope of information required to be disclosed on Form D. As Form D provides meaningful information about the Regulation D market, and our need for information about this market will only increase once Rule 506(c) is in effect, we are not considering eliminating Form D or significantly reducing the scope of information required to be disclosed on Form D.

C. Small Entities Subject to the Final Rule and Form Amendments

For purposes of the Regulatory Flexibility Act, under our rules, an issuer, other than an investment company, is a "small business" or "small organization" if it has total assets of $5 million or less as of the end of its most recent fiscal year and is engaged or proposing to engage in an offering of securities which does not exceed $5 million.[282] For purposes of the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[283]

Rule 506(c) will affect small issuers (including both operating businesses and investment funds that raise capital under Rule 506) relying on this exemption from Securities Act registration. All issuers that sell securities in reliance on Regulation D are

[281] See letter from K. Bishop.

[282] 17 CFR 230.157.

[283] 17 CFR 270.0-10(a).

required to file a Form D with the Commission reporting the transaction. For the year ended December 31, 2012, 16,067 issuers made 18,187 new Form D filings, of which 15,208 issuers relied on the Rule 506 exemption. Based on the information reported by issuers on Form D, there were 3,958 small issuers[284] relying on the Rule 506 exemption in 2012. This number likely underestimates the actual number of small issuers relying on the Rule 506 exemption, however, because over 60% of issuers that are not pooled investment funds and over 80% of issuers that are pooled investment funds declined to report their amount of revenues in 2012.

The final amendment to Rule 144A will affect small entities that engage in Rule 144A offerings.[285] Unlike issuers that use Regulation D, issuers conducting Rule 144A offerings are not required to file any form with the Commission. This lack of data significantly limits our ability to assess the number and the size of issuers that conduct Rule 144A offerings. Still, we are able to obtain some data on non-ABS Rule 144A offerings during the 2009 to 2012 period from two commercial databases.[286] Based on these data, we identified 3,510 offerings involving 1,965 issuers from 2009 to 2012. We were able to obtain 2011 financial information for 598 of these issuers,[287] of which only 11 issuers reported total assets of less than $50 million.

[284] Of this number, 3,627 of these issuers are not investment companies, and 331 are investment companies. We also note that issuers that are not investment companies disclose only revenues on Form D, and not total assets. Hence, we use the amount of revenues as a measure of issuer size.

[285] While it may be theoretically possible for a small entity to meet one part of the definition of "qualified institutional buyer" (e.g., an "entity, all of the equity owners of which are qualified institutional buyers, acting for its own account or the accounts of other qualified institutional buyers"), we do not have any information to suggest that there are such small entities. Accordingly, the regulatory flexibility analysis in regard to Rule 144A is focused on small issuers that engage in Rule 144A offerings.

[286] These databases are Thomson Financial's SDC Platinum Service and Sagient Research System's Placement Tracker database.

[287] Financial data for fiscal year 2011 was obtained from Compustat, a product of Standard and Poor's.

(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 design rather than performance standards; and (4) exempting small entities from coverage of all or part of the amendment to Rule 506.

With respect to using design rather than performance standards, we note that the "reasonable steps to verify" requirement in Rule 506(c) is a performance standard. We believe that the flexibility of a performance standard accommodates different types of offerings and purchasers without imposing overly burdensome methods that may be ill-suited or unnecessary to a particular offering or purchaser, given the facts and circumstances. The Commission is not adopting different compliance or reporting requirements or timetables for small entities under Rule 506(c). The particular steps necessary to meet the requirement to take reasonable steps to verify that purchasers are accredited investors will vary according to the circumstances. Different compliance requirements for small entities may create the risk that the requirements may be too prescriptive or, alternatively, insufficient to verify a purchaser's accredited investor status. Special requirements for small entities may also lead to investor confusion or reduced investor participation in Rule 506 offerings if they create the impression that small entities have a different standard of verification than other issuers of securities. As the verification requirement is intended to protect investors by limiting participation in unregistered offerings to those who are most able to bear the risk, we are of the view that a flexible standard applicable to all issuers better accomplishes the goal of investor protection that this requirement is intended to serve. At the same time, the non-exclusive list of verification methods that we are including in the final rule will provide additional legal certainty to all issuers, including small entities. The Commission is not adopting a different reporting requirement for small entities because the additional information that will be required in Form D is minimal and should not be unduly burdensome or costly for small entities.

We similarly believe that it does not appear consistent with the objective of the final amendments or the considerations described above regarding investor confusion and investor participation to further clarify, consolidate or simplify the amendments for small entities. With respect to exempting small entities from coverage of these final amendments, we believe such an approach would be contrary to the requirements of, and the legislative intent behind, Section 201(a) of the JOBS Act, as evidenced by the plain language of the statute.

VIII. STATUTORY AUTHORITY AND TEXT OF FINAL RULE AND FORM AMENDMENTS

The final amendments contained in this release are being adopted under the authority set forth in Sections 4(a)(1), 4(a)(2), 7, 17(a), 19 and 28 of the Securities Act, as amended, Sections 2, 3, 9(a), 10, 11A(c), 12, 13, 14, 15(c), 15(g), 17(a), 23(a) and 30 of the Exchange Act, as amended, Sections 23, 30 and 38 of the Investment Company Act, as amended, and Section 201(a) of the JOBS Act.[288]

List of Subjects in 17 CFR Parts 230, 239 and 242

Reporting and recordkeeping requirements, Securities.

[288] Although 15 U.S.C. 77d note is not an authority for the amendments in this release, it is being included in the instruction below for the general authority citation for Part 230 to ensure that the Code of Federal Regulations is correctly updated for purposes of the bad actor disqualification rule for Rule 506 offerings also published today. See Bad Actor Release.

For the reasons set out above, the Commission is amending Title 17, chapter II of the Code of Federal Regulations, as follows:

PART 230–GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The general authority citation for Part 230 is revised to read as follows:

Authority: 15 U.S.C. 77b, 77b note, 77c, 77d, 77d note, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78o-7 note, 78t, 78w, 78ll (d), 78mm, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, and 80a-37, and Pub. L. No. 112-106, § 201(a), 126 Stat. 313 (2012), unless otherwise noted.

2. Amend § 230.144A by:

a. In Preliminary Note 7, removing the reference to "section 4(2)" and adding in its place "section 4(a)(2)";

b. In paragraph (a)(1)(i)(A), removing the reference to "section 2(13)" and adding in its place "section 2(a)(13)";

c. In paragraph (b), removing the reference to "sections 2(11) and 4(1)" and adding in its place "sections 2(a)(11) and 4(a)(1)";

d. In paragraph (c), removing the references to "section 4(3)(C)," "section 2(11)" and "section 4(3)(A)" and adding in their place "section 4(a)(3)(C)," "section 2(a)(11)" and "section 4(a)(3)(A)," respectively;

e. In paragraph (d)(1), first sentence, removing the phrase "offered or"; and

f. In paragraph (d)(1), first sentence, removing the phrase "an offeree or" and adding in its place "a".

3. Amend § 230.500(c) by:

a. Removing the reference to "section 4(2)" and adding in its place "section 4(a)(2)"; and

b. In the second sentence, adding "(b)" after "rule 506" and after "(§230.506".

4. Amend § 230.501 by:

a. In paragraph (a)(1), removing the reference to "section 2(13)" and adding in its place "section 2(a)(13)"; and

b. In paragraph (g), removing the reference to "section 2(4)" and adding in its place "section 2(a)(4)".

5. Amend § 230.502 by:

a. In paragraphs (b)(1), (b)(2)(iv), (b)(2)(v) and (b)(2)(vii), removing the reference to "§ 230.506" and adding in its place "§ 230.506(b)";

b. In paragraph (c), first sentence, adding the phrase "or § 230.506(c)" after the phrase "Except as provided in § 230.504(b)(1)";

c. In paragraph (d), removing the reference to "section 4(2)" and adding in its place "section 4(a)(2)"; and

d. In paragraph (d), removing the reference to "section 2(11)" and adding in its place "section 2(a)(11)."

6. Amend § 230.506 by:

a. In paragraph (a), adding the phrase "or (c)" after the phrase "satisfy the conditions in paragraph (b)";

b. In paragraph (a), removing the phrase "section 4(2)" and adding in its place "section 4(a)(2)";

c. In paragraph (b), adding the phrase "in offerings subject to limitation on manner of offering" after the phrase "Conditions to be met";

d. In the note following paragraph (b)(2)(i), removing the phrase "this section" and adding in its place "§ 230.506(b)"; and

e. Adding paragraph (c) to read as follows:

§ 230.506 Exemption for limited offers and sales without regard to dollar amount of offering.

* * * * *

(c) Conditions to be met in offerings not subject to limitation on manner of offering

(1) General conditions. To qualify for exemption under this section, sales must satisfy all the terms and conditions of §§ 230.501 and 230.502(a) and (d).

(2) Specific conditions

(i) Nature of purchasers. All purchasers of securities sold in any offering under paragraph (c) of this section are accredited investors.

(ii) Verification of accredited investor status. The issuer shall take reasonable steps to verify that purchasers of securities sold in any offering under paragraph (c) of this section are accredited investors. The issuer shall be deemed to take reasonable steps to verify if the issuer uses, at its option, one of the following non-exclusive and non-mandatory methods of verifying that a natural person who purchases securities in such offering is an accredited investor; provided, however, that the issuer does not have knowledge that such person is not an accredited investor:

(A) In regard to whether the purchaser is an accredited investor on the basis of income, reviewing any Internal Revenue Service form that reports the purchaser's income for the two most recent years (including, but not limited to, Form W-2, Form 1099, Schedule K-1 to Form 1065, and Form 1040) and obtaining a written representation from the purchaser that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year;

(B) In regard to whether the purchaser is an accredited investor on the basis of net worth, reviewing one or more of the following types of documentation dated within the prior three months and obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed:

(1) With respect to assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third parties; and

(2) With respect to liabilities: a consumer report from at least one of the nationwide consumer reporting agencies; or

(C) Obtaining a written confirmation from one of the following persons or entities that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor:

(1) A registered broker-dealer;

(2) An investment adviser registered with the Securities and Exchange Commission;

(3) A licensed attorney who is in good standing under the laws of the jurisdictions in which he or she is admitted to practice law; or

(4) A certified public accountant who is duly registered and in good standing under the laws of the place of his or her residence or principal office.

(D) In regard to any person who purchased securities in an issuer's Rule 506(b) offering as an accredited investor prior to the effective date of paragraph (c) of this section and continues to hold such securities, for the same issuer's Rule 506(c) offering, obtaining a certification by such person at the time of sale that he or she qualifies as an accredited investor.

Instructions to paragraph (c)(2)(ii)(A) through (C) of this section:

1. The issuer is not required to use any of these methods in verifying the accredited investor status of natural persons who are purchasers. These methods are examples of the types of non-exclusive and non-mandatory methods that satisfy the verification requirement in § 230.506(c)(2)(ii).

2. In the case of a person who qualifies as an accredited investor based on joint income with that person's spouse, the issuer would be deemed to satisfy the verification requirement in § 230.506(c)(2)(ii)(A) by reviewing copies of Internal Revenue Service forms that report income for the two most recent years in regard to, and obtaining written representations from, both the person and the spouse.

3. In the case of a person who qualifies as an accredited investor based on joint net worth with that person's spouse, the issuer would be deemed to satisfy the verification requirement in § 230.506(c)(2)(ii)(B) by reviewing such documentation in regard to, and obtaining written representations from, both the person and the spouse.

PART 239 – FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

7. The authority citation for Part 239 continues to read, in part, as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77sss, 78c, 78l, 78m, 78n, 78o (d), 78o-7 note, 78u-5, 78w(a), 78ll, 78mm, 80a-2(a), 80a-3, 80a-8, 80a-9, 80a-10, 80a-13, 80a-24, 80a-26, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

8. Amend Form D (referenced in § 239.500) by:

a. In Item 6, removing the phrase "Rule 506" and adding in its place "Rule 506(b)" next to the appropriate check box, and removing the phrase "Securities Act Section 4(5)" and adding in its place "Securities Act Section 4(a)(5)" next to the appropriate check box;

b. In Item 6, adding a check box that reads "Rule 506(c)" after the newly redesignated Rule 506(b) check box; and

c. In the instruction "Who must file:", removing the reference to "Section 4(5)" and adding in its place "Section 4(a)(5)."

(Note: The text of Form D does not, and the amendments will not, appear in the Code of Federal Regulations.)

PART 242—REGULATIONS M, SHO, ATS, AC, AND NMS AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

9. The general authority citation for Part 242 continues to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm, 80a-23, 80a-29, and 80a-37.

10. Amend § 242.101 by:

a. In paragraph (b)(10), removing the phrase "offered or"; and

b. In paragraph (b)(10)(i), removing the phrase "offerees or".

11. Amend § 242.102 by:

a. In paragraph (b)(7), removing the phrase “offered or”; and

b. In paragraph (b)(7)(i), removing the phrase “offerees or”.

12. Amend § 242.104 by:

a. In paragraph (j)(2), removing the phrase “offered or”; and

b. In paragraph (j)(2)(i), removing the phrase “offerees or”.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

July 10, 2013

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 200, 230, and 239

Release No. 33-9414; File No. S7-21-11

RIN 3235-AK97

Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: We are adopting amendments to our rules to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 926 requires us to adopt rules that disqualify securities offerings involving certain "felons and other 'bad actors'" from reliance on Rule 506 of Regulation D. The rules must be "substantially similar" to Rule 262 under the Securities Act, which contains the disqualification provisions of Regulation A under the Securities Act, and must also cover matters enumerated in Section 926 of the Dodd-Frank Act (including certain state regulatory orders and bars).

DATES: Effective Date: [insert date 60 days after publication in the Federal Register].

Comment Date: Comments regarding the collection of information requirements within the meaning of the Paperwork Reduction Act of 1995 should be received on or before [insert date 30 days after publication in the Federal Register.]

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

- Use the Commission's Internet comment form (http://www.sec.gov/rules/final.shtml);

SUPPLEMENTARY INFORMATION: We are adopting amendments to Rules 145,[1] 147,[2] 152[3] and 155;[4] Rules 501[5] and 506[6] of Regulation D;[7] and Form D[8] under the Securities Act of 1933[9] and to Rule 30-1[10] of our Rules of Organization and Program Management.

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[1] 17 CFR 230.145.

[2] 17 CFR 230.147.

[3] 17 CFR 230.152.

[4] 17 CFR 230.155.

[5] 17 CFR 230.501.

[6] 17 CFR 230.506.

[7] 17 CFR 230.500 through 230.508.

[8] 17 CFR 239.500.

[9] 15 U.S.C. 77a et seq.

[10] 17 CFR 200.30-1.

I. BACKGROUND AND SUMMARY

Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), entitled "Disqualifying felons and other 'bad actors' from Regulation D offerings," requires the Commission to adopt rules to disqualify certain securities offerings from reliance on Rule 506 of Regulation D.[11] The Commission proposed rule amendments to implement Section 926 of the Dodd-Frank Act on May 25, 2011.[12] Today we are adopting amendments to Rules 501 and 506 and to Form D to implement Section 926. The disqualification provisions we are adopting, to be codified as new paragraph (d) of Rule 506,[13] are generally consistent with the proposal, but will apply only to triggering events occurring after effectiveness of the rule amendments (with pre-existing events subject to mandatory disclosure) and also reflect some changes in response to comments.

Rule 506 is one of three exemptive rules for limited offerings under Regulation D.[14] It is by far the most widely used Regulation D exemption, accounting for an estimated 90% to 95%

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[11] Pub. L. No. 111-203, § 926, 124 Stat. 1376, 1851 (July 21, 2010) (codified at 15 U.S.C. 77d note).

[12] See Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Release No. 33-9211 (May 25, 2011) [76 FR 31518 (June 1, 2011)].

[13] Because of the adoption of new Rule 506(c), the disqualification provisions we adopt today, which were proposed as Rule 506(c), will be adopted and codified as Rule 506(d).

[14] The others are Rule 504 and Rule 505, 17 CFR 230.504 and 230.505. Rule 504 permits offerings of up to $1 million of securities by issuers that are not (i) reporting companies under the Securities Exchange Act of 1934, (ii) investment companies or (iii) development stage companies with no specific business plan or purpose, or whose business plan is to engage in a merger or acquisition with an unidentified entity or entities. Offerings under Rule 504 must generally comply with Regulation D requirements regarding limitations on manner of sale (no general solicitation) and limitations on resale. The manner of sale and resale limitations do not apply, however, to offerings that are subject to state-level registration or that rely on state law exemptions permitting general solicitation so long as sales are made only to accredited investors. Rule 505 permits offerings of up to $5 million of securities annually, without general solicitation, to an unlimited number of accredited investors and up to 35 non-accredited investors. Rule 505 offerings are subject to the same conditions as apply to Rule 506 offerings, which are described elsewhere, except that non-accredited investors are not required to be sophisticated and such offerings are subject to bad actor disqualification provisions.

of all Regulation D offerings[15] and the overwhelming majority of capital raised in transactions under Regulation D.[16] Rule 506 permits sales of an unlimited dollar amount of securities to be made without Securities Act registration, provided that the requirements of the rule are satisfied.

Rule 506 historically has permitted sales to an unlimited number of accredited investors[17] and up to 35 non-accredited investors, so long as there was no general solicitation, appropriate resale limitations were imposed, any applicable information requirements were satisfied, and the other conditions of the rule were met.[18] Section 201(a) of the Jumpstart Our Business Startups Act ("JOBS Act") required the Commission to eliminate the prohibition against general solicitation and general advertising for offers and sales of securities made pursuant to Rule 506, provided that all purchasers of the securities are accredited investors and the issuer takes

[15] In 2012, the Commission received 18,187 initial filings for offerings under Regulation D, of which 17,203 (approximately 95%) claimed a Rule 506 exemption.

[16] Staff of the Commission's Division of Economic and Risk Analysis estimates that, for 2009, 2010, 2011 and 2012, approximately $607 billion, $1.003 trillion, $850 billion and $899 billion, respectively, was raised in transactions claiming the Rule 506 exemption, in each case representing more than 99% of funds raised under Regulation D for the period, based on Form D filings with the Commission. The amount of capital raised through offerings under Regulation D and the number of Regulation D offerings may be considerably larger than what is disclosed in Form D filings because the filing of a Form D notice is a requirement of Rule 503(a) of Regulation D [17 CFR 230.503(a)], but is not a condition to the availability of the exemptions of Regulation D. We understand that some issuers, therefore, may not make Form D filings for offerings made in reliance on Regulation D. Further, once a Form D filing is made, the issuer is not required to file an amendment to reflect a change that occurs after the offering terminates or a change that occurs solely with respect to certain information, such as the amount sold in the offering. For example, if the amount sold does not exceed the offering size by more than 10% or the offering closes before a year has passed, the filing of an amendment to Form D would not necessarily be required. Therefore, the Form D filings for an offering may not reflect the total amount of securities sold in the offering in reliance on the exemption.

[17] Rule 501 of Regulation D lists eight categories of "accredited investor," including entities and natural persons that meet specified income or asset thresholds. See 17 CFR 230.501.

[18] Except as provided under new Rule 506(c), offerings under Rule 506 are subject to all the terms and conditions of Rules 501 and 502, including applicable limitations on the manner of offering, limitations on resale and, if securities are sold to any non-accredited investors, specified information requirements. Where securities are sold only to accredited investors, the information requirements do not apply. See 17 CFR 230.502 and 230.506. In addition, any non-accredited investors must satisfy the investor sophistication requirements of Rule 506(b)(2)(ii). Offerings under Rule 506 must also comply with the notice of sale requirements of Rule 503. See 17 CFR 230.503.

reasonable steps to verify their accredited investor status.[19] In a separate release today, we are adopting amendments to Rule 506 and Form D, including adding new paragraph (c) to Rule 506 to implement JOBS Act Section 201(a).[20] As a result, offers and sales of securities involving the use of general solicitation will be permitted under Rule 506, provided that the requirements of new Rule 506(c) are satisfied.

"Bad actor" disqualification requirements, sometimes called "bad boy" provisions, disqualify securities offerings from reliance on exemptions if the issuer or other relevant persons (such as underwriters, placement agents and the directors, officers and significant shareholders of the issuer) have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws. Rule 506 in its current form does not impose any bad actor disqualification requirements.[21] In addition, because securities sold under Rule 506 are "covered securities" under Section 18(b)(4)(D) of the Securities Act, state-level bad actor disqualification rules do not apply.[22]

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[19] See Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313 (Apr. 5, 2012).

[20] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9415 (July 10, 2013).

[21] Rule 507 of Regulation D imposes a different kind of disqualification specific to Regulation D offerings. Under Rule 507, any person that is subject to a court order, judgment or decree enjoining such person for failure to file the notice of sale on Form D required under Rule 503 is disqualified from relying on Regulation D. 17 CFR 230.507(a). We are not amending Rule 507 at this time but, in a separate release the Commission is issuing today, we are proposing amendments to Rule 507 that would disqualify an issuer from reliance on Rule 506 if the issuer or its predecessor or affiliates had conducted a previous securities offering in reliance on Rule 506 without complying with the Form D filing requirements of Rule 503. See Amendments to Regulation D, Form D, and Rule 156 under the Securities Act, Release No. 33-9416 (July 10, 2013).

[22] See 15 U.S.C. 77r(b)(4)(D). This provision of Section 18 was added by Section 102(a) of the National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290,110 Stat. 3416 (Oct. 11, 1996) ("NSMIA"). NSMIA preempts state registration and review requirements for transactions involving "covered securities," which include securities offered or sold in transactions that are exempt from registration under Commission rules or regulations issued under Securities Act Section 4(a)(2) (formerly Section 4(2)). Rule 506 was originally adopted as a safe harbor under Section 4(a)(2). Section 201(a) of the JOBS Act provides that Rule 506, as amended in accordance with the mandate of that provision, "shall continue to be treated as a regulation issued under" Section 4(a)(2) of the Securities Act.

Section 926 of the Dodd-Frank Act instructs the Commission to issue disqualification rules for Rule 506 offerings that are "substantially similar" to the bad actor disqualification provisions contained in Rule 262 of Regulation A,[23] and also provides an expanded list of disqualifying events, including certain actions by state regulators, enumerated in Section 926. The disqualifying events listed in Rule 262 cover the issuer and certain other persons associated with the issuer or the offering, including: issuer predecessors and affiliated issuers; directors, officers and general partners of the issuer; beneficial owners of 10% or more of any class of the issuer's equity securities; promoters connected with the issuer; and underwriters and their directors, officers and partners. Rule 262 disqualifying events include:

- Felony and misdemeanor convictions in connection with the purchase or sale of a security or involving the making of a false filing with the Commission (the same criminal conviction standard as in Section 926 of the Dodd-Frank Act) within the last five years in the case of issuers and ten years in the case of other covered persons;
- Injunctions and court orders within the last five years against engaging in or continuing conduct or practices in connection with the purchase or sale of securities, or involving the making of any false filing with the Commission;
- U.S. Postal Service false representation orders within the last five years;
- Filing, or being named as an underwriter in, a registration statement or Regulation A offering statement that is the subject of a proceeding to determine whether a stop

[23] 17 CFR 230.262. Regulation A (17 CFR 230.251 through 230.263) is a limited offering exemption that permits public offerings of securities not exceeding $5 million in any 12-month period by companies that are not required to file periodic reports with the Commission. Regulation A offerings are required to have an offering circular containing specified information, which is filed with the Commission and subject to review by the staff of the Division of Corporation Finance.

order should be issued, or as to which a stop order was issued within the last five years; and

- For covered persons other than the issuer:
  - being subject to a Commission order:
    - revoking or suspending their registration as a broker, dealer, municipal securities dealer, or investment adviser;
    - placing limitations on their activities as such;
    - barring them from association with any entity; or
    - barring them from participating in an offering of penny stock; or
  - being suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange or national securities association for conduct inconsistent with just and equitable principles of trade.

The disqualifying events specifically required by Section 926 are:

- Final orders issued by state securities, banking, credit union, and insurance regulators, federal banking regulators, and the National Credit Union Administration that either
  - bar a person from association with an entity regulated by the regulator issuing the order, or from engaging in the business of securities, insurance or banking, or from savings association or credit union activities; or
  - are based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within a ten-year period; and
- Felony and misdemeanor convictions in connection with the purchase or sale of a security or involving the making of a false filing with the Commission.

On May 25, 2011, we proposed amendments to Rules 501 and 506 of Regulation D and Form D to implement Section 926.[24] We received 44 comment letters in response to our proposal.[25] In addition, we received three advance comment letters commenting on Section 926 before the publication of the proposing release.[26] These comment letters and advance comment letters came from a variety of individuals, groups and constituencies, including state securities regulators, professional and trade associations, lawyers, academics and individual investors. Most commenters expressed general support for the proposed amendments and the objectives that we articulated in the proposing release, but many suggested modifications to the proposals.

Today we are adopting amendments to Rules 501 and 506 of Regulation D and to Form D to implement Section 926 of the Dodd-Frank Act.[27] The amendments we are adopting are generally consistent with the proposal, with the following principal differences:

- disqualification will apply only for triggering events that occur after the effective date of the amendments; however, pre-existing matters will be subject to mandatory disclosure;

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[24] See Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Release No. 33-9211 (May 25, 2011) [76 FR 31518 (June 1, 2011)].

[25] The comment letters we received on the proposal are available on our website at http://www.sec.gov/comments/s7-21-11/s72111.shtml. In this release, we refer to these letters as the "comment letters" to differentiate them from the "advance comment letters" described in note 26.

[26] To facilitate public input on its Dodd-Frank Act rulemaking before issuance of rule proposals, the Commission provided a series of e-mail links, organized by topic, on its website at http://www.sec.gov/spotlight/regreformcomments.shtml. In this release, we refer to comment letters we received on this rulemaking project in response to this invitation as "advance comment letters." These advance comment letters appear on the Commission's website under the heading "Adding Disqualification Requirements to Regulation D Offerings, Title IX Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act."

[27] We are also adopting technical amendments to Rules 145, 147, 152 and 155 to update references to Section 4(2) of the Securities Act, which was renumbered as Section 4(a)(2) by Section 201(c) of the JOBS Act, Pub. L. No. 112-106, § 201(c), 126 Stat. 306, 314 (Apr. 5, 2012).

- the rule includes additional disqualifying events for certain orders of the Commodity Futures Trading Commission ("CFTC") and for Commission cease-and-desist orders arising out of scienter-based anti-fraud violations and violations of Section 5 of the Securities Act;
- instead of covering all officers of the issuer and of any compensated solicitors of purchasers of securities, the rule is limited to executive officers and officers who participate in the offering;
- rather than covering beneficial owners of 10% or more of any class of the issuer's securities, the rule covers beneficial owners of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power;
- for issuers that are pooled investment funds, the rule covers the funds' investment managers and their principals; and
- disqualification will not apply if the authority issuing the relevant judgment, order or other triggering directive or statement determines and advises the Commission that disqualification from reliance on Rule 506 should not arise as a result.

Part III of the proposing release requested comment on a number of potential further rule amendments that would result in more uniform bad actor disqualification rules, including the application of the new bad actor disqualification standards to offerings under Regulation A, Regulation E and Rules 504 and 505 of Regulation D. Commenters were divided in their views with respect to uniform bad actor standards. Some commenters supported uniformity on the basis that it would enhance investor protection, increase clarity and consistency in our regulations and avoid the creation of opportunities for regulatory arbitrage.[28] Others opposed it, generally arguing that attempts to impose uniformity would be premature or inappropriate given the limits of the Dodd-Frank Act mandate, and that uniformity should be considered, if at all, in a separate rulemaking.[29]

We note that the JOBS Act requires us to adopt rules for two new exemptions from the Securities Act – one for "crowdfunding" offerings, contained in Title III of the JOBS Act, and one for offerings of up to $50 million in a 12-month period under Section 3(b) of the Securities Act, contained in Title IV of the JOBS Act. The statutory requirements for these exemptions contemplate bad actor disqualifications with language similar to that in Section 926 of the Dodd-Frank Act.[30] We are working on separate rulemakings for these new exemptions. In light of these additional rulemakings, we have decided to limit the disqualification provisions adopted today to Rule 506 offerings. At the time of those rulemakings, we will have an opportunity to consider to what extent any bad actor disqualification provisions to be adopted in connection with those rules should differ from those applicable to Rule 506 offerings. At a later time, we

[28] See comment letters from the Federal Regulation of Securities Committee, Business Law Section of the American Bar Association (Oct. 4, 2011) ("ABA Fed. Reg. Comm."); Chris Barnard (June 1, 2011) ("C. Barnard"); North American Securities Administrators Association, Inc. (July 25, 2011) ("NASAA"); SNR Denton LLC on behalf of The Depository Trust & Clearing Corporation (July 14, 2011) ("DTC"); Better Markets, Inc. (July 14, 2011) ("Better Markets"); Whitaker Chalk Swindle & Schwartz, PLLC (July 30, 2011 ("Whitaker Chalk"); and Professor J. Robert Brown, Jr. (Feb. 1, 2012).

[29] See comment letters from the Committee on Securities Regulation of the New York City Bar Association (July 14, 2011) ("NYCBA"); Cravath, Swaine & Moore LLP, Davis Polk & Wardwell LLP, Gibson, Dunn & Crutcher LLP, Skadden, Arps, Slate, Meagher & Flom LLP and Wilmer Cutler Pickering Hale and Dorr LLP (July 14, 2011) ("Five Firms"); S.W. Coy Capital, Inc. (July 13, 2011) ("Coy Capital").

[30] For crowdfunding, the Commission is directed to adopt rules establishing disqualification provisions for issuers, brokers and funding portals seeking to participate in crowdfunding transactions. The requirement in Section 302(d) of the JOBS Act is identical to the language of Section 926 of the Dodd-Frank Act. For the new $50 million offering exemption, Section 401(b)(2) of the JOBS Act states that the Commission may require the issuer to meet certain conditions including disqualification provisions that are substantially similar to the disqualification provisions contained in regulations adopted in accordance with Section 926 of the Dodd-Frank Act, which we are adopting today.

will also have an opportunity to consider to what extent bad actor disqualifications currently applicable to Regulation A and Rule 505 offerings should be more uniform or similar to those applicable to Rule 506 offerings.

II. DISCUSSION OF THE FINAL AMENDMENTS

A. Introduction

Section 926(1) of the Dodd-Frank Act requires the Commission to adopt disqualification rules that are substantially similar to Rule 262, the bad actor disqualification provisions applicable to offerings under Regulation A, and that also cover the triggering events specified in Section 926. In general, we understand this mandate to mean that the provisions we adopt to implement Section 926 should have similar effects as Rule 262, except to the extent that circumstances, such as the different context for the use of Rule 506 compared to Regulation A and the need to update or otherwise revise the provisions of Regulation A, dictate a different approach.

B. Covered Persons

We proposed amendments to Rule 506 of Regulation D to apply the disqualification provisions required under Section 926 to the following categories of persons:

- the issuer and any predecessor of the issuer or affiliated issuer;
- any director, officer,[31] general partner or managing member of the issuer;
- any beneficial owner of 10% or more of any class of the issuer's equity securities;
- any promoter connected with the issuer in any capacity at the time of the sale;

[31] Under Rule 405, the term "officer" is defined as "a president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions with respect to any organization." 17 CFR 230.405. This definition is applicable to Rule 262 by virtue of Rule 261, 17 CFR 230.261.

- any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with sales of securities in the offering; and
- any director, officer, general partner, or managing member of any such compensated solicitor.[32]

The proposal reflected the categories currently covered by Rule 262 of Regulation A, with two modifications. First, because Rule 506 transactions may involve the use of persons paid for solicitation of purchasers, such as placement agents and finders, rather than traditional underwriters, we added compensated solicitors as a category of covered persons.[33] In addition, we proposed to add managing members to the list of directors, officers and general partners of the issuer and any underwriter or compensated solicitor to standardize the treatment of controlling persons of limited liability companies for disqualification purposes.

In the proposing release, we solicited comment on whether the rules should cover a broader or narrower group of persons. We specifically requested comment on whether the new disqualification provisions should cover all officers of issuers and covered financial intermediaries, as Rule 262 currently does, or only some officers (such as executive officers[34] and/or officers actually participating in the offering). We also requested comment on a variety of possible modifications to the scope of the coverage of shareholders and the possible inclusion of investment advisers of pooled investment funds.

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[32] See Release No. 33-9211, Part II.B (May 25, 2011).

[33] This is modeled on the disqualification provisions for offerings under Rule 505 which, like Rule 506 offerings, may involve the use of placement agents and finders, rather than traditional underwriters. See 17 CFR 230.505(b)(2)(iii)(B).

[34] The term "executive officer" is defined in Rule 501(f) of Regulation D (and in Rule 405) to mean a company's "president, any vice president . . . in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions." 17 CFR 230.501(f), 230.405.

Officers. Commenters generally supported limiting the coverage of the disqualification provisions to executive officers rather than all officers, citing such issues as the policy benefits of focusing on role rather than title;[35] the fact that executive officers of an issuer are recognized within Regulation D as "accredited investors" by virtue of their participation in the policy-making functions of the issuer;[36] the fact that certain entities have a large number of titular officers who do not have a policy or decision-making role or any involvement in the relevant offerings;[37] the potentially heavy compliance burden associated with broad application, which may make it difficult for issuers to meet a "reasonable care" standard;[38] and the obligation it would create for compensated solicitors to disclose the identities of their employees to issuers.[39] Some commenters argued for limiting the rule further as it applies to executive officers of compensated solicitors, and covering only executive officers that are engaged in the relevant private placement activities[40] or that are responsible for the approval or supervision of Rule 506 offerings.[41]

Two commenters advocated that the new rules mirror Rule 262's coverage of "officers," as proposed.[42] These commenters argued both that a rule "substantially similar" to Rule 262 must include officers and that, based on the presumption of control that attaches to officers, the

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35 See comment letters from DTC; NYCBA; Sullivan & Cromwell LLP (July 14, 2011) ("S&C").

36 See comment letter from ABA Fed. Reg. Comm.

37 See comment letters from ABA Fed. Reg. Comm.; S&C; Cleary Gottlieb Steen & Hamilton LLP (July 14, 2011) ("Cleary Gottlieb"); Lehman & Eilen LLP (July 14, 2011) ("Lehman & Eilen").

38 See comment letters from ABA Fed. Reg. Comm.; Cleary Gottlieb; Five Firms; S&C; see also comment letter from Kutak Rock LLP (July 8, 2011) ("Kutak Rock") (noting that a narrower rule would be more workable).

39 See comment letter from Cleary Gottlieb.

40 See comment letters from ABA Fed. Reg. Comm.; NYCBA.

41 See comment letter from Lehman & Eilen.

42 See comment letters from Better Markets; NASAA.

ability of officers to set the tone of an organization and the risk that any officer may be involved with any given offering, coverage of "officers" is needed for the protection of investors.

We also requested comment on whether the coverage of "officers" should be limited to officers who participate in or are involved with the offering. Two commenters addressed this point, acknowledging that it may be appropriate to cover participating officers to address investor protection concerns[43] and that doing so may be preferable to covering all officers.[44] Both commenters, however, expressed concern about the potential difficulty of determining which officers were actually involved with or participating in an offering.[45]

We agree with the majority of commenters that, in the context of Rule 506 offerings, an "officer" test based solely on job title would be unduly burdensome and overly restrictive. Consequently, the final rule covers only executive officers of covered entities and officers who participate in the offering. We believe that this coverage is an appropriate adaptation of the Rule 262 list of covered persons, taking into account the larger and more complex organizations that are involved in many Rule 506 transactions[46] as compared to the smaller entities that have used Regulation A, and, on that basis, this provision of the final rule is "substantially similar" to Rule 262. We note that the term "officer" in Rule 262 was used as early as 1955, before we adopted the "executive officer" concept that we use in several of our rules.[47] It also reflects a

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[43] See comment letter from Cleary Gottlieb.

[44] See comment letter from S&C.

[45] See comment letters from Cleary Gottlieb; S&C.

[46] There is no cap on the amount of proceeds that may be raised in an offering relying on Rule 506, and many Rule 506 offerings are larger—in some cases, considerably larger—than would be permitted under the $5 million aggregate proceeds cap of Regulation A. For 2012, approximately 41% of Rule 506 offerings raised more than $5 million, 14% raised more than $50 million and 10% raised more than $100 million.

[47] See Revision and Consolidation of Regulation A and Regulation D, Release No. 33-3555 (July 18, 1955) [20 FR 5401 (July 28, 1955)].

consideration of costs and benefits, focusing on situations where the risks that Section 926 is intended to address are at their most pronounced (when bad actors are performing policy-making functions or are personally involved with a securities offering) while alleviating the potential compliance burden by limiting covered persons to a more manageable number who should generally be easier to identify.

Many issuers will already have determined who their executive officers are (among other reasons, to provide disclosure about executive officers in the offering materials), and the officers participating in an offering will be a question of fact. Participation in an offering would have to be more than transitory or incidental involvement, and could include activities such as participation or involvement in due diligence activities, involvement in the preparation of disclosure documents, and communication with the issuer, prospective investors or other offering participants. We anticipate that issuers should be able to determine which of their own officers are participating in an offering without undue difficulty, and can exercise control over which officers participate. We also believe that it is reasonable to expect that compensated solicitors should be prepared to confirm which of their officers are participating in an offering as part of any engagement.

Beneficial Owners of Issuer Equity Securities. The inclusion of holders of 10% or more of any class of the issuer's equity securities as covered persons was one of the areas of the proposing release that attracted the most comment. The majority of commenters did not support the inclusion of 10% beneficial owners as covered persons for purposes of the Rule 506 disqualification provisions.[48] Several commenters identified a range of potential burdens and costs issuers would face in identifying 10% beneficial owners. They described the inclusion of 10% beneficial owners in the context of Rule 506 offerings as unduly burdensome,[49] with 10% holders potentially a "moving target" for issuers engaged in continuous sales and regular redemptions.[50] Others pointed out that a person could acquire 10% or more of a class of securities while having no input or control over the company's management, or even having an adversarial relationship with management.[51] One commenter questioned whether public companies would be able to comply with the rule.[52] Two commenters urged the Commission not to include beneficial owners as covered persons at all in the new disqualification rule.[53]

Some commenters suggested higher ownership thresholds, from 20% to majority ownership[54] or

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[48] See comment letters from ABA Fed. Reg. Comm.; Cleary Gottlieb; Five Firms; Lehman & Eilen; NYCBA; S&C; Whitaker Chalk; the Investment Program Association (July 14, 2011) ("IPA"); Katten Muchin Rosenman LLP (July 14, 2011) ("Katten Muchin"); the Real Estate Investment Securities Association (July 14, 2011) ("REISA"); Seward & Kissel (July 20, 2011) ("Seward & Kissel"); the Securities Industry and Financial Markets Association (July 14, 2011) ("SIFMA").

[49] See comment letter from Seward & Kissel.

[50] See comment letters from ABA Fed. Reg. Comm.; IPA.

[51] See comment letter from Lehman & Eilen; see also comment letters from ABA Fed. Reg. Comm.; Five Firms; S&C.

[52] See comment letter from ABA Fed. Reg. Comm. (pointing out that 10% beneficial owners have no obligation to disclose whether they are bad actors).

[53] See comment letters from ABA Fed. Reg. Comm.; Seward & Kissel.

[54] See comment letters from ABA Fed. Reg. Comm. (25% ownership threshold, consistent with the "control" presumption in Section 2(a)(5) of the Investment Company Act); NYCBA (20% or 25%); IPA (20%); Lehman & Eilen (25%, consistent with the thresholds used in other contexts under the federal securities laws, including Form BD); Cleary Gottlieb (20%, consistent with the level at which reporting as a "passive" investor under Regulation 13D-G is no longer permitted); S&C (25%, consistent with the "control" presumptions in Form BD and Section 2(a)(9) of the Investment Company Act); Whitaker Chalk (at least 25%, and disregard if there is a controlling shareholder or group); SIFMA (at least 25%, which would accord with Form BD and Section 2(a)(9) of the Investment Company Act, but would prefer 50%); Seward & Kissel (if coverage of shareholders cannot be eliminated, increase threshold to a majority).

a test based on actual control,[55] while others argued against an actual control test and in favor of a bright-line standard based on a stated percentage of ownership.[56]

Some commenters also supported including only voting equity securities, rather than all equity securities, in determining which securityholders should be covered persons, generally arguing that only voting interests confer control.[57] More specifically, one commenter recommended that the disqualification provision incorporate the definition of "voting security" contained in Section 2(a)(42) of the Investment Company Act,[58] which includes only securities presently entitling the holder to vote for the election of directors, so that these rules would apply only to a beneficial owner of equity securities of an issuer who was entitled to vote for the election of directors (or their equivalents) of the issuer.[59] Another suggested that the provision be limited to voting securities, including general partner and managing member interests, and exclude passive interests.[60]

Other commenters supported the proposed inclusion of 10% beneficial owners of any class of the issuer's equity securities, based on their presumptive control of the issuer and the mandate to adopt rules that are "substantially similar" to Rule 262, which covers 10% beneficial

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55 See comment letters from Kutak Rock; REISA; Five Firms; see also comment letters from Whitaker Chalk (advocating use of the "affiliate" standard in Rule 144) and Seward & Kissel (remove 10% beneficial owners from the list of covered persons, or increase the ownership threshold to a majority interest).

56 See comment letters from Cleary Gottlieb; NYCBA; S&C.

57 See comment letters from ABA Fed. Reg. Comm.; Kutak Rock; Lehman & Eilen; NYCBA; Whitaker Chalk; see also Seward & Kissel (objecting to the disqualification of pooled investment funds based on the conduct of a 10% passive equity owner).Comment letter from NYCBA.

58 15 USC 80a-2(a)(42).

59 See comment letter from ABA Fed. Reg. Comm.

60 See comment letter from NYCBA.

owners.[61]

We are persuaded, with the majority of commenters, that the Rule 262 standard of 10% ownership of any class of the issuer's equity securities could be overinclusive, pulling in securityholders who do not control the activities of the issuer and whose prior bad conduct may not reflect on the issuer or the current offering. It may therefore impose costs and burdens that are not justified in relation to the potential benefits. We considered in particular the underlying objectives of the bad actor rules, as well as the potential administrative complexity of monitoring fluctuating ownership levels resulting from continuous sales or regular redemptions by certain issuers, and an issuer's inability to control the actions of an adversarial or non-compliant securityholder who does not disclose whether its relationship to the issuer may trigger disqualification.

We agree with most commenters that it would be appropriate to limit the coverage of securityholders under new Rule 506(d) to those having voting rights. In light of the range of possible structures and control arrangements among issuers relying on Rule 506, however, we have not adopted a specific definition of "voting securities." We intend that the term should be applied based on whether securityholders have or share the ability, either currently or on a contingent basis, to control or significantly influence the management and policies of the issuer through the exercise of a voting right.[62] For example, we would consider that securities that confer to securityholders the right to elect or remove the directors or equivalent controlling persons of the issuer, or to approve significant transactions such as acquisitions, dispositions or

[61] See comment letters from Better Markets; DTC; NASAA; Bybel Rutledge LLP (July 11, 2011) ("Rutledge").

[62] We note that securityholders that have the ability to control or significantly influence the management and policies of the issuer through other means will generally be covered by Rule 506(d) in another capacity, such as, for example, as the functional equivalent of an "executive officer" or "director" of an issuer.

financings, would be considered voting securities for purposes of the rule. Conversely, securities that confer voting rights limited solely to approval of changes to the rights and preferences of the class would not be considered voting securities for purposes of the rule.

We are also concerned that measuring ownership based on the percentage beneficial ownership of any class of an issuer's securities, rather than of the issuer's total outstanding securities, may be both overinclusive and underinclusive. Where a class of securities represents a very small percentage of the issuer's outstanding equity securities or voting power, even a large percentage ownership of the class may not confer the kind of control or influence over the issuer that the bad actor disqualification rules are intended to address. At the same time, in the case of a class of supervoting or high vote securities, ownership of a relatively small percentage of that class may carry with it control over a relatively large percentage of total voting power. Accordingly, rather than including beneficial owners of any class of the issuer's equity securities, the final rule includes beneficial owners of a specified percentage of the issuer's total outstanding voting equity securities, calculated on the basis of voting power. This change will focus the rule on securityholders that have or share the ability to direct a substantial portion of a vote, and will avoid the potential overinclusiveness and underinclusiveness of a share-based or class-based calculation.

After considering commenters' concerns, we have also determined to raise the beneficial ownership threshold from 10% to 20%, which we believe is a reasonable and measured approach in the context of Rule 506 offerings that preserves investor protection and provides an efficient and clear "bright-line" test.[63]

Accordingly, the rules we adopt today cover beneficial owners of 20% or more of the issuer's outstanding equity securities, calculated on the basis of voting power, rather than 10% beneficial owners of any class of securities, as originally proposed.

We considered, but are not adopting, a standard based on actual control of the issuer. We share the concern voiced by some commenters[64] that a facts-and-circumstances based standard such as actual control would significantly increase the burden of inquiry associated with determining whether an offering was disqualified, and may give rise to unnecessary cost and uncertainty in the application of Rule 506(d). We believe that keeping a "bright-line" standard based on a specified level of ownership reduces the burden of compliance and responds to the statutory mandate to adopt a rule that is "substantially similar" to Rule 262.

Assessing beneficial share ownership based on ownership of total outstanding voting securities, based on voting power, rather than ownership of any class, and increasing the ownership threshold from 10% to 20% should ease the burden of compliance because there will be fewer beneficial owners to track. Nevertheless, we do not believe that the change will diminish the investor protection benefits of Rule 506(d) in the circumstances posing the highest potential risk to investors, when securityholders exercise actual control over the issuer, because such securityholders are likely to be covered persons in some other capacity. Under the functional definitions of "director" and "executive officer," anyone who performs the functions of a director; controls a principal business unit, division or function of the issuer or performs

[63] We note that the 20% threshold aligns with the level of ownership at which filing as a "passive investor" on Schedule 13G under Regulation 13D-G is no longer permitted. See 17 CFR 230.13d-1(c).

[64] See comment letters from Cleary Gottlieb; NYCBA; S&C.

policy making functions for the issuer will be a covered person as a director or executive officer of the issuer. In addition, as discussed below, shareholders that are "promoters" involved with the issuer will be covered in that capacity.

Investment Managers of Pooled Investment Funds. After further consideration and review of comment letters, we have determined to expand the list of covered persons to include investment managers[65] of issuers that are pooled investment funds; the directors, executive officers, other officers participating in the offering, general partners and managing members of such investment managers; and the directors and executive officers of such general partners and managing members and their other officers participating in the offering.[66] We requested comment on whether to include investment advisers of private funds, but did not propose to include them. Three commenters supported such an expansion to promote investor protection,[67] while six opposed it on a variety of bases, including that investment advisers are already subject to fiduciary duties and an extensive regulatory regime;[68] that persons who actually control a pooled investment fund issuer would likely be covered in other capacities, for example as promoters or through a position with the fund's general partner;[69] and that extending the rule in

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[65] We are using the term "investment manager," rather than "investment adviser" as discussed in the proposing release. Under Section 202(a)(11) of the Investment Advisers Act of 1940 [15 USC 80b-2(a)(11)], an "investment adviser" is generally a person or firm that, for compensation, is engaged in the business of providing advice, making recommendations, issuing reports, or furnishing analyses on securities. Some pooled investment funds invest in assets other than securities, such as commodities, real estate and certain derivatives. In order to ensure that Rule 506(d) covers the control persons of these funds, we are using a more general term, which encompasses both investment advisers and other investment managers.

[66] We are not adopting a definition of the term "pooled investment fund" as it is used in Rule 506(d). The term has been used in Form D for years in its ordinary and commonly understood sense, and we intend to use it in Rule 506(d) in the same way. The term should not be confused with "pooled investment vehicle," a term defined more narrowly in Rule 206(4)-8 under the Investment Advisers Act of 1940, 17 CFR 275.206(4)-8.

[67] See comment letters from Better Markets; DTC; NASAA.

[68] See comment letters from ABA Fed. Reg. Comm.; SIFMA; Whitaker Chalk.

[69] See comment letter from Katten Muchin;

this way would be premature, would require a separate rulemaking project or would violate the "substantially similar" requirement.[70] We agree that, depending on the circumstances, investment managers that actually control a pooled investment fund may already be covered persons as "promoters" (a concept discussed in greater detail below), or as "directors" or "executive officers" of the issuer. We also note that the regulation of investment advisers has been subject to recent change, so that many investment managers to pooled investment funds that invest in securities are subject to new reporting and other obligations.[71] As a result of our reconsideration and review of the comment letters, however, we have determined to include investment managers to pooled investment funds and their principals as covered persons in the Rule 506 disqualification rules.[72]

Most operating companies making Rule 506 offerings are corporations or limited liability companies that function through their officers, directors and managing members. By comparison, most pooled investment funds making Rule 506 offerings are partnerships or other flow-through entities that have few, if any, employees, and function through their investment managers and the managers' personnel. In order to provide equivalent treatment of operating companies and pooled investment funds, the final rule establishes a new "bright-line" category of presumed control persons for pooled investment fund issuers. This should make the final rule clearer and easier to apply, and will more effectively protect investors from bad actors that exercise influence or control over a pooled investment fund.

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[70] See comment letters from Lehman & Eilen; Rutledge.

[71] See Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Release No. IA-3308 (Oct 31, 2011) [76 FR 71128]; Rules Implementing Amendments to the Investment Advisers Act of 1940, Release No. IA-3221 (June 22, 2011) [76 FR 42950].

[72] See Rule 506(d)(1).

Some commenters argued that adding fund investment managers was unnecessary, given that fund investment advisers are generally subject to regulation either at the state or the federal level. We believe our Securities Act disqualification rules are, in many respects, designed to supplement and build upon other enforcement and regulatory efforts. For instance, registered broker-dealers subject to limitations on their activities as a result of disciplinary proceedings could separately be disqualified from participating in a Rule 506 offering under the amendments we adopt today. We do not believe that the regulatory scheme to which a pooled investment fund's investment manager may be subject is a substitute for bad actor disqualification.

We appreciate that the bad actor provisions in Rule 262 do not cover investment managers of issuers that are pooled investment funds. Regulation A, however, is generally not available to or used by pooled investment funds,[73] so its disqualification provisions do not have to address the structure and governance arrangements typical of pooled investment fund issuers. Analogous disqualification rules under the Securities Act and the Investment Company Act do, however, include investment managers of pooled investment funds. For example, the disqualification provisions of Regulation E (which, like Regulation A, is an exemption from registration under Section 3(b)(1) of the Securities Act,[74] but is designed for use by pooled investment funds and similar entities) include as covered persons both the investment adviser to a pooled investment fund issuer as well as partners, directors, and officers of the investment

[73] Regulation A by its terms is not available to any pooled investment fund that is an "investment company registered or required to be registered under the Investment Company Act of 1940." 17 CFR 230.251(a)(4). As a practical matter, it is not available to other pooled investment funds because most such funds attempt to maintain that status under either Section 3(c)(1) or Section 3(c)(7) of that statute, which prohibits them from engaging in public offerings like those under Regulation A. See Investment Company Act §§ 3(c)(1), 3(c)(7), 15 U.S.C. 80a-3(c)(1), 80a-3(c)(7).

[74] 15 U.S.C. 77c(b)(1).

adviser.[75] Similarly, Section 9(a) of the Investment Company Act automatically disqualifies investment advisers of registered investment companies (and certain affiliated persons) based on criminal convictions and certain court orders.[76]

We also recognize that, depending on the circumstances, some investment managers of pooled investment funds and certain of their personnel would be covered already under Rule 506(d), even if we did not expand the coverage of the rule. For example, some investment manager firms would be deemed to be "promoters" of a pooled investment fund issuer, and some of their individual principals would be deemed the functional equivalent of "directors," "executive officers" or "promoters" of the issuer. Nevertheless, since we have concluded that such persons should be covered, we believe it is preferable to cover them directly, rather than indirectly. This treatment will avoid the necessity for issuers or others to engage in a potentially time-consuming, fact-intensive inquiry to determine whether or not they are within another category of covered persons.

Promoters. Although "promoters" are included as covered persons in Rule 262[77] and were included as covered persons in the proposed rules for that reason, three commenters raised questions about the treatment of promoters under the new disqualification rules.[78] One suggested that directors, executive officers, general partners and managing members of promoters be

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75 17 CFR 230.602(c).

76 See 15 U.S.C. 80a-9(a).

77 Rule 262(b) covers "any promoter of the issuer presently connected with it in any capacity." The term "promoter" is defined in Rule 405 to mean any person who: (i) acting alone or together with others, directly or indirectly takes initiative in founding or organizing the business or enterprise of an issuer; or (ii) in connection with the founding or organization of the business or enterprise of an issuer, directly or indirectly receives 10% or more of any class of issuer securities or 10% or more of the proceeds from the sale of any class of issuer securities (not including securities received solely as underwriting commissions or solely in exchange for property). The Rule 405 definition applies to Rule 262 by virtue of Rule 261. 17 CFR 230.261.

78 See comment letters from Cleary Gottlieb; SIFMA; S&C.

included, so that promoters would be addressed in the rule in the same way as issuers and compensated solicitors.[79] The second questioned whether inclusion was necessary given the breadth of the other categories of covered persons, but suggested that if promoters are included, the term should be defined so as to include only persons who are involved with the offering and have a material financial interest in its outcome (or at a minimum, the rule should be revised to make clear that fund investment advisers are not deemed to be promoters).[80] The third argued that promoters should not be covered persons unless they are involved in the day-to-day management of the issuer or will be paid remuneration for the solicitation of purchasers.[81]

We determined not to make any changes in the definition or coverage of promoters. The category of "promoter" is broad, and captures all individuals and entities that have the relationships with the issuer or to the offering specified in Rule 405.[82] In particular, the definition requires issuers to look through entities and makes it unnecessary for us to separately cover the officers, directors and other control persons of entities that qualify as promoters. Rule 405 defines a promoter as any person—individual or legal entity—that either alone or with others, directly or indirectly takes initiative in founding the business or enterprise of the issuer, or, in connection with such founding or organization, directly or indirectly receives 10% or more of any class of issuer securities or 10% or more of the proceeds from the sale of any class of issuer securities (other than securities received solely as underwriting commissions or solely in exchange for property). The test considers activities "alone or together with others, directly or

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[79] See comment letter from Cleary Gottlieb.

[80] See comment letter from S&C.

[81] See comment letter from SIFMA.

[82] See note 77.

indirectly"; therefore, the result does not change if there are other legal entities (which may themselves be promoters) in the chain between that person and the issuer.

As adopted, the disqualification provisions of Rule 506(d) will cover the following persons, which we refer to in this release as "covered persons":

- the issuer and any predecessor of the issuer or affiliated issuer;
- any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer;
- any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power;
- any investment manager to an issuer that is a pooled investment fund and any director, executive officer, other officer participating in the offering, general partner or managing member of any such investment manager, as well as any director, executive officer or officer participating in the offering of any such general partner or managing member;
- any promoter connected with the issuer in any capacity at the time of the sale;
- any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with sales of securities in the offering (which we refer to as a "compensated solicitor"); and
- any director, executive officer, other officer participating in the offering, general partner, or managing member of any such compensated solicitor.[83]

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[83] See Rule 506(d)(1).

We are also adopting a provision under which events relating to certain affiliated issuers are not disqualifying if they pre-date the affiliate relationship.[84] Rule 262(a)(5) currently provides that orders, judgments and decrees entered against affiliated issuers before the affiliation arose do not disqualify an offering if the affiliated issuer is not (i) in control of the issuer or (ii) under common control, together with the issuer, by a third party that controlled the affiliated issuer at the time such order, judgment or decree was entered. We included a similar provision in the proposal, but clarified that it applied to all potentially disqualifying events that pre-date affiliation. All of the commenters that addressed that point were supportive of the proposal,[85] and we are adopting it as proposed.

We also solicited comment on whether we should apply the disqualification rules differently to entities that have undergone a change of control. Five commenters supported differential treatment following a change of control, primarily arguing that entities act only through their personnel, and disqualifying events would no longer be relevant if the persons responsible for the events are no longer in control.[86] Another commenter argued that disqualification should cease to apply following changes of policy, as well as changes of control.[87] Three commenters opposed providing different treatment for entities that have

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[84] See Rule 506(d)(3).

[85] See comment letters from ABA Fed. Reg. Comm.; NYCBA; Rutledge; Whitaker Chalk; Alfaro Oil and Gas LLC (July 14, 2011) ("Alfaro").

[86] See comment letters from ABA Fed. Reg. Comm.; Five Firms; Kutak Rock; Lehman & Eilen, Whitaker Chalk; see also comment letter from L. Burningham (June 29, 2011) ("Burningham") (suggesting that issuers not be disqualified if they have removed bad actors).

[87] See comment letter from SIFMA (disqualification should apply only if senior management in control when disqualifying event arose are still employed by the issuer or a controlling affiliate continues in a senior management or executive role; disqualification should also cease to apply if issuer has implemented policies and procedures designed to prevent occurrence of activities that gave rise to disqualification, and such policies and procedures have been approved by a regulator or a court).

undergone a change of control, generally noting that it would be difficult to establish whether a change of control had occurred, that such a provision could be susceptible to abuse, and that change of control might more appropriately be considered in the context of an application for waiver of disqualification.[88] We have decided to adopt the rules as proposed, as advocated by the latter group of commenters, and are not providing different treatment for entities that have undergone a change of control or a change of policy. We wish to avoid both undue complexity in application of the rules and potential abuse by bad actors that may claim to have undergone a change of control when no bona fide change of control has in fact occurred. As discussed in Part II.E below, we are amending the existing delegation of authority to the Director of the Division of Corporation Finance so it will cover waivers of disqualification under Rule 506. We expect that staff will adopt procedures for the prompt issuance of waivers of Rule 506 disqualification upon a proper showing that there has been a change of control and the persons responsible for the activities resulting in a disqualification are no longer employed by the entity or exercise influence over such entity.

C. Disqualifying Events

Section 926 of the Dodd-Frank Act requires our Rule 506 disqualification provisions to be "substantially similar" to those set forth in Rule 262 of Regulation A, and also to cover certain criminal convictions and regulatory orders enumerated in Section 926. In the proposal, the disqualifying events from Rule 262 and Section 926 were combined and integrated in a proposed rule that included the following disqualifying events:

[88] See comment letters from DTC; NYCBA; Rutledge.

- Criminal convictions (felony or misdemeanor), entered within the last five years in the case of issuers and ten years in the case of other covered persons, in connection with the purchase or sale of any security; involving the making of a false filing with the Commission; or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;[89]
- Court injunctions and restraining orders, including any order, judgment or decree of any court of competent jurisdiction, entered within five years before such sale, that, at the time of such sale, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice in connection with the purchase or sale of any security; involving the making of a false filing with the Commission; or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;[90]
- Final orders issued by state banking, credit union, and insurance regulators, federal banking regulators, and the National Credit Union Administration that either create a bar from association with any entity regulated by the regulator issuing the order, or from engaging in the business of securities, insurance or banking or from savings association or credit union activities; or are based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the last ten years;[91]

[89] See Proposed Rule 506(c)(1)(i).

[90] See Proposed Rule 506(c)(1)(ii).

[91] See Proposed Rule 506(c)(1)(iii).

- Commission disciplinary orders entered pursuant to Section 15(b) or 15(B)(c) of the Securities Exchange Act of 1934 (the "Exchange Act") or Section 203(e) or (f) of the Investment Advisers Act of 1940 (the "Advisers Act") that, at time of the sale, suspend or revoke a person's registration as a broker, dealer, municipal securities dealer or investment adviser; place limitations on the activities, functions or operations of such person; or bar such person from being associated with any entity or from participating in the offering of any penny stock;[92]
- Suspension or expulsion from membership in, or suspension or a bar from association with a member of, an SRO, i.e., a registered national securities exchange or a registered national or affiliated securities association;[93]
- Stop orders applicable to a registration statement and orders suspending the Regulation A exemption for an offering statement that an issuer filed or in which the person was named as an underwriter within the last five years and being the subject at the time of sale of a proceeding to determine whether such a stop or suspension order should be issued;[94] and
- U.S. Postal Service false representation orders including temporary or preliminary orders entered within the last five years.[95]

We solicited comment on a number of possible modifications to the list of disqualifying events, such as including additional events and lengthening or shortening the look-back period

[92] See Proposed Rule 506(c)(1)(iv).

[93] See Proposed Rule 506(c)(1)(v).

[94] See Proposed Rule 506(c)(1)(vi).

[95] See Proposed Rule 506(c)(1)(vii).

associated with each event. Following is a discussion of each of the disqualifying events originally proposed, the comments on the proposal and the disqualifying event as adopted today.

1. Criminal Convictions

Section 926(2)(B) of the Dodd-Frank Act provides for disqualification if any covered person "has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the Commission." This essentially mirrors the language of Rule 262(a)(3), which covers criminal convictions of issuers, and Rule 262(b)(1), which covers criminal convictions of other covered persons. In the proposing release, we identified two differences between the felony and misdemeanor conviction provisions of Section 926(2)(B) and Rule 262. First, Section 926(2)(B) does not include a specific time limit (or "look-back period") on convictions that trigger disqualification, whereas Rule 262 provides a five-year look-back period for criminal convictions of issuers and a ten-year look-back period for criminal convictions of other covered persons. Second, Rule 262 includes a reference to criminal convictions "arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer or investment adviser," which does not appear in Section 926.

The proposed rule was based on Rule 262, and provided that a covered person would be disqualified if such covered person:

(i) Has been convicted, within ten years before such sale (or five years, in the case of issuers, their predecessors and affiliated issuers), of any felony or misdemeanor:

(A) In connection with the purchase or sale of any security;

(B) Involving the making of any false filing with the Commission; or

(C) Arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities.[96]

The proposed rule included look-back periods of five years for criminal convictions of issuers (including predecessors and affiliated issuers) and ten years for other covered persons, which correspond to Rule 262.[97] We requested comment on whether the scope of the provision should be broader or narrower, and whether a longer, or permanent, look-back period would be appropriate for either issuers or other covered persons.

Commenters were divided in their reaction to this aspect of the proposal. Most commenters argued that the Commission should stay close to the language of Section 926 and Rule 262.[98] One commenter criticized the proposal as overbroad and suggested ways to narrow it,[99] while two commenters urged expansion of the rule to cover a broader range of criminal convictions.[100] In an advance comment letter[101] and again in its comment letter, NASAA argued for extension of the disqualification rules to cover all criminal convictions involving fraud or deceit, as well as convictions involving the making of a false filing with any state, involving a commodity future or option contract, or any aspect of a business involving securities,

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96 Proposed Rule 506(c)(1)(i).

97 Consistent with Rule 262, the look-back period is to the date of the conviction, not to the date of the conduct that led to the conviction. The measurement date is the date of the relevant order or other sanction, not the date of the conduct that was the subject of the order or other sanction.

98 See comment letters from Rutledge; Five Firms; S&C; Seward & Kissel; SIFMA; NYCBA.

99 See comment letter from REISA (suggesting limiting false filings provision to "intentional, material and misleading" false filings and limiting convictions "arising out of the business" to those "directly related to the offer or sale of securities to investors").

100 See comment letters from NASAA; Better Markets.

101 See advance comment letter from NASAA (Nov. 4, 2010).

commodities, investments, franchises, insurance, banking or finance. One other commenter supported extending coverage to all criminal convictions involving fraud or deceit.[102] Three commenters expressly opposed NASAA's suggested extension on the basis that it would create a vague and overbroad standard.[103]

On the length of look-back periods, some commenters argued for a uniform ten-year period,[104] some for longer or permanent disqualification in certain cases,[105] some for the five- and ten-year periods proposed,[106] and some for shorter periods for covered persons and issuers.[107] On whether convictions in foreign courts should be considered, most commenters objected, generally citing due process concerns and concerns about the cost and burden of inquiry into foreign proceedings.[108] Four commenters supported adding foreign convictions, generally on the basis that conduct outside the United States was as relevant as conduct within the United States for disqualification purposes.[109] One commenter suggested that Section 926(2)(B) could be read not to be limited to U.S. proceedings.[110]

In sum, most commenters agreed that the final rules should be closely based on Rule 262.

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102 See comment letter from Better Markets.

103 See comment letters from NYCBA; S&C; SIFMA.

104 See comment letters from Better Markets; Kutak Rock; see also comment letters from NASAA (uniform look-back period of at least ten years); DTC (ten-year look-back except permanent disqualification for securities fraud and violations of Rule 506).

105 See comment letters from DTC (permanent disqualification for securities fraud and Section 5 violations); J. Davis (June 13, 2011) (suggesting that conviction of any securities violation or felony should be permanently disqualifying).

106 See comment letters from Cleary Gottlieb; Rutledge.

107 See comment letters from REISA (uniform five-year period); D. Sarna (August 23, 2011) (uniform five-year period); SIFMA (uniform period not longer than one year).

108 See comment letters from Cleary Gottlieb; Five Firms; NYCBA; S&C; Sullivan & Worcester LLP (July 1, 2011) ("S&W"); SIFMA; Whitaker Chalk.

109 See comment letters from C. Barnard; DTC; Better Markets; advance comment letter from NASAA.

110 See comment letter from Rutledge.

To the extent that commenters advocated changes from the proposal, however, there was no consensus about what changes would be desirable or appropriate. We do not believe that the shift from Regulation A to potentially larger and more complex transactions under Rule 506 warrants either expanding or narrowing the scope of coverage of criminal convictions, or modifying the existing five- and ten-year look-back periods. Given that the rule is required to be "substantially similar" to Rule 262, and that there are no changes warranted by the application to the Rule 506 context, we are adopting the provision as proposed.

2. Court Injunctions and Restraining Orders

Under current Rule 262(a)(4), an issuer is disqualified from reliance on Regulation A if it, or any predecessor or affiliated issuer, is subject to a court injunction or restraining order against "engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or involving the making of any false filing with the Commission."[111] Similarly, under current Rule 262(b)(2), an offering is disqualified if any other covered person is subject to such a court injunction or restraining order, or to one "arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer or investment adviser."[112] Disqualification is triggered by temporary or preliminary injunctions and restraining orders that are currently in effect, and by permanent injunctions and restraining orders entered within the last five years.[113]

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[111] 17 CFR 230.262(a)(4).

[112] 17 CFR 230.262(b)(2).

[113] Disqualification is triggered only when a person "is subject to" a relevant injunction or order. Therefore, injunctions and orders that have expired or are otherwise no longer in effect are not disqualifying, even if they were issued within the relevant look-back period. For example, an injunction issued four years before the relevant securities offering (within the five-year look-back period), and then lifted before the offering occurred, would not be disqualifying. The look-back period functions as a cut-off for injunctions and orders that are still in effect at the

The proposed provision reflected the substance of these two provisions in a simplified, combined format. Rule 506 transactions may involve compensated solicitors, rather than traditional underwriters, so the proposed rule also covered orders arising out of the conduct of the business of such compensated solicitors. Under the proposal, an offering would be disqualified if any covered person:

(ii) Is subject to any order, judgment or decree of any court of competent jurisdiction, entered within five years before any sale in the offering that, at the time of such sale, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice:

(A) In connection with the purchase or sale of any security;

(B) Involving the making of any false filing with the Commission; or

(C) Arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities.[114]

Five commenters recommended adoption of the provisions as proposed.[115] Two commenters suggested narrowing the coverage of orders arising out of the conduct of the business of the listed financial intermediaries, and limiting the provision either to cases where

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time of an offering. For example, disqualification will not arise from an injunction issued more than five years before an offering, even if the injunction is permanent.

114 Proposed Rule 506(c)(1)(ii).

115 See comment letters from Cleary Gottlieb; Lehman & Eilen; NYCBA; Rutledge (arguing, as to look-back periods in particular, that "substantially similar" means that new rules should mirror as much as possible existing Rule 262 provisions); SIFMA.

there is a finding of fraudulent, manipulative or deceptive conduct,[116] or to matters relating to a broker-dealer's activities of offering securities as a placement or selling agent or underwriter.[117] Two commenters argued that court orders and judgments should not trigger disqualification unless the defendant was afforded notice and an opportunity to appear.[118] One such commenter went further to recommend that all appeals should have been exhausted or the time for appeal expired before disqualification is triggered.[119]

One commenter requested clarification that disqualification will apply only for persons specifically named in an order, and not to all who may be within a class of persons brought within the scope of an order.[120] For example, an injunction may be issued against a named defendant "and its agents, servants, employees, attorneys, and all persons in active concert or participation with them who receive actual notice" of the order. The commenter requested confirmation that, in these circumstances, only the named defendant, and not all members of the class of persons brought within the scope of the order, would be understood as "subject to" the order for disqualification purposes.

We are adopting the provision as proposed. We see no basis for departing from the coverage and look-back periods that apply under existing Rule 262. In particular, we have determined not to impose due process requirements, such as notice and an opportunity to appear, or to require that all appeals have been exhausted or the time for appeal expired, as a condition to

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[116] See comment letter from NYCBA (acknowledging that the limitation they recommend may not be "substantially similar" to Rule 262).

[117] See comment letter from SIFMA.

[118] See comment letters from ABA Fed. Reg. Comm.; R. Sherman (May 25, 2011).

[119] See comment letter from ABA Fed. Reg. Comm.

[120] See comment letter from ABA Fed. Reg. Comm.

disqualification. We are sensitive to the concerns raised by commenters about the risk that ex parte orders may trigger disqualification. Nevertheless, in light of the statutory mandate and the Commission's waiver authority, we are not narrowing the provision. We believe that disqualifying events that arise out of such circumstances are better addressed through the waiver process.

We are also not persuaded that the shift to potentially larger, more complex transactions under Rule 506 or other considerations justifies such a change from the Rule 262 standards. Nor do we want to add a significant new burden of inquiry, requiring issuers to determine not just that a covered person is subject to an order, but also that the order is procedurally adequate. On balance, we believe that the risk that disqualification may arise from ex parte proceedings could be better addressed through the waiver process, rather than through additional requirements for factual inquiry that would affect all offerings. As for appealable orders, as noted in the proposing release, we are concerned that suspending disqualification during the pendency of a potentially lengthy appeals process may significantly undermine the intended benefits of the rule.[121]

With regard to who would be viewed as subject to an order, we intend to apply the new provisions consistently with the way that Rule 262 has historically been applied. For disqualification purposes, the staff has interpreted Rule 262 to limit those considered "subject to" an order to only the persons specifically named in the order.[122] Others who are not specifically named but who come within the scope of an order (such as, for example, agents, attorneys and

121 Disqualification would be terminated immediately, however, if the judgment or order were reversed or vacated.

122 For a more general discussion of interpretations of the meaning of "subject to" an order, see note 156 and accompanying text.

persons acting in concert with the named person) will not be treated as "subject to" the order for purposes of disqualification.

3. Final Orders of Certain Regulators

The text of Section 926(2)(A) of the Dodd-Frank Act provides that Commission requirements for Rule 506 offerings must disqualify any covered person that

> A) is subject to a final order of a State securities commission (or an agency or officer of a State performing like functions), a State authority that supervises or examines banks, savings associations, or credit unions, a State insurance commission (or an agency or officer of a State performing like functions), an appropriate Federal banking agency, or the National Credit Union Administration, that—
>
> (i) bars the person from—
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> (I) association with an entity regulated by such commission, authority, agency, or officer;
>
> (II) engaging in the business of securities, insurance, or banking; or
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> (III) engaging in savings association or credit union activities; or
>
> (ii) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the 10-year period ending on the date of filing of the offer or sale.

As we noted in the proposing release, Section 926(2)(A) is essentially identical to Section 15(b)(4)(H) of the Exchange Act and Section 203(e)(9) of the Advisers Act. The only difference is that Section 926(2)(A)(ii) contains a ten-year look-back period for final orders based on violations of laws and regulations that prohibit fraudulent, manipulative and deceptive conduct, while the Exchange Act and Advisers Act provisions have no express time limit for such orders.

We proposed to reflect Section 926(2)(A) as new Rule 506(c)(1)(iii), with three changes from the text of Section 926(2)(A), which were intended to eliminate potential ambiguities and allow for easier application of the rule. First, the proposal specified that an order must bar the covered person "at the time of [the] sale," to clarify that a bar would be disqualifying only for as long as it has continuing effect. Second, the provision measured the look-back period from the date of the relevant sale, not from "the date of filing of the offer or sale," as provided in Section 926 of the Dodd-Frank Act, so it would align with the other look-back periods in the rule. Finally, the provision required that orders must have been "entered" within the look-back period, to clarify that the date of the order, and not the date of the underlying conduct, was relevant for that determination.

Under the proposal, an offering would be disqualified if any covered person:

(iii) Is subject to a final order of a state securities commission (or an agency or officer of a state performing like functions); a state authority that supervises or examines banks, savings associations, or credit unions; a state insurance commission (or an agency or officer of a state performing like functions); an appropriate federal banking agency; or the National Credit Union Administration that:

(A) At the time of such sale, bars the person from:

(1) Association with an entity regulated by such commission, authority, agency, or officer;

(2) Engaging in the business of securities, insurance or banking; or

(3) Engaging in savings association or credit union activities; or

(B) Constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years before such sale.[123]

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[123] Proposed Rule 506(c)(1)(iii).

We solicited comment on a number of aspects of the proposed provision, including the treatment of bars, the definition of the terms "final order" and "fraudulent, manipulative and deceptive conduct," and the potential to cover orders of other regulators in addition to those mandated by Section 926 of the Dodd-Frank Act, particularly the Commission and the Commodity Futures Trading Commission ("CFTC"). As discussed in more detail below, we are adopting the provision substantially as proposed, but adding the CFTC to the list of regulators whose regulatory bars and other final orders will trigger disqualification.

CFTC Orders. The proposing release solicited comment on whether orders of the CFTC or any other regulator not referred to in Section 926 should result in disqualification from Rule 506 offerings. Four commenters favored adding CFTC orders as a disqualification trigger.[124] One noted that "conduct that would typically give rise to a CFTC sanction is similar to the type of conduct that would result in disqualification if it were the subject of action by other regulators in the securities, banking and insurance fields."[125] Others cited benefits such as improved investor protection, harmonization of the treatment of regulatory entities, and improved internal consistency of the bad actor rules.[126] Another asserted that it was "obvious" that at least some CFTC orders should be covered by the disqualification rules.[127] Two of these commenters also recommended that the rules cover orders of additional regulators.[128] Seven comment letters opposed adding CFTC orders, generally arguing that such an addition would not

124 See comment letters from Better Markets, Cleary Gottlieb, NYCBA, NASAA.

125 See comment letter from Better Markets.

126 See comment letters from Cleary Gottlieb, NASAA.

127 See comment letter from NYCBA.

128 See comment letters from Better Markets (advocating addition of orders by other agencies with jurisdiction over misconduct in the financial services arena, including the Consumer Financial Protection Bureau and the Federal Trade Commission); NASAA (advocating addition of orders under state franchise, investment and finance laws).

be "substantially similar" to Rule 262 and questioning the Commission's legal authority to add such a new disqualifying event.[129]

We are persuaded that appropriate CFTC orders should be included as a disqualification trigger in new Rule 506(d). As we noted in the proposing release, the conduct that would typically give rise to CFTC sanctions is similar to the type of conduct that would result in disqualification if it were the subject of sanctions by another financial services industry regulator. For that reason, CFTC orders trigger consequences under other Commission rules (for example, both registered broker-dealers and investment advisers may be subject to Commission disciplinary action based on violations of the Commodity Exchange Act).[130] In addition, the CFTC (rather than the Commission) has authority over the investment managers of pooled investment funds that invest in commodities and certain derivatives products; unless Rule 506(d) covers CFTC orders, regulatory sanctions against those investment managers are not likely to trigger disqualification. For these reasons, we believe that including orders of the CFTC will make the bad actor rules more internally consistent, treating relevant sanctions similarly for disqualification purposes, and should enable the disqualification rules to more effectively screen out felons and bad actors.

We have decided to include CFTC orders in the bad actor disqualification scheme by adding the CFTC to the list of regulators in Rule 506(d)(1)(iii). As a result, disqualification will be triggered only by CFTC orders that constitute "bars" or "final orders" relating to prohibitions on "fraudulent, manipulative or deceptive conduct" on the basis discussed below.

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129 See comment letters from ABA Fed. Reg. Comm.; Five Firms; Katten Muchin; Lehman & Eilen; Rutledge; Schuyler Roche; SIFMA.

130 See, e.g., Section 15(b)(4)(D) of the Exchange Act (15 U.S.C. 80(b)(4)(C)) and Section 203(e)(5) of the Advisers Act (15 U.S.C. 80-b3(e)(5)).

Bars. Our requests for comment focused on whether there was a need for the Commission to explicitly state that all orders that have the practical effect of a bar (prohibiting a person from engaging in a particular activity) should be treated as such, even if the relevant order did not call it a "bar." We also requested comment on whether it would be appropriate to provide a cut-off date (for example, ten years) for permanent bars.

Several commenters urged us to provide additional guidance about what constitutes a bar.[131] We believe the statutory language is clear: bars are orders issued by one of the specified regulators that have the effect of barring a person from association with certain regulated entities; from engaging in the business of securities, insurance or banking; or from engaging in savings association or credit union activities. Any such order that has one of those effects is a bar, regardless of whether it uses the term "bar." Orders that do not have any of those effects are not bars, although they may be disqualifying "final orders," as discussed below.

Consistent with the proposal, the final rule provides that an order must bar the person "at the time of [the] sale" from one or more of the specified activities, to make clear that a bar is disqualifying only for as long as it has continuing effect.[132] Thus, for example, a person who was barred indefinitely, with the right to apply to reassociate after three years, would be disqualified until such time as he or she is permitted to reassociate, assuming that the bar had no continuing effect after reassociation. Several commenters argued that we should impose a cut-

[131] See comment letters from Alfaro; ABA Fed. Reg. Comm.; Rutledge; SIFMA; Whitaker Chalk.

[132] This accords with the Commission's interpretive position on Rule 262. See Release No. 33-6289 (Feb. 13, 1981) [46 FR 13505, 13506 (Feb. 23, 1981)] (Commission consistently has taken the position that a person is "subject to" an order under Section 15(b), 15B(a) or (c) of the Exchange Act or Section 203(e) or (f) of the Advisers Act only so long as some act is being performed (or not performed) pursuant to the order). See note 156 and accompanying text.

off date for permanent bars.[133] This would effectively treat permanent bars the same as other final orders, which are disqualifying only if issued during the look-back period. We are not, however, departing from the current standard under Rule 262 either by imposing a look-back period (making all regulatory bars issued within a specified period before a sale disqualifying, even if no longer in effect) or by imposing a cut-off date (which would make bars no longer disqualifying after the requisite time period has passed, even if the bar is permanent or otherwise still in effect). Under Rule 262, bars are disqualifying for as long as they are in effect but no longer, matching the period of disqualification to the duration of the regulatory sanction. We are adopting the same approach for Rule 506. Persons who are subject to an indefinite bar who do not wish to reassociate but do wish to participate in Rule 506 offerings could consider applying for a waiver.

We recognize that, in the proposal and in the final rule, the treatment of court injunctions and restraining orders, on one hand, and regulatory bars and orders, on the other hand, is different in some respects. Court injunctions and restraining orders are subject to a five-year look-back period, which functions as a cut-off (i.e., injunctions and restraining orders issued more than five years before the relevant sale are no longer disqualifying, even if they are still in effect or permanent). The treatment of court injunctions and restraining orders is consistent with Rule 262, and therefore responds to the requirement to develop a "substantially similar" rule, while the treatment of regulatory bars and orders is specifically mandated by Section 926 of the Dodd-Frank Act. Commenters did not generally support harmonizing our approach to court injunctions and restraining orders with the mandated treatment of regulatory bars and orders, and

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[133] See comment letters from ABA Fed. Reg. Comm.; Katten Muchin; Lehman & Eilen; Rutledge; Schuyler, Roche & Crisham, P.C. (July 14, 2011) ("Schuyler Roche"); SIFMA.

we do not believe that the shift from Regulation A to Rule 506 offerings justifies extending the time period for disqualification associated with court injunctions and restraining orders.

Final Orders. Section 926 of the Dodd-Frank Act does not specify what should be deemed to constitute a "final order" that triggers disqualification. The proposal included an amendment to Rule 501 to provide a definition of "final order," based on the definition that the Financial Industry Regulatory Authority ("FINRA") uses in forms that implement language in Section 15(b)(4)(H) of the Exchange Act, which is identical[134] to the language used in Section 926.[135] Under the proposal, "final order" would mean "a written directive or declaratory statement issued pursuant to applicable statutory authority and procedures by a federal or state agency described in § 230.506(c)(1)(iii), which constitutes a final disposition or action by that federal or state agency."

The proposing release requested comment on other potential approaches to the term "final order," such as whether the rule should consider orders final only if they are non-appealable, and whether the rule should cover only orders issued in a process that provides for certain due process rights, such as notice, a right to be heard, and a requirement for a record with written findings of fact and conclusions of law. We also queried whether disqualifying matters that arose in the context of a settlement with a regulatory authority should be treated the same as non-settled matters. The proposing release also discussed whether the Commission should defer

134 Note, however, that Section 15(b)(4)(H) does not contain a look-back period, unlike the 10-year look-back period specified in Section 926(2)(A)(ii).

135 The definition of "final order" used by FINRA applies to Forms U4, U5 and U6, which are used for reporting the disciplinary history of broker-dealers and associated persons under Exchange Act Section 15(b)(4)(H). Form U4 is the Uniform Application for Securities Industry Registration or Transfer, used by broker-dealers to register associated persons. Form U5 is the Uniform Termination Notice for Securities Industry Registration, used by broker-dealers to report the termination of an associated person relationship. Form U6 is the Uniform Disciplinary Action Reporting Form, used by SROs and state and federal regulators to report disciplinary actions against broker-dealers and associated persons.

to the regulator issuing the order to determine whether the issued order was a "final order" for purposes of disqualification in Rule 506.

Several commenters agreed that a definition of "final order" would be helpful in promoting uniform and predictable treatment of regulatory actions.[136] Four commenters were generally supportive of the proposed definition.[137]

Two commenters suggested adding minimum procedural standards to the definition of "final order."[138] One advocated building "basic due process elements" into the definition by adding the concept of notice and an opportunity for a hearing.[139] This commenter suggested that, in order to ensure that settled matters would be treated the same as litigated matters, the definition should require "an opportunity for hearing" rather than some specified actual proceeding.[140] The other commenter recommended that, for an order to constitute a "final order," a regulator "must have made a finding of fact and set forth conclusions of law on a record."[141]

Taking into account the potential impact of disqualification on issuers and other market participants, we are persuaded that the definition of "final order" should be limited to orders issued under statutory authority—including statutes, rules and regulations—that provides for notice and an opportunity for hearing.[142] As a result, under our final definition, *ex parte* orders

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136 See, e.g., letters from NYCBA; Rutledge; SIFMA.

137 Letters from C. Barnard; Rutledge; Better Markets; Munck Carter, LLP (July 14, 2011) ("Munck Carter").

138 Letters from NYCBA; SIFMA.

139 Letter from NYCBA.

140 Id.

141 Letter from SIFMA.

142 See Rule 501.

issued under statutory authority that does not provide for notice and an opportunity for hearing will not trigger disqualification. We are not, however, imposing procedural requirements beyond a basic requirement that notice and opportunity for hearing be provided for in the statutes, rules and regulations under which an order is issued. The proceedings covered in Rule 506(d)(1)(iii) take many different forms, and it would not be appropriate for our rules to impose procedural requirements that may not be met by the proceedings of every state or federal regulator whose orders are required to trigger disqualification under Section 926 of the Dodd-Frank Act. We are also not requiring that a hearing actually have occurred. There may be no hearing, for example, in the context of a settled matter; however a settlement is considered for this purpose to have been made after an opportunity for hearing. The basic requirement we have included should be sufficient to address the fundamental fairness concern.

We believe that focusing on the nature of the relevant legal authority for an order rather than the particular facts and circumstances surrounding the order will provide more certainty to issuers seeking to determine whether a covered person subject to an order is in fact subject to a "final order" that would be disqualifying. An issuer would only need to determine whether the statutory authority provided for these procedural safeguards, not whether in fact notice was given and an opportunity for hearing was provided. This approach is consistent with comment we received stressing the importance of making the disqualification provisions clear and simple to administer, based on "bright line" provisions or an "objective test" wherever possible.[143] The focus on legal authority rather than the facts of each case will also likely reduce the incidence of covered persons, in an effort to participate in an offering, claiming procedural irregularities

[143] Letter from NYCBA

where such irregularities did not occur. A market participant that is subject to an order that was issued without in fact receiving notice and an opportunity for hearing will be able to challenge the order itself, and may also seek a waiver of disqualification from the Commission.

We do not believe that limiting final orders in this way will compromise investor protection because, in most instances, *ex parte* orders are of short duration and will either expire or be replaced by a subsequent order that would meet our procedural requirements.

Commenters were divided on the question of whether orders should be deemed final if they are still subject to appeal. Three commenters objected to adding a requirement that final orders be non-appealable, generally on the basis that the resulting delay could compromise investor protection.[144] Three other commenters argued that the definition of "final order" should be limited to non-appealable orders.[145] We remain concerned that delay incident to the appeals process could undermine the intended benefits of the rule, and are therefore adopting the definition of "final order" without a requirement that the order be non-appealable.[146]

As adopted, the definition of "final order" contained in new Rule 501(g) provides as follows:

(g) *Final order*. *Final order* shall mean a written directive or declaratory statement issued by a federal or state agency described in § 230.506(d)(1)(iii) under applicable statutory authority that provides for notice and an opportunity for hearing, which constitutes a final disposition or action by that federal or state agency.

<u>Fraudulent, Manipulative or Deceptive Conduct</u>. Section 926(2)(A)(ii) of the Dodd-

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144 Letters from C. Barnard; NYCBA; Rutledge.

145 Letters from SIFMA; REISA; Alfaro.

146 <u>See</u> Rule 501.

Frank Act provides that disqualification must result from final orders of the relevant regulators that are "based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct." In light of the specificity of the language of Section 926, the proposal did not include standards or guidance with respect to what constitutes "fraudulent, manipulative or deceptive conduct."

In the proposing release we solicited comment on whether the rule should provide a definition for "fraudulent, manipulative or deceptive conduct" and, if we provided a definition, what should be included in such a definition. Recognizing that Section 926(2)(A)(ii) refers to the final orders of the relevant regulators, the proposing release also requested comment on whether the "fraudulent, manipulative or deceptive conduct" determination should be considered and decided only by the relevant regulator issuing the final order. In particular, we asked whether "fraudulent, manipulative or deceptive conduct" should be understood to require knowing misconduct or scienter, and noted the concern expressed by some commenters that "technical or administrative violations" should not be a source of disqualification.[147]

Some commenters believed that the Commission should provide standards for fraudulent, manipulative or deceptive conduct to clarify and limit the types of orders by state and federal regulators that will trigger disqualification.[148] These commenters supported a definition that requires scienter, generally modeled on the scienter standards of Section 10(b) of the Exchange

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[147] See advance comment letter from Investment Program Association (Mar. 2, 2011) (available at http://www.sec.gov/comments/df-title-ix/regulation-d-disqualification/regulationddisqualification-3.pdf). See also Record of Proceedings of 29th Annual SEC Government-Business Forum on Small Business Capital Formation, at 18 (Nov. 18, 2010) (remarks of Deborah Froling) (available at http://www.sec.gov/info/smallbus/sbforumtrans-111810.pdf).

[148] See comment letters from Alfaro; ABA Fed. Reg. Comm.; Five Firms; the Managed Funds Association (Aug. 12, 2011) ("MFA"); NYCBA; REISA; SIFMA; S&C; Whitaker Chalk.

Act and Rule 10b-5.[149] Many of these commenters also argued that violations they characterized as "technical" or "administrative," such as late filings and books and records violations, without a requirement of scienter, should not give rise to disqualification.[150] On the other hand, a commenter who opposed defining "final order" to include scienter pointed out that scienter is not required for all state securities law violations or for violations of federal banking regulations (where the standard is unsafe or unsound banking practices or breach of fiduciary duty), so limiting the definition of fraudulent, manipulative or deceptive conduct to scienter-based violations would potentially result in orders by those regulators not giving rise to disqualification even though they are explicitly mandated to be covered by Section 926. In the commenter's view, this would be contrary to Congressional intent and the plain language of Section 926.[151]

We do not believe that Section 926(A)(ii) is limited to matters involving scienter. Scienter is not a requirement under Section 15(b)(4)(H) of the Exchange Act or Section 203(e)(9) of the Advisers Act, from which the language of Section 926 is drawn. Commission orders are issued under these sections based only on the existence of a relevant state or federal regulatory order; the Commission has stated that, while the degree of scienter involved is a factor in determining what sanction is appropriate,[152] the Commission can order sanctions even where scienter is not an element of the underlying state anti-fraud law violation.[153] Scienter

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149 See comment letters from ABA Fed. Reg. Comm.; Five Firms; MFA; NYCBA; REISA; SIFMA; S&C; Whitaker Chalk. See also comment letter from Cleary Gottlieb (supporting a scienter requirement for all regulatory orders, including orders of the Commission, with an exception for Commission orders related to violations of Section 5 of the Securities Act).

150 See, e.g., comment letters from Five Firms; MFA; SIFMA.

151 See comment letter from Rutledge.

152 Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981).

153 See In the Matter of Mitchell M. Maynard and Dorice A. Maynard, Release No. IA-2875 (May 15, 2009).

may also not play a similar role in other areas of regulation specified in Section 926(A)(ii), such as insurance, banking and credit union regulation, as it does under the federal securities laws. We do not believe it is appropriate to limit the provision to matters involving scienter absent a clear statutory direction to do so, particularly when the relevant language has been construed in other contexts not to be so limited, and when imposing such a limitation may result in excluding regulatory orders that are explicitly mandated to be covered by the new rules. Accordingly, the final rules do not include a definition of "fraudulent, manipulative or deceptive conduct" and in particular do not limit "fraudulent, manipulative or deceptive conduct" to matters involving scienter.

Final Rule. As adopted, Rule 506(d)(1)(iii) provides as follows:

(iii) Is subject to a final order of a state securities commission (or an agency or officer of a state performing like functions); a state authority that supervises or examines banks, savings associations, or credit unions; a state insurance commission (or an agency or officer of a state performing like functions); an appropriate federal banking agency; the U.S. Commodity Futures Trading Commission; or the National Credit Union Administration that:

(A) At the time of such sale, bars the person from:

(1) Association with an entity regulated by such commission, authority, agency, or officer;

(2) Engaging in the business of securities, insurance or banking; or

(3) Engaging in savings association or credit union activities; or

(B) Constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years before such sale.[154]

4. **Commission Disciplinary Orders**

Rule 262(b)(3) of Regulation A imposes disqualification on an issuer if any covered person is subject to an order of the Commission "entered pursuant to section 15(b), 15B(a), or 15B(c) of the Exchange Act, or section 203(e) or (f) of the Investment Advisers Act."[155] Under these provisions (other than Section 15B(a), discussed below), the Commission has authority to order a variety of sanctions against registered brokers, dealers, municipal securities dealers and investment advisers and their associated persons, including suspension or revocation of registration, censure, placing limitations on their activities, imposing civil money penalties and barring individuals from being associated with specified entities and from participating in the offering of any penny stock.

Our proposed rule was based on Rule 262(b)(3), but eliminated the anomalous reference to Section 15B(a), which is not a source of sanctioning authority, and codified the prior interpretive position that disqualification would continue only for as long as some act is prohibited or required to be performed pursuant to the order (with the consequence that censures and orders to pay civil money penalties, assuming the penalties are paid in accordance with the order, are not disqualifying, and a disqualification based on a suspension or limitation of

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[154] Rule 506(d)(1)(iii).

[155] 17 CFR 230.262(b)(3) (citing 15 U.S.C. 78o(f), 78o(4)(a), 78o(4)(c), 80b-3(e) and 80b-3(f)). Section 21B(a) of the Exchange Act, 15 U.S.C. 78u-2(a)(1), and Section 203(i)(1)(A) of the Advisers Act, 15 U.S.C. 80b-3(i)(1)(A), give the Commission authority to impose civil money penalties in these disciplinary proceedings.

activities expires when the suspension or limitation expires).[156] Under the proposed rule, an offering would be disqualified if any covered person:

(iv) Is subject to an order of the Commission entered pursuant to section 15(b) or 15B(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b) or 78o-4(c)) or section 203(e) or (f) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(e) or (f)) that, at the time of such sale:

(A) Suspends or revokes such person's registration as a broker, dealer, municipal securities dealer or investment adviser;

(B) Places limitations on the activities, functions or operations of such person; or

(C) Bars such person from being associated with any entity or from participating in the offering of any penny stock.[157]

We requested comment on the appropriateness of codifying the interpretive position and imposing any look-back period for Commission disciplinary sanctions. Specifically, we requested comment on whether the rules should provide that orders to pay civil money penalties are disqualifying if the penalties are not paid as ordered. The proposal drew relatively little

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[156] See Proposed Rule 506(c)(1)(iv); Release No. 33-6289 (Feb. 13, 1981) [46 FR 13505, 13506 (Feb. 23, 1981)] (in adopting amendments to Rule 252 of Regulation A, the predecessor to Rule 262, the Commission noted "[i]n those instances where persons are subject to orders containing no definite time limitations, the Commission has consistently taken the position that a person is subject to an order only so long as some act is being performed pursuant to such order, [such as] establishing procedures to assure appropriate supervision of salesmen and reporting on such procedures.") The staff of the Division of Corporation Finance has taken the same view. See Release No. 33-6455, Question 66 (Mar. 3, 1983) [48 FR 10045, 10053 (Mar. 10, 1983)] (in interpretive release on Regulation D, the staff advised that censure has no continuing force and thus censured person is not "subject to an order of the Commission entered pursuant to section 15(b)" within the meaning of Rule 505); Howard, Prim, Rice, Nemerovski, Canady & Pollak, SEC No-Action Letter, 1975 WL 11300 (Jan. 8, 1975, publicly available Feb. 11, 1975) (Rule 252 does not comprehend a situation where an underwriter of a Regulation A offering has stipulated to a consent order in a Commission administrative proceeding providing only for a censure, with no suspension or other sanction); Samuel Beck, SEC No-Action Letter, 1975 WL 11471 (May 15, 1975, publicly available June 24, 1975).

[157] Proposed Rule 506(c)(iv).

comment, all of which was supportive.[158] We are adopting the rule as proposed, now numbered Rule 506(d)(1)(iv).

5. Certain Commission Cease-and-Desist Orders

Section 926 of the Dodd-Frank Act mandates that bad actor disqualification result from final orders issued within a ten-year period by the state and federal regulators identified in Section 926(2)(A) of the Dodd-Frank Act. The state and federal regulators listed in Section 926 include: state authorities that supervise banks, savings associations, or credit unions; state insurance regulators; appropriate federal banking agencies; and the National Credit Union Administration. The Commission is not included in the Section 926(2)(A) list of regulators. Although we did not propose specific amendments to the rule to include the Commission, we explained that adding the Commission's cease-and-desist orders to the disqualification provisions could further enhance the investor protection intent of the disqualification provisions and would contribute to creating an internally consistent set of rules that would treat relevant sanctions similarly for disqualification purposes. In the proposing release, we pointed out in particular that orders issued in stand-alone Commission cease-and-desist proceedings[159] are not disqualifying under current bad actor disqualification provisions,[160] and the proposal did not include such orders as disqualifying for purposes of Rule 506 offerings.

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158 See comment letter from Rutledge; see also comment letters from Lehman & Eilen; SIFMA.

159 In cease-and-desist proceedings, the Commission can issue orders against "any person," including entities and individuals outside the securities industry, imposing sanctions such as penalties, accounting and disgorgement or officer and director bars. In contrast, administrative proceedings are generally limited to regulated entities and their associated persons.

160 Current provisions also do not cover other types of Commission actions. For example, the Commission has authority under Section 9(b) of the Investment Company Act to bring proceedings against "any person" and may impose investment company bars, civil penalties and disgorgement under Sections 9(d) and (e) of the Investment Company Act. 15 U.S.C. 80a-9(b), (d) and (e). The Commission also has authority under Rule 102(e) of its Rules of Practice to censure persons (such as accountants and attorneys) who appear or practice before it, or to deny them

Our request for comment covered a range of issues, including whether it was appropriate to include the Commission in the list of regulators and if so, what types of Commission cease-and-desist orders should give rise to Rule 506 disqualification. In the proposing release, we presented possible approaches to including Commission orders as a disqualifying event and requested comment on those approaches. We requested comment on whether it would be appropriate to include cease-and-desist orders issued by the Commission for violations of the anti-fraud provisions of the federal securities laws, and whether requiring scienter and including cease-and-desist orders related to violations of Section 5 of the Securities Act would be appropriate. Given that Rule 506 offerings provide an exemption from Section 5 registration, we noted that on that basis, persons who violate Section 5 should potentially lose the benefit of exemptive relief for some period afterward.

The request for comment generated a substantial response. Five comment letters favored covering all Commission orders, including cease-and-desist orders (subject in some cases to a scienter requirement).[161] One comment letter noted that although including Commission cease-and-desist orders could impair capital formation, the benefits of doing so would outweigh the risks because adding Commission orders would more effectively work to screen out bad actors and improve internal consistency of the rules.[162] This comment letter described the proposed rule and the absence of Commission orders as "under-inclusive" because the proposed

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the privilege of appearing before the Commission temporarily or permanently. 17 CFR 201.102(e). Orders under these sections are not disqualifying under Rule 262.

161 See comment letters from Better Markets; Cleary Gottlieb (scienter required except for Section 5 violations); NYCBA; NASAA; Whitaker Chalk (scienter required; suggesting that Commission list the violations that lead to disqualification or adopt a willful violation standard).

162 See comment letter from Cleary Gottlieb.

amendments did not explicitly address all final orders issued by the Commission addressing fraudulent, manipulative or deceptive conduct.

Five comment letters opposed adding Commission cease-and-desist orders, generally arguing that the Commission lacks authority to expand on the Section 926 statutory scheme in that way.[163] One comment letter suggested the decision to include cease-and-desist orders would add a large class of regular and routine disciplinary proceedings to the disqualification provisions, expressing concern that including administrative cease-and-desist orders that do not require any showing or finding of intentional misconduct could be viewed as unnecessarily punitive by disqualifying an organization from particular types of capital formation activity.[164] This comment letter also noted that including cease-and-desist orders marked a departure from the disciplinary order provisions of Rule 262(b)(3) in which the Commission has historically interpreted Rule 262 "to require disqualification only for as long as some act is prohibited or required to be performed pursuant to the order."[165] Another comment letter stated that cease-and-desist orders should not create a disqualification unless it imposes a limitation or restriction on conduct.[166] One commenter also opposed adding Commission cease-and-desist orders based on the legislative history of Section 15(b)(4)(H) of the Exchange Act, from which the language used in Section 926 is drawn.[167]

We believe that including certain Commission cease-and-desist orders in the bad actor disqualification scheme would enhance its investor protection benefits and make the overall

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163 See comment letters from ABA Fed. Reg. Comm.; Five Firms; Katten Muchin; Rutledge; SIFMA.

164 See comment letter from Five Firms.

165 Id.

166 See comment letter from SIFMA.

167 See comment letter from Rutledge.

scheme of Rule 506 of Regulation D more internally consistent. We believe an injunctive or restraining order issued by a federal court and a Commission cease-and-desist order arising out of the same legal violation equally demonstrate disqualifying conduct and should have the same consequences under our disqualification rules. The benefits associated with screening bad actors out of the Rule 506 market should not depend on whether a particular enforcement action is brought in court or through a Commission cease-and-desist proceeding. For that reason, the final rules include a provision that makes certain Commission cease-and-desist orders a disqualifying event.

We disagree with the commenters who argue that the Commission lacks authority, as part of this rulemaking, to add additional disqualification triggers not provided in Section 926. In our view, Section 926 does not limit the existing authority we previously used to create other bad actor provisions.

In expanding the list of disqualification triggers beyond those required in Section 926, we are mindful of our mandate to promote investor protection and capital formation. In particular, we are mindful of the concerns expressed by commenters about the potentially negative impact on capital raising of overbroad disqualification standards.[168] The concerns associated with including Commission cease-and-desist orders involved expanding the class of covered persons subject to disqualification and including administrative cease-and-desist orders that do not require any showing or finding of scienter. With those issues in mind, the additional disqualification trigger we are adopting covers only Commission orders to cease and desist from violations and future violations of the scienter-based anti-fraud provisions of the federal

[168] See notes 296-98 and accompanying text.

securities laws (including, without limitation, Section 17(a)(1) of the Securities Act,[169] Section 10(b) of the Exchange Act[170] and Rule 10b-5 thereunder,[171] Section 15(c)(1) of the Exchange Act,[172] and Section 206(1) of the Advisers Act[173]) and violations of Section 5 of the Securities Act.[174] The additional disqualification trigger for Section 5 violations will not require scienter, which is consistent with the strict liability standard imposed by Section 5.[175] As a policy matter, we do not believe that exemptions from registration based on Rule 506 should be available to persons whose prior conduct has resulted in an order to cease and desist from violations of Section 5's registration requirements.

The additional disqualification trigger will be subject to the same five-year look-back period that applies to court restraining orders and injunctions,[176] rather than the 10-year look-back that is mandated to apply to other regulatory orders under Section 926, which will provide consistent Commission treatment of cease and desist orders with court orders.

As adopted, Rule 506(d)(1)(v) imposes disqualification if any covered person:

(v) Is subject to any order of the Commission entered within five years before such sale that, at the time of such sale, orders the person to cease and desist from committing or causing a violation or future violation of:

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169 15 U.S.C. 77q(a)(1).

170 15 U.S.C. 78j(b).

171 17 CFR 240.10b-5.

172 15 U.S.C. 78o(c)(1).

173 15 U.S.C. 80b-6(1).

174 15 U.S.C. 77e.

175 See SEC v. North American Research and Development Corp., 424 F.2d 63, 8182 (2d Cir.1970); Swenson, 626 F.2d at 424 (5th); SEC v. Ross, 504 F.3d 1130, 1137 (9th Cir.2007); SEC v. Pearson, 426 F.2d 1339, 1343 (10th Cir.1970).

176 Rule 506(d)(1)(ii).

(A) any scienter-based anti-fraud provision of the federal securities laws, including without limitation Section 17(a)(1) of the Securities Act of 1933 (15 U.S.C. 77q(a)(1)), Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)) and Rule 10b-5 thereunder (17 CFR 240.10b-5), Section 15(c)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(c)(1)) and Section 206(1) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-6(1)), or any other rule or regulation thereunder; or

(B) Section 5 of the Securities Act of 1933 (15 U.S.C. 77e).[177]

6. Suspension or Expulsion from SRO Membership or Association with an SRO Member

Rule 262(b)(4) disqualifies an offering if any covered person is suspended or expelled from membership in, or suspended or barred from association with a member of, a securities self-regulatory organization or "SRO" (i.e., a registered national securities exchange or national securities association) for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade.[178] The proposed rule added a reference to a registered affiliated securities association and applied the standard to all covered persons,[179] but did not otherwise change the substance of the rule. Under the proposed rule, an offering would be disqualified if any covered person:

Is suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange or a registered national or

[177] Rule 506(d)(1)(v).

[178] See 17 CFR 230.262(b)(4).

[179] Proposed Rule 506(c)(1)(vi). Rule 262(b)(4) does not apply to issuers and their predecessors and affiliated issuers. 17 CFR 230.262(b)(4).

affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade.[180]

The proposal drew little comment,[181] and we are adopting the text of the rule as proposed. It is now numbered Rule 506(d)(1)(vi) because of the addition of the new provision covering certain Commission cease-and-desist orders in Rule 506(d)(1)(v).

7. Stop Orders and Orders Suspending the Regulation A Exemption

Paragraphs (a)(1) and (2) of Rule 262 impose disqualification on an offering if the issuer, or any predecessor or affiliated issuer, has filed a registration statement or Regulation A offering statement that was the subject of a Commission refusal order, stop order or order suspending the Regulation A exemption within the last five years, or is the subject of a pending proceeding to determine whether such an order should be issued.[182] Similarly, paragraphs (c)(1) and (2) impose disqualification if any underwriter of the securities proposed to be issued was, or was named as, an underwriter of securities under a registration statement or Regulation A offering statement that was the subject of a Commission refusal order, stop order or order suspending the Regulation A exemption within the last five years, or is the subject of a pending proceeding to determine whether such an order should be issued.[183] The proposed rule incorporated the substance of these four paragraphs in a single paragraph that applied to all covered persons. Under the proposed rule, an offering would be disqualified if any covered person:

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[180] Proposed Rule 501(c)(v).

[181] Three commenters responded to our request for comment on whether commodities exchanges and commodities self-regulatory organizations should be covered by the provision. One favored such an extension (comment letter from Better Markets) and two opposed it (comment letters from Lehman & Eilen, Rutledge). We have not included such an extension in the final rule.

[182] 17 CFR 230.262(a)(1) and (2).

[183] 17 CFR 230.262(c)(1) and (2).

> Has filed (as a registrant or issuer), or was or was named as an underwriter in, any registration statement or Regulation A offering statement filed with the Commission that, within five years before such sale, was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of such sale, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued.[184]

The proposal drew only one comment,[185] which supported the proposal, and we are adopting the text as proposed, now numbered Rule 506(d)(1)(vii).

8. U.S. Postal Service False Representation Orders

Paragraphs (a)(5) and (b)(5) of Rule 262 impose disqualification on an offering if the issuer or another covered person is subject to a U.S. Postal Service false representation order entered within the preceding five years, or to a temporary restraining order or preliminary injunction with respect to conduct alleged to have violated the false representation statute that applies to U.S. mail.[186] Our proposed rule incorporated the substance of these paragraphs in a single paragraph, disqualifying an offering if any covered person:

> Is subject to a United States Postal Service false representation order entered within five years before such sale, or is, at the time of such sale, subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the United States

[184] Proposed Rule 506(c)(1)(vi).

[185] See comment letter from Rutledge.

[186] Paragraph (a)(5) relates to issuers and their predecessors and affiliated issuers, and paragraph (b)(5) relates to other covered persons. Disqualification results if any covered person "is subject to a United States Postal Service false representation order entered under 39 U.S.C. § 3005 within 5 years prior to the filing of the offering statement, or is subject to a temporary restraining order or preliminary injunction entered under 39 U.S.C. § 3007 with respect to conduct alleged to have violated 39 U.S.C. § 3005." 17 CFR 230.262(a)(5) and (b)(5).

Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations.[187]

The proposal drew only one comment,[188] which supported the proposal, and we are adopting the text as proposed, now numbered Rule 506(d)(1)(viii).

D. Reasonable Care Exception

1. Reasonable Care Standard

The proposal included an exception from disqualification for offerings where the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed because of the presence or participation of another covered person.[189]

The proposal also included an instruction to the reasonable care exception explaining that an issuer would not be able to establish that it had exercised reasonable care unless it made a factual inquiry into whether any disqualifications existed. As proposed, the instruction noted that the nature and scope of the inquiry would vary based on the circumstances of the issuer and the other offering participants. We proposed the reasonable care exception to preserve the intended benefits of Rule 506 and avoid creating an undue burden on capital-raising activities, by reducing the risk that issuers could lose the benefit of Rule 506 as a result of disqualifications of which they were unaware.[190]

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187 Proposed Rule 506(c)(1)(vii)

188 See comment letter from Rutledge.

189 See Proposed Rule 506(c)(2)(ii).

190 Rule 508 of Regulation D provides that "insignificant deviations" from the terms, conditions and requirements of Regulation D will not necessarily result in loss of the exemption from Securities Act registration requirements. Rule 508 provides that the exemption will not be lost with respect to any offer or sale to a particular individual or entity as a result of a failure to comply with a term, condition or requirement of Regulation D if the person relying

The proposing release did not prescribe or delineate what steps an issuer would be required to take to show reasonable care. Rather, it noted that the steps an issuer would take would vary according to the circumstances of the covered persons and the offering, taking into account the risk of having a bad actor, the impact of other screening and compliance mechanisms already in place, and the cost and burden of the inquiry. We requested comment on the appropriateness of the reasonable care exception and whether the rule should specify what factual inquiry is required or provide examples of specific factual inquiries that would be deemed to constitute reasonable care. The proposing release also recognized that requiring large issuers or large financial institutions acting as compensated solicitors to conduct factual inquiries on potentially lengthy lists of officers could be burdensome, and therefore we requested comment on whether the rules should provide specific steps to establish reasonable care in these circumstances.

In the proposing release, we discussed the reasonable care exception in the NASAA-approved Model Accredited Investor Exemption ("MAIE"), which serves as a standard in blue sky law and has been adopted in some form by a majority of the states. The MAIE requires the issuer to conduct a "factual inquiry" before asserting the reasonable care exception but does not provide specific information on what steps are required for the factual inquiry. We also noted in the proposing release that, as part of the proposed amendments to Regulation D in 2007, the

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on the exemption shows that: (i) the failure to comply did not pertain to a term, condition or requirement directly intended to protect that particular individual or entity; (ii) the failure to comply was insignificant with respect to the offering as a whole (provided that certain Regulation D requirements, including limitations on general solicitation and any applicable limits on the amount of securities offered and the number of investors, are always deemed significant); and (iii) a good faith and reasonable attempt was made to comply. 17 CFR 230.508. We do not believe that Rule 508 would cover circumstances in which an offering was disqualified based on Rule 506(d).

Commission proposed disqualification provisions that included a reasonable care exception based on the MAIE, without any express reference to factual inquiry.

The proposed reasonable care exception attempted to address the potential difficulty for issuers in establishing whether any covered persons are the subject of disqualifying events, particularly given that there is no central repository that aggregates information from all the federal and state courts and regulatory authorities that would be relevant in determining whether covered persons have a disqualifying event in their past. We believe such a reasonable care exception will facilitate the continued utility of Rule 506 in light of the new disqualification requirements.

Commenters who addressed the issue were unanimous in their support for a reasonable care exception.[191] Many, however, voiced concerns about the perceived vagueness of the proposed exception, and urged us to provide more guidance on what types of factual inquiry would constitute compliance.[192] Some commenters suggested that specific steps be presumed to establish reasonable care, such as obtaining questionnaires from appropriate persons (provided the issuer has no knowledge of undisclosed disqualifying events)[193] or use of a reputable background investigations firm.[194] Another suggested that issuers be permitted to rely on contractual representations from registered broker-dealers and other regulated entities, and that broker-dealers that adopt reasonable policies and procedures to identify disqualifications in

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[191] See, e.g., comment letters from ABA Fed. Reg. Comm.; Angel Capital Association (July 14, 2011) ("Angel Capital Comment Letter 1"); Better Markets; DTC; Kutak Rock; Lehman & Eilen; NASAA; NYCBA; Rutledge; SIFMA; Seward & Kissel; S&C; S&W; Whitaker Chalk.

[192] See, e.g., comment letters from ABA Fed. Reg. Comm.; Kutak Rock; NYCBA; S&C.

[193] See Angel Capital Comment Letter 1; see also comment letter from ABA Fed. Reg. Comm..

[194] See comment letter from S&W.

respect of other offering participants should be presumed to satisfy the "reasonable care" test.[195] One commenter requested a cut-off date for the determination of bad actor involvement (*e.g.*, 15 days before commencement of the offering).[196] Three commenters who supported the reasonable care exception criticized the proposed factual inquiry requirement, suggesting it would impose undue burdens on issuers and recommending that we remove it from the adopted rule.[197] Another commenter suggested that the Commission look to the standards that were adopted by NASAA in the Uniform Limited Offering Exemption and endorsed by NASAA in the Uniform Securities Act, neither of which contains a factual inquiry component.[198]

Other commenters stressed the importance of conditioning the availability of the reasonable care exception on the issuer's factual inquiry.[199] These commenters viewed the factual inquiry as a way to ensure that investor protection is not compromised by issuers' taking minimal steps designed primarily to satisfy minimum requirements for the reasonable care standard rather than to ascertain whether disqualifications actually apply.[200]

We continue to believe that the concept of reasonable care necessarily includes inquiry by the issuer into the relevant facts, and we are adopting the provision and its accompanying

[195] See comment letter from NYCBA; see also comment letters from ABA Fed. Reg. Comm.; Angel Capital Comment Letter 1; Kutak Rock (issuers should be able to rely on registered broker-dealer's confirmation that no disqualification exists).

[196] See comment letter from Cleary Gottlieb.

[197] See Angel Capital Comment Letter 1; see also comment letters from Rutledge; S&C.

[198] Comment letter from Rutledge. The Uniform Limited Offering Exemption and the Uniform Securities Act provide exceptions from disqualification where the issuer shows that it did not know and in the exercise of reasonable care could not have known that a disqualification existed.

[199] See comment letters from Better Markets; NASAA.

[200] E.g., comment letter from Better Markets.

instruction substantially as proposed.[201] There is a wide range of issuers involved in Rule 506 offerings, from large reporting companies, to private investment funds, to smaller private companies, all of which have different legal and ownership structures and may employ a wide range of financial intermediaries, in terms of size, number of employees and scope. As a result, we do not believe it is appropriate to prescribe specific steps as being necessary or sufficient to establish reasonable care.

Accordingly, as we stated in the proposing release, the steps an issuer should take to exercise reasonable care will vary according to the particular facts and circumstances. For example, we anticipate that issuers will have an in-depth knowledge of their own executive officers and other officers participating in securities offerings gained through the hiring process and in the course of the employment relationship, and in such circumstances, further steps may not be required in connection with a particular offering. Factual inquiry by means of questionnaires or certifications, perhaps accompanied by contractual representations, covenants and undertakings, may be sufficient in some circumstances, particularly if there is no information or other indicators suggesting bad actor involvement.

The timeframe for inquiry should also be reasonable in relation to the circumstances of the offering and the participants. Consistent with this standard, the objective should be for the issuer to gather information that is complete and accurate as of the time of the relevant transactions, without imposing an unreasonable burden on the issuer or the other participants in the offering. With that in mind, we expect that issuers will determine the appropriate dates to make a factual inquiry, based upon the particular facts and circumstances of the offering and the

[201] See Rule 506(d)(2)(iii) and instruction thereto.

participants involved, to determine whether any covered persons are subject to disqualification before seeking to rely on the Rule 506 exemption.

In general, issuers should make factual inquiry of the covered persons, but in some cases—for example, in the case of a registered broker-dealer acting as placement agent—it may be sufficient to make inquiry of an entity concerning the relevant set of covered officers and controlling persons, and to consult publicly available databases concerning the past disciplinary history of the relevant persons.[202] Broker-dealers are already required to obtain much of this information for their own compliance purposes. We anticipate that financial intermediaries and other market participants will develop procedures for assisting issuers in gathering the information necessary to satisfy the issuer's factual inquiry requirement.

If the circumstances give an issuer reason to question the veracity or accuracy of the responses to its inquiries, then reasonable care would require the issuer to take further steps or undertake additional inquiry to provide a reasonable level of assurance that no disqualifications apply.

2. Continuous and Long-Lived Offerings

Some commenters requested specific guidance from the Commission on factual inquiry procedures for continuous offerings such as those by hedge funds and some other pooled investment funds.[203] One commenter criticized the application of the factual inquiry requirement

[202] FINRA maintains BrokerCheck, an online tool that enables the public to check the professional backgrounds of current and former FINRA-registered brokerage firms and brokers, as well as investment adviser firms and representatives. The information included in BrokerCheck about brokers and brokerage firms is derived from the Central Registration Depository, the securities industry online registration and licensing database. The information about investment adviser firms and representatives made available through BrokerCheck is derived from the Commission's Investment Adviser Public Disclosure (IAPD) database..

[203] See comment letters from Lehman & Eilen; NYCBA; S&C.

to offerings made on a continuous or delayed basis under Rule 506, arguing that reasonable factual inquiry for all covered persons could be interpreted to require continuous, real-time monitoring, which would be especially onerous for issuers in such offerings.[204] Others suggested permitting issuers to establish the reasonable care exception solely through an initial representation about the potential applicability of disqualifying events followed by subsequent periodic updates, such as annual negative consent letters relating to any changes to such representation on a basis consistent with FINRA Rules 5130 and 5131.[205]

We believe that for continuous, delayed or long-lived offerings, reasonable care includes updating the factual inquiry on a reasonable basis. Again, the frequency and degree of updating will depend on the circumstances of the issuer, the offering and the participants involved, but in the absence of facts indicating that closer monitoring would be required (for example, notice that a covered person is the subject of a judicial or regulatory proceeding or knowledge of weaknesses in an organization's screening procedures), we would expect that periodic updating could be sufficient. We expect that issuers will manage this through contractual covenants from covered persons to provide bring-down of representations, questionnaires and certifications, negative consent letters, periodic re-checking of public databases, and other steps, depending on the circumstances.

E. Waivers

Consistent with the requirement of Section 926 that the Commission promulgate

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[204] See comment letter from S&C.

[205] See comment letters from ABA Fed. Reg. Comm.; SIFMA; S&C; see also comment letter from NYCBA (semi-annual updates). FINRA Rules 5130 and 5131 permit reliance on written representations for up to 12 months, with annual negative consent letters thereafter, to confirm that accounts are not beneficially owned by certain "restricted persons" (Rule 5130) or by certain executive officers and directors or persons materially supported by them (Rule 5131).

disqualification provisions "substantially similar" to Regulation A, the proposal included a waiver provision based on current Rule 262, under which the Commission could grant a waiver of disqualification if it determined that the issuer had shown good cause "that it is not necessary under the circumstances that the [registration] exemption . . . be denied."[206]

The proposing release requested comment on whether the proposed rule should include a provision such as in the one in the MAIE that provides an exception from disqualification if the state authority that issued the disqualifying order waives the disqualification. The proposing release also requested comment on whether the Commission should provide guidance as to the circumstances that would likely give rise to the grant or denial of a waiver and whether the Commission should exercise waiver authority for cases involving final orders of state regulators.

1. Waiver for Good Cause Shown

Under current rules, the Commission has delegated authority to grant disqualification waivers under Regulation A and Rule 505 to the Director of the Division of Corporation Finance.[207] Under the proposal, there would have been no delegation of authority for waivers of bad actor disqualification under the new Rule 506 disqualification provisions, and all such waivers would have been issued by a direct order of the Commission.

Commenters who addressed the issue were universally supportive of including a waiver provision in the bad actor disqualification provisions applicable to Rule 506.[208] We are adopting

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[206] Proposed Rule 506(c)(2)(i).

[207] See 17 CFR 200.30-1(b), 200.30-1(c).

[208] See comment letters from ABA Fed. Reg. Comm.; Coy Capital; DTC; Five Firms; IPA; Katten Muchin; Lehman & Eilen Cotter; I. Linder (July 14, 2011); MFA; NYCBA; NASAA; REISA; Rutledge; SIFMA; Seward & Kissel; S&C; Whitaker Chalk.

he waiver provision substantially as proposed, with the modifications discussed below.[209]

Given the expectation of a short time frame for many Rule 506 offerings, a number of commenters expressed concern over the timeliness of waiver application reviews by the Commission and the risk that a lengthy review process may disadvantage issuers seeking speedy access to capital.[210] Three commenters urged that authority be delegated to Commission staff to grant waivers, out of a concern for potential delays.[211] We are sensitive to concerns about delay in the waiver process, and believe that the staff has managed the process of granting waivers from Regulation A and Rule 505 disqualification appropriately in the past. Accordingly, we have determined to clarify the existing delegation of authority to the Director of the Division of Corporation Finance by amending it to cover waivers of Rule 506 disqualification.[212]

Several commenters requested clear guidance on circumstances that would give rise to the grant of a waiver from disqualification.[213] Three commenters argued that having clear disqualification waiver guidelines would result in greater efficiency for market participants and Commission staff, and encouraged the development of uniform standards that would prevent unfair application of the disqualification provisions.[214] We believe it would be premature to attempt to articulate standards for granting waivers, although we may consider doing so after we and the Commission staff have developed experience in handling waiver requests under the new Rule 506 disqualification rules. We have, nonetheless, identified in this adopting release a

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209 See Rule 506(d)(2)(ii).

210 See comment letters from IPA; Seward & Kissel; Whitaker Chalk.

211 See comment letters from ABA Fed. Reg. Comm.; MFA; Seward & Kissel.

212 See 17 CFR 200.30-1(c).

213 See comment letters from ABA Fed. Reg. Comm.; DTC; Lehman & Eilen; MFA; Rutledge; Whitaker Chalk.

214 See comment letters from ABA Fed. Reg. Comm.; MFA; Rutledge.

number of circumstances (such as a change of control, change of supervisory personnel, absence of notice and opportunity for hearing, and relief from a permanent bar for a person who does not intend to apply to reassociate with a regulated entity) that could, depending on the specific facts, be relevant to the evaluation of a waiver request. This is not an exhaustive list, and we expect that other factors would also be relevant to our consideration of waiver requests in particular cases.

2. Waiver Based on Determination of Issuing Authority

In response to our request for comment on how the Commission should handle waiver applications involving final orders of state regulators, three commenters recommended that the Commission retain its authority to waive disqualification arising out of such orders.[215] One commenter recommended that waivers should be permitted to be determined by the state or local authorities or the Commission, at the option of the issuer.[216] Several commenters recommended adoption of automatic exceptions from disqualification similar to those in the MAIE and Uniform Limited Offering Exemption ("ULOE").[217] Under both the MAIE and ULOE, bad actor disqualification is waived if either (i) the person against whom an order is issued is licensed or regulated in the relevant state and is still permitted to conduct securities-related work in the state, or (ii) the regulator issuing the relevant order determines that disqualification is not

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215 See comment letters from ABA Fed. Reg. Comm.; Coy Capital; NYCBA.

216 See comment letter from REISA.

217 See comment letters from ABA Fed. Reg. Comm.; Five Firms; IPA; I. Linder; Rutledge; SIFMA; Whitaker Chalk; see also comment letter from NYCBA. The Uniform Limited Offering Exemption was adopted by NASAA in 1983 and again in 1989. It is designed to provide a state-level exemption for offerings that are exempt from registration at the federal level under Rule 505 of Regulation D. Peter M. Fass and Derek A. Wittner, Blue Sky Practice for Public and Private Direct Participation Offerings, § 9.19 and Appendix 9A (Thomson Reuters/West 2008).

necessary under the circumstances.[218] Another commenter recommended that the Commission not grant a waiver if such a grant would be prejudicial to an action by the state or regulator.[219]

We are persuaded that the second leg of the MAIE/ULOE exception to disqualification, under which disqualification does not apply if the regulator issuing the relevant order determines that Rule 506 disqualification is not necessary under the circumstances, strikes an appropriate balance. It allows the relevant authorities to determine the impact of their orders and conserves Commission resources (which might otherwise be devoted to consideration of waiver applications) in cases where the relevant authority determines that disqualification from Rule 506 offerings is not warranted. Accordingly, the final rule contains a provision based on MAIE paragraph (D)(2)(b), under which disqualification will not arise if, before the relevant sale is made in reliance on Rule 506, the court or regulatory authority that entered the relevant order, judgment or decree advises in writing, whether in the relevant judgment, order or decree or separately to the Commission or its staff, that disqualification under Rule 506 should not arise as a consequence of such order, judgment or decree.[220] Because disqualification will not arise in those circumstances, no waiver need be sought from the Commission for a person subject to such an order, judgment or decree to participate in a Rule 506 offering. Even in the absence of such advice, however, the Commission may still exercise its discretion to grant waivers under Rule 506(d)(2)(ii) in cases where it considers it appropriate to do so.[221]

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[218] See MAIE paragraphs (D)(2)(a)-(b) (available at http://www.nasaa.org/wp-content/uploads/2011/07/24-Model_Accredited_Investor_Exemption.pdf) and Fass and Wittner, note 205, at Appendix 9A, paragraph B.6.

[219] See comment letter from NASAA.

[220] See Rule 506(d)(2).

[221] Conversely, in cases where disqualification does not arise on the basis of an order, judgment or decree because the issuing authority advises that it should not, the Commission would not be precluded from pursuing its own

We are not, however, including a provision based on the first leg of the MAIE/ULOE test, which prevents disqualification if the triggering event occurs with respect to a regulated person, such as a broker-dealer, and such person continues to be licensed or registered to conduct securities-related business in the relevant state. As a practical matter, this approach eliminates from the MAIE/ULOE disqualification scheme all orders that are not bars or revocation of registration or licensure. We believe such an approach would be incompatible with the language of Section 926, which, by its terms, covers both bars and other final orders. For that reason, we have not adopted it. We may, however, take the fact that registration or licensure has not been suspended or revoked into account when considering waiver applications.

F. Transition Issues

1. Disqualification Applies Only to Triggering Events that Occur After Effectiveness of the Rule Amendments

Under the proposal, the new disqualification provisions would have applied to all sales made under Rule 506 after the effective date of the rule amendments. Offerings made after the effective date would have been subject to disqualification for all disqualifying events that occurred within the relevant look-back periods, regardless of whether the events occurred before enactment of the Dodd-Frank Act, or the proposal or effectiveness of the amendments to Rule 506.

We requested comment on this approach, both in broad terms and as to specific aspects, such as whether we should make special provision for orders issued in the context of negotiated settlements and whether we should provide for extensions of waivers granted with respect to bad

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enforcement action, which may result in a court order or judgment or a Commission order that constitutes an independent basis for disqualification.

actor disqualification under Regulation A, Rule 505 of Regulation D or Regulation E, so they would apply to Rule 506 disqualification as well. This section of the proposing release drew more comment than any other.

Five commenters supported including prior bad actor disqualifying events in the disqualification provisions, generally arguing, on investor protection grounds, that the purpose of the rule is to prevent all bad actors from participating in Rule 506 offerings.[222] For example, one such commenter asserted, "[a]s between issuers and investors, it is far preferable that issuers face the delays or inconvenience necessary to cure disqualifications or register their offerings than for investors to be victimized by an issuer or promoter that was demonstrably unfit to invoke the Rule 506 exemption."[223] One commenter argued that contested proceedings should not be grandfathered because in those cases the respondent had no choice in the ultimate result of the proceeding.[224]

On the other hand, 15 comment letters requested that the Commission not apply the rules to past triggering events, or else provide for widespread grandfathering.[225] Critics of applying the rules to past events objected on the basis of statutory construction,[226] the Supreme Court decision in Landgraf v. USI Film Products,[227] and Congressional intent.[228] Many commenters also argued that such application of the new disqualification rules would unfairly upset

222 See comment letters from Anonymous (July 12, 2011); Better Markets; J. Davis (June 13, 2011); DTC; NASAA.

223 See comment letter from Better Markets.

224 See comment letter from Lehman & Eilen.

225 See comment letters from Alfaro; ABA Fed. Reg. Comm.; Cleary Gottlieb; Coy Capital; Five Firms; IPA; Katten Muchin; Munck Carter; NYCBA; REISA; Rutledge; Seward & Kissel; SIFMA; S&C; Whitaker Chalk.

226 See comment letters from ABA Fed. Reg. Comm.; Coy Capital; Five Firms; MFA; NYCBA; S&C.

227 See comment letters from ABA Fed. Reg. Comm.; Coy Capital; Five Firms.

228 See comment letters from Five Firms; MFA.

previously negotiated civil and administrative settlements, or impose an unforeseeable new sanction in respect of prior conduct.[229] Several commenters recommended providing automatic waivers for settlements, or automatic extension of existing Regulation A and Rule 505 waivers if the new rules were to be applied to pre-existing events.[230] Another commenter argued that prospective application of disqualification provisions would be consistent with the Commission's approach to analogous bad actor disqualification provisions in the past, such as the "ineligible issuer" provisions of the Securities Offering Reform rule adopted in 2005 and the disqualification provisions adopted under the Private Securities Litigation Reform Act of 1995.[231]

In light of the views expressed by commenters, including concerns about potential unfairness, we have determined not to trigger Rule 506 disqualification on the basis of preexisting events. Accordingly, the amendments we are adopting today include a provision specifying that disqualification will not arise as a result of triggering events that occurred before the effective date of the rule amendments.[232] We will, however, require disclosure to investors regarding such events.

2. Mandatory Disclosure of Triggering Events that Pre-Date Effectiveness of the Rule Amendments

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[229] See comment letters from ABA Fed. Reg. Comm.; Coy Capital; IPA; Lehman & Eilen; MFA; Munck Carter; REISA; Rutledge; SIFMA; Whitaker Chalk.

[230] See comment letters from ABA Fed. Reg. Comm.; Cleary Gottlieb; Five Firms; Rutledge; S&C.

[231] See comment letter from ABA Fed. Reg. Comm.

[232] See Rule 506(d)(2)(i). The rule looks to the timing of the triggering event (e.g., a criminal conviction or court or regulatory order) and not the timing of the underlying conduct. A triggering event that occurs after effectiveness of the rule amendments will result in disqualification, even if the underlying conduct occurred before effectiveness.

In the proposing release, we solicited comment on whether we should require disclosure, rather than disqualification, for bad actor triggering events that occurred before the effective date of the new rules. Several commenters were supportive.[233] One commenter viewed the disclosure requirement favorably as a way to balance fairness to issuers and other covered persons with the need for investor protection without impairing the effectiveness of the rule.[234] This commenter noted that any negative impact associated with applying disqualification only to events occurring after the effective date of the rule amendments would be ameliorated by requiring disclosure to investors of the existence of the event. Another commenter viewed disclosure as an appropriate method of dealing with past orders or convictions rather than imposing automatic disqualification since issuers would be unable to revisit the disqualifying conduct and alter the collateral consequences of those past convictions and orders as a result of the new disqualifying provisions.[235] In addition, one commenter argued more generally that the disqualification rules should be broadly reconsidered and a disclosure-based approach adopted instead.[236]

In lieu of imposing disqualification for pre-existing triggering events, the rule amendments require written disclosure of matters that would have triggered disqualification, except that they occurred before the effective date of the new disqualification provisions.[237] In light of Congress' concerns about the participation of certain felons and other bad actors in Rule 506 offerings, we believe this disclosure is important to put investors on notice of bad actor

233 See comment letters from Lehman & Eilen; Munck Carter; REISA.

234 See comment letter from Munck Carter.

235 See comment letter from REISA.

236 See comment letter from ABA Fed. Reg. Comm.

237 See Rule 506(e).

involvement in Rule 506 offerings that they are evaluating as potential investments. We believe this is particularly important after adoption of the new bad actor disqualification requirements for Rule 506 offerings because, as a result of the adoption of the new requirements implementing Section 926, investors may have the impression that all bad actors are now disqualified from participation in Rule 506 offerings. We expect that issuers will give reasonable prominence to the disclosure to ensure that information about pre-existing bad actor events is appropriately presented in the total mix of information available to investors.

The disclosure requirement in new Rule 506(e) will apply to all offerings under Rule 506, regardless of whether purchasers are accredited investors. Issuers will be required to provide disclosure "a reasonable time prior to sale," which is the same timing that currently applies to disclosures to non-accredited investors under Rule 502(b)(1).[238]

If disclosure is required and not adequately provided to an investor, we do not believe that relief will be available under Rule 508, under which "insignificant deviations" from Regulation D requirements do not necessarily result in loss of the Securities Act exemption with regard to an offer or sale of securities to a particular individual or entity.[239] For Rule 508 to apply to an offer or sale of securities, the failure to comply with a Regulation D requirement must not pertain to a term, condition or requirement directly intended to protect that offeree or purchaser.[240] Disclosure of pre-existing triggering events under new Rule 506(e) is intended to benefit all investors by alerting them to any bad actors associated with the issuer or the offering,

[238] 17 CFR 230.502(b)(1).

[239] See note 190.

[240] See 17 CFR 230.508(a)(1).

and, therefore, this condition of Rule 508 cannot be met where the required disclosure is not provided.

Rule 506(e) does, however, provide that the failure to furnish required disclosure on a timely basis will not prevent an issuer from relying on Rule 506 if the issuer establishes that it did not know, and in the exercise of reasonable care could not have known, of the existence of the undisclosed matter or matters. This "reasonable care" exception to the disclosure requirement is similar to the "reasonable care" exception to disqualification we are also adopting today, and will preserve an issuer's claim to reliance on Rule 506 if disclosure is required but the issuer can establish that it did not know and in the exercise of reasonable care could not have known of the matters required to be disclosed. The provision also includes an instruction, similar to the instruction to Rule 506(d)(2)(iv), clarifying that reasonable care requires factual inquiry.

3. Timing of Implementation

Under our proposal, the new bad actor disqualification rules would have been implemented without any deferral period. We solicited comment on whether deferral would be appropriate. While two commenters opposed any delayed implementation, citing investor protection concerns,[241] several others urged us to implement the rules on a delayed basis to permit issuers to put compliance procedures in place and allow time for obtaining any necessary waivers.[242]

As adopted, the bad actor disqualification provisions of Rule 506(d) will take effect 60 days after publication in the Federal Register, without any additional deferral period. We

241 See comment letters from DTC; NASAA.

242 See, e.g., comment letters from ABA Fed. Reg. Comm.; Five Firms; Kutak Rock; NYCBA; SIFMA.

concluded that an additional deferral is not necessary or appropriate since disqualification will not be imposed in respect of pre-existing triggering events so, although issuers and other offering participants will need to make reasonable factual inquiries during this 60-day period, no additional time is needed for waivers to be sought in respect of such events. Accordingly, the new disqualification provisions of Rule 506(d) and the mandatory disclosure provision of Rule 506(e) will apply to each sale of securities made in reliance on Rule 506 after the rule amendments go into effect.

As we discussed in the proposing release, sales of securities made before the applicable effective dates will not be affected by any disqualification or disclosure requirement, even if such sales are part of an offering that continues after the relevant effective date. Only sales made after the effective date of the amendments will be subject to disqualification and mandatory disclosure.

Disqualifying events that occur while an offering is underway will be treated in a similar fashion. Sales made before the occurrence of the disqualification trigger will not be affected by it, but sales made afterward will not be entitled to rely on Rule 506 unless the disqualification is waived or removed, or, if the issuer is not aware of a triggering event, the issuer can rely on the reasonable care exception.[243]

This approach is consistent with our other rules and we believe provides appropriate incentives to issuers and other covered persons. We solicited comment on other possible approaches, including not applying the new rules to offerings that are underway at the time of

[243] Disqualifying events that exist at the time the offering is commenced but are only discovered later will be disqualifying, and the sales will not be eligible for reliance on Rule 506, subject to the application of the reasonable care exception.

effectiveness of the new disqualification provisions. Several commenters supported complete or partial grandfathering for offerings that are underway at the time of effectiveness.[244] We do not think such grandfathering would be necessary, given that pre-existing events will give rise only to a disclosure requirement and not to disqualification. Further, some ongoing offerings could continue for years after the rule amendments take effect. We do not believe it would be appropriate to implement Section 926 in a way that would exempt such offerings on a long-term basis. Issuers should be able to make reasonable factual inquiries and prepare any necessary disclosures during the 60 days before the rules become effective.

G. Amendment to Form D

We are adopting as proposed the conforming amendment to Form D. Under the amendment, the signature block of the Form D will contain a certification, similar to the current certification by Rule 505 issuers, whereby issuers claiming a Rule 506 exemption will confirm that the offering is not disqualified from reliance on Rule 506 for one of the reasons stated in Rule 506(d).

III. PAPERWORK REDUCTION ACT

A. Background

The mandatory disclosure provisions required under the final rules contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[245] The title for the collection of information is:

- "Regulation D Rule 506(e) Felons and Other Bad Actors Disclosure Statement."

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[244] See comment letters from Katten Muchin; Whitaker Chalk; Coy Capital; Rutledge.

[245] 44 U.S.C. 3501 et seq.

We are requesting comment on the collection of information requirements in this adopting release, and are submitting these requirements to the Office of Management and Budget ("OMB") for review in accordance with the PRA and its implementing regulations.[246] We are applying for an OMB control number for the proposed new collection of information in accordance with 44 U.S.C. 3507(j) and 5 CFR 1320.13, and OMB has not yet assigned a control number to the new collection. Responses to the new collection of information would be mandatory. 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 adopted, the amendments to Rule 506 require that the issuer furnish to each purchaser, a reasonable time prior to sale, a written description of any matters that occurred before effectiveness of the final amendments and within the time periods described in the list of disqualification events set forth in Rule 506(d)(1) of Regulation D, in regard to the issuer or any other "covered person" associated with the offering. For purposes of the mandatory disclosure provision of Rule 506(e), issuers will be required to ascertain whether any disclosures are required in respect of covered persons involved in their offerings, prepare any required disclosures and furnish them to purchasers.

The Commission adopted the Regulation D Rule 506(e) Felons and Other Bad Actors Disclosure Statement under the Securities Act. The Regulation D Rule 506(e) Felons and Other Bad Actors Disclosure Statement required to be furnished to investors does not involve submission of a form filed with the Commission and is not required to be presented in any

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[246] In the proposing release, we did not submit a PRA analysis because we did not propose mandatory disclosure of past disqualifying events. At this time, we do not have any comments regarding overall burden estimates for the rule amendments. This release is requesting such comments.

particular format, although it must be in writing. The hours and costs associated with preparing and furnishing the Regulation D Rule 506(e) Felons and Other Bad Actors Disclosure Statement to investors in the offering constitute reporting and cost burdens imposed by the collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

The disclosure or paperwork burden imposed on issuers appears in Rule 506(e) and pertains to events that occurred before effectiveness of the final rules but which would have triggered disqualification had they occurred after effectiveness. Issuers relying on Rule 506 must furnish disclosure of any relevant past events listed in Rule 506(e) that relate to the issuer or any other covered person. If there are any such events, a disclosure statement is required to be furnished, a reasonable time before sale, to all purchasers in the offering. The disclosure requirement serves to protect purchasers by ensuring that they receive information regarding any covered persons that were subject to such disqualifying events.

The disclosure requirement does not apply to triggering events occurring after the effective date of the rule amendments adopted today, because those events will result in disqualification from reliance on Rule 506 (absent a waiver or other exception provided in Rule 506(d)), rather than any disclosure obligation.

The steps that issuers will take to comply with the disclosure requirement are expected to mirror the steps they take to determine whether they are disqualified from relying on Rule 506. We expect that issuers planning or conducting a Rule 506 offering will undertake a factual inquiry to determine whether they are subject to any disqualification. Disqualification and mandatory disclosure are triggered by the same types of events in respect of the same covered persons, with disqualification arising from triggering events occurring after these rules take effect and mandatory disclosure applicable to events occurring before that date. Therefore, we expect that factual inquiry into potential disqualification can simply be extended to cover the period before the rules become effective. On that basis, we expect that the factual inquiry process for the disclosure statement requirement will impose a limited incremental burden on issuers.

As stated earlier, we expect that the size of the issuer and the circumstances of the particular Rule 506 offering will determine the scope of the factual inquiry and require tailored and offering-specific data gathering approaches. It should not generally be necessary for any issuer or any compensated solicitor to make inquiry of any covered individual with respect to ascertaining the existence of events that require disclosure more than once, because the period to be covered by the inquiry ends with the effective date of the new disqualification rules (so future events are unlikely to affect the inquiry or change the disclosures that have to be made). We do, however, expect that issuers may be required to revise their factual inquiry for each Rule 506 offering due to changes in management or intermediaries, other changes to the group of covered persons or if questions arise about the accuracy of previous responses. We also expect that the disclosure requirement may serve the additional function of helping issuers develop processes and procedures for the factual inquiry required to establish reasonable care under the disqualification provisions of Rule 506(d), which will be effective prospectively.

B. Burden and Cost Estimates Related to the Adopted Amendments

We anticipate that the disclosure requirement will result in an incremental increase in the burdens and costs for issuers that rely on the Rule 506 exemption by requiring these issuers to conduct factual inquiries into the backgrounds of covered persons with regard to events that occurred before effectiveness of the final bad actor disqualification rules. For purposes of the

PRA, we estimate the total annual increase in paperwork burden for all affected Rule 506 issuers to comply with our proposed collection of information requirements to be approximately 22,108 hours of company personnel time and approximately $264,000 for the services of outside professionals. These estimates include the incremental time and cost of conducting a factual inquiry to determine whether the Rule 506 issuers have any covered persons with past disqualifying events. The estimates also include the cost of preparing a disclosure statement that issuers are required to furnish to each purchaser a reasonable time prior to sale.[247]

In deriving our estimates, we assume that:

- Approximately 19,908 Rule 506 issuers[248] relying on Rule 506 of Regulation D will spend on average one additional hour to conduct a factual inquiry to determine whether any covered persons had a disqualifying event that occurred before the effective date of the rule amendments; and
- On the basis of the factual inquiry, approximately 220[249] Rule 506 issuers will spend ten hours to prepare a disclosure statement describing matters that would have

[247] 17 CFR 230.502(b)(2)(iii).

[248] Filing data reviewed by the staff of the Commission's Division of Economic and Risk Analysis indicate that for 2012, 15,028 issuers claiming the Rule 506 exemption filed one Form D and 1,250 such issuers filed more than one Form D. For purposes of the PRA estimates, we assume that all initial filers and approximately one quarter of repeat filers will conduct a factual inquiry, with the remaining repeat filers relying on prior factual inquiries. There is evidence that some issuers are not filing Form D for their offerings in compliance with Rule 503 as discussed in Part IX.B.4.a. of Amendments to Regulation D, Form D and Rule 156 under the Securities Act, Proposing Release No. 33-9416, (July 10, 2013). In addition, we estimate that the amendments to Rule 506(c) adopted today will result in a 20% increase in Form D filings relying on the Rule 506(c) exemption. See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Adopting Release No. 33-9415, Part V.B. (July 10, 2013). For purposes of our PRA estimates, we have assumed that the estimated 20% increase in the number of Form D filings corresponds to a 20% increase in the number of issuers that will need to conduct a factual inquiry to determine whether a disclosure statement is necessary.

[249] Staff estimates that there were at least 549 SEC enforcement cases involving an unregistered offering in which someone who would be disqualified as a bad actor participated in the five years from 2007 through 2011, see Part IV.B.3, or at least 110 such offerings per year. This is a lower bound estimate based on a review of triggering events arising from Commission action only, and not other triggering events such as criminal convictions and state

triggered disqualification under Rule 506(d)(1) of Regulation D had they occurred on or after the effective date of the rule amendments; and

- For purposes of the disclosure statement, 220 Rule 506 issuers will retain outside professional firms to spend three hours on disclosure preparation at an average cost of $400 per hour.

The increase in burdens and costs associated with conducting the factual inquiry for the disclosure statement requirement should pose a minimal incremental effort given that issuers are simultaneously required to conduct a similar factual inquiry for purposes of determining disqualification from the Rule 506 exemption.

It is difficult to provide any standardized estimates of the costs involved with the factual inquiry. There is no central repository that aggregates information from all federal and state courts and regulators that would be relevant in determining whether a covered person has a disqualifying event in his or her past. In this regard, we are currently unable to accurately estimate the burdens and costs for issuers in a verifiable way. We expect, however, that the costs to issuers may be higher or lower depending on the size of the issuer and the number and roles of covered persons. We realize there may be a wide range of issuer size, management structure, and offering participants involved in Rule 506 offerings and that different issuers may develop a variety of different factual inquiry procedures.

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regulatory action. For purposes of the Paperwork Reduction Act analysis, we are doubling the number of Rule 506 offerings estimated to involve a bad actor, to account for such other triggering events. We are not aware of any database that would allow us to estimate with precision the number of other triggering events or the number of additional bad actors associated with them. Some data on state enforcement actions indicate that there would be a substantial number of other triggering events (see, e.g., NASAA's 2012 Enforcement Report, discussed at text accompanying note 283); however, the data do not allow us to determine how many state enforcement actions are unique, as more than one state may take regulatory action against the same person and some state actions may overlap with Commission actions.

Where the issuer or any covered person is subject to an event listed in Rule 506(e) existing before the effective date of these rules, the issuer will be required to prepare disclosure for each relevant Rule 506 offering. The estimates include the time and the cost of data gathering systems, the time and cost of preparing and reviewing disclosure by in-house and outside counsel and executive officers, and the time and cost of delivering or furnishing documents and retaining records.

Issuers conducting ongoing or continuous offerings will be required to update their factual inquiry and disclosure as necessary to address additional covered persons. The annual incremental paperwork burden, therefore, depends on an issuer's Rule 506 offering activity and the changes in covered persons from offering to offering. For example, some issuers may only conduct one Rule 506 offering during a year while other issuers may have multiple, separate Rule 506 offerings during the course of the same year involving different financial intermediaries, may hire new executive officers or may have new 20% shareholders, any of which will result in a different group of covered persons. In deriving our estimates, we recognize that the burdens will likely vary among individual companies based on a number of factors, including the size and complexity of their organizations. We believe that some companies will experience costs in excess of this estimated average and some companies may experience less than the estimated average costs.

Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), we request comment to:

- evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility;

- evaluate the accuracy of our estimate 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 will have any effects on any other collections of information not previously identified in this section.

Any member of the public may direct to us any comments concerning the accuracy of these burden estimates and any suggestions for reducing the burdens. Persons who wish to submit comments on the collection of information requirements should direct their comments to OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503 and should send a copy to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-31-10. Requests for materials submitted to the OMB by us with regard to these collections of information should be in writing, refer to File No. S7-31-10 and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street NE, Washington, DC 20549-0213. Because OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, your comments are best assured of having their full effect if OMB receives them within 30 days of publication.

IV. ECONOMIC ANALYSIS

A. Background and Summary of the Rule Amendments

As discussed above, we are adopting amendments to implement the requirements of Section 926 of the Dodd-Frank Act, relating to the disqualification of "felons and other 'bad actors'" from participation in Rule 506 offerings. Section 926 of the Dodd-Frank Act requires the Commission to issue rules that disqualify issuers making securities offerings involving felons and other bad actors from relying on Rule 506 of Regulation D. These rules are required to be "substantially similar" to the disqualification rules in Rule 262 (which apply to Regulation A offerings as well as offerings under Rule 505 of Regulation D) and also to cover the matters enumerated in Section 926 (including certain state regulatory orders and bars). We believe the rules we are adopting comply with that mandate. The final rules include the following provisions not specifically required under Section 926:

- a reasonable care exception;
- mandatory disclosure of triggering events pre-dating the effective date of the rule amendments;
- the inclusion of additional triggering events for certain orders of the CFTC and for Commission cease-and-desist orders relating to scienter-based anti-fraud violations and violations of Section 5 of the Securities Act;
- the addition of coverage of investment managers of pooled investment funds and directors, executive officers, other officers participating in the offering, general partners and managing members of such investment managers and directors, executive officers and other officers participating in the offering of such general partners and managing members;

- narrower coverage of officers of issuers and financial intermediaries (covering only executive officers and officers participating in the offering, rather than all officers);
- narrower coverage of shareholders of the issuer (covering only beneficial owners of at least 20% of the issuer's outstanding voting securities, calculated on the basis of voting power, rather than 10% of any class of the issuer's equity securities); and
- a provision under which disqualification will not be triggered by regulatory orders if the authority that issued the order advises in writing that Rule 506 disqualification should not arise.

While commenters had differing views on whether disqualification under Rule 506 could or should be applied to events that occurred before the effective date of the rule amendments, we determined to apply disqualification only to events that occur after effectiveness of the rule amendments. As noted above, we are requiring disclosure of disqualifying events that pre-date effectiveness of the amendments.

We are sensitive to the costs and benefits imposed by our rules. The discussion below attempts to address both the costs and benefits of Section 926 of the Dodd-Frank Act itself, as well as the incremental costs and benefits of the rules and rule amendments associated with the exercise of our discretion in implementing Section 926. The costs and benefits attributable to the statutory mandate and those attributable to our discretion may not be entirely separable to the extent that our discretion is exercised to realize the benefits that we believe were intended by the Dodd-Frank Act.

Section 2(b) of the Securities Act[250] requires us, when engaging in rulemaking where we

[250] 15 U.S.C. 77b(b).

are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. We have considered those issues as part of this economic analysis.

B. Economic Baseline

The baseline analysis that follows is in large part based on information collected from Form D filings submitted by issuers relying on Regulation D to raise capital. As we describe in more detail below, we believe that we do not have a complete view of the Rule 506 market, particularly with respect to the amount of capital raised. Currently, issuers are required to file a Form D within 15 days of the first sale of securities, and are required to report additional sales through amended filings only under certain conditions. In addition, issuers may not report all required information, either due to error or because they do not wish to make the information public. Commenters have suggested and we also have evidence that some issuers do not file a Form D for their offerings in compliance with Rule 503.[251] Consequently, the analysis that follows is necessarily subject to these limitations in the current Form D reporting process.

1. Size of the Exempt Offering Market

[251] Many commenters asserted that non-compliance with Form D filing obligations is widespread. See, e.g., letters from Investor Advisory Committee (stating that "[i]t is generally acknowledged that a significant number of issuers do not currently file Form D..."); AARP (stating that "[s]imply adding a checkbox to a form that too often goes unfiled and then only after the fact is inadequate to the task at hand."); AFL-CIO and AFR (stating that "many issuers today flout the Form D filing requirement for such offerings, further limiting the Commission's ability to provide effective oversight"). See also Securities and Exchange Commission, Office of Inspector General, Regulation D Exemption Process (Mar. 31, 2009) ("OIG Report"), available at: http://www.sec-oig.gov/Reports/AuditsInspections/2009/459.pdf (stating that while the Commission staff "strongly encourage companies to comply with Rule 503, they are aware of instances in which issuers have failed to comply with Rule 503..."). Based on its analysis of the filings required by FINRA Rules 5122 and 5123 during the period of December 3, 2012 to February 5, 2013, DERA estimates that as many as 9% of the offerings represented in the FINRA filings for Regulation D or other private offerings that used a registered broker did not have a corresponding Form D.

Exempt offerings play a significant role in capital formation in the United States. Offerings conducted in reliance on Rule 506 account for 99% of the capital reported as being raised under Regulation D from 2009 to 2012, and represent approximately 94% of the number of Regulation D offerings.[252] The significance of Rule 506 offerings is underscored by the comparison to registered offerings. In 2012, the estimated amount of capital reported as being raised in Rule 506 offerings (including both equity and debt) was $898 billion, compared to $1.2 trillion raised in registered offerings.[253] Of this $898 billion, operating companies (issuers that are not pooled investment funds) reported raising $173 billion, while pooled investment funds reported raising $725 billion.[254] The amount reported as being raised by pooled investment funds is comparable to the amount of capital raised by registered investment funds. In 2012, registered investment funds (which include money market mutual funds, long-term mutual funds, exchange-traded funds, closed-end funds and unit investment trusts) raised approximately $727 billion.[255]

In 2011, the estimated amount of capital (including both equity and debt) reported as being raised in Rule 506 offerings was $849 billion compared to $985 billion raised in registered

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[252] See Vladimir Ivanov and Scott Bauguess, Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009-2012 (July 2013), available at http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf ("Ivanov/Bauguess Study").

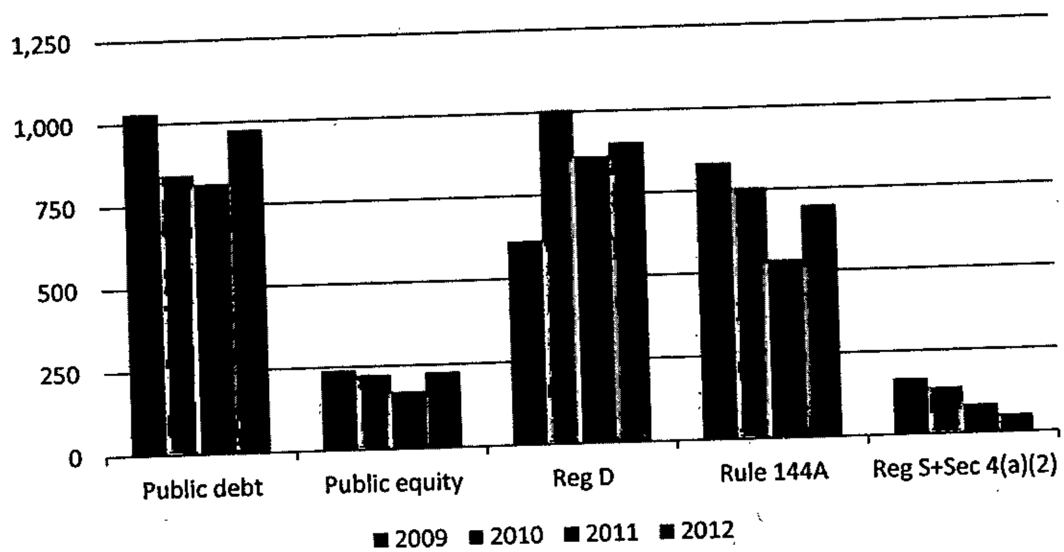
[253] See id.

[254] See id.

[255] In calculating the amount of capital raised by registered investment funds, we use the net amounts (plus reinvested dividends and reinvested capital gains), which reflect redemptions, and not gross amounts, by open-ended registered investment funds because they face frequent redemptions, and do not have redemption restrictions and lock-up periods common among private funds. In addition, we use the new issuances of registered closed-end funds and the new deposits of registered unit investment trusts. See 2013 Investment Company Institute Factbook, available at http://www.icifactbook.org.

offerings.[256] Of the $849 billion, operating companies reported raising $71 billion, while pooled investment funds reported raising $778 billion.[257] More generally, when including offerings pursuant to other exemptions – Rule 144A, Regulation S and Section 4(a)(2) – significantly more capital appears to be raised through exempt offerings than registered offerings (Figure 1).[258]

Figure 1: Capital Raised in U.S. Capital Markets during 2009-2012[259]



At present, issuers are required to file a Form D not later than 15 days after the first sale of securities in a Regulation D offering and an amendment to the Form D only under certain circumstances. Since issuers are not required to submit a filing when an offering is completed, and submit amendments only under certain circumstances, we have no definitive information on the final amounts raised. Figure 2, below, illustrates that at the time of the initial Form D filing,

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256 See Ivanov/Bauguess Study.

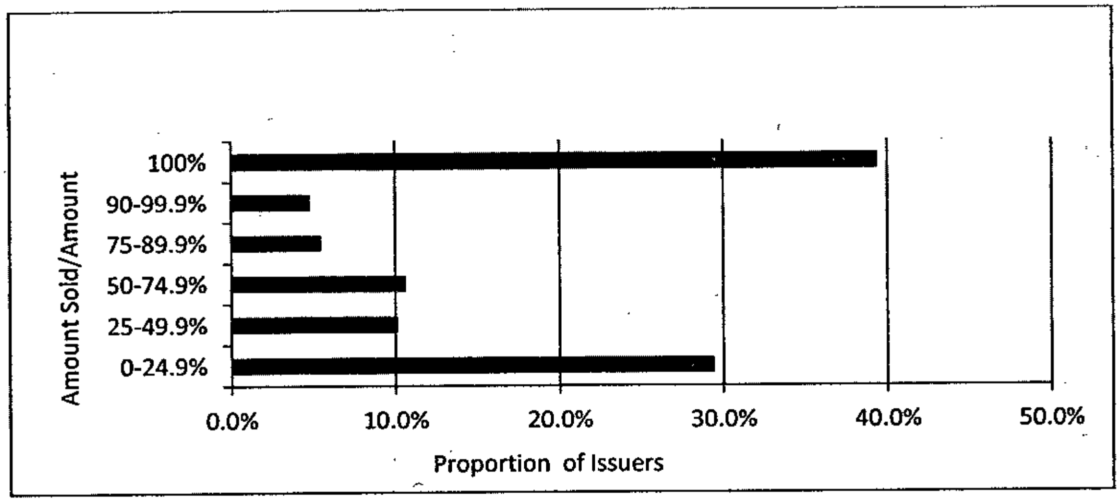
257 See id.

258 See id.

259 The 2012 non-ABS Rule 144A offerings data is based on an extrapolation of currently available data through May 2012 from Sagient Research System's Placement Tracker database. For more detail, see the Ivanov/Bauguess Study.

only 39% of offerings by non-pooled investment fund issuers were completed relative to the total amount sought. Separately, 70% of pooled investment funds state their total offering amount to be "Indefinite" in their Form D filings. As a result, the initial Form D filings of these pooled investment funds likely do not accurately reflect the total amount of securities offered or sold.

Figure 2: Amount Sold as Percentage of Total Offering Amount by Non-Pooled Investment Fund Issuers in Regulation D Offerings at the Time of Form D Filing: 2009-2012



2. Affected Market Participants

The amendments to Rule 506 we are adopting today will affect a number of different market participants. Issuers of securities in Rule 506 offerings include both reporting and non-reporting operating companies and pooled investment funds. Investment advisers organize and sponsor pooled investment funds that conduct Rule 506 offerings. Intermediaries that facilitate Rule 506 offerings include registered broker-dealers, finders and placement agents. Investors in Rule 506 offerings include accredited investors (both natural persons and legal entities) and non-accredited investors who meet certain "sophistication" requirements. Each of these market participants is discussed in further detail below.

a. **Issuers**

Based on the information submitted in 112,467 new and amended Form D filings between 2009 and 2012, there were 67,706 new Regulation D offerings by 49,740 unique issuers during this four-year period.[260] The size of the average Regulation D offering during this period was approximately $30 million, whereas the size of the median offering was approximately $1.5 million.[261] The difference between the average and median offering sizes indicates that the Regulation D market is comprised of many small offerings, which is consistent with the view that many smaller businesses are relying on Regulation D to raise capital, and a smaller number of much larger offerings.

Some information about issuer size is available from Item 5 in Form D, which calls for issuers in Regulation D offerings to report their size in terms of revenue ranges or, in the case of certain pooled investment funds, net asset value ranges. All issuers can currently choose not to disclose this size information, however, and a significant majority of issuers that are not pooled investment funds declined to disclose their revenue ranges in the Forms D that they filed between 2009 and 2012. For those that did, most reported a revenue range of less than $1 million (Figure 3).[262] During the 2009-2011 period, approximately 10% of all public companies

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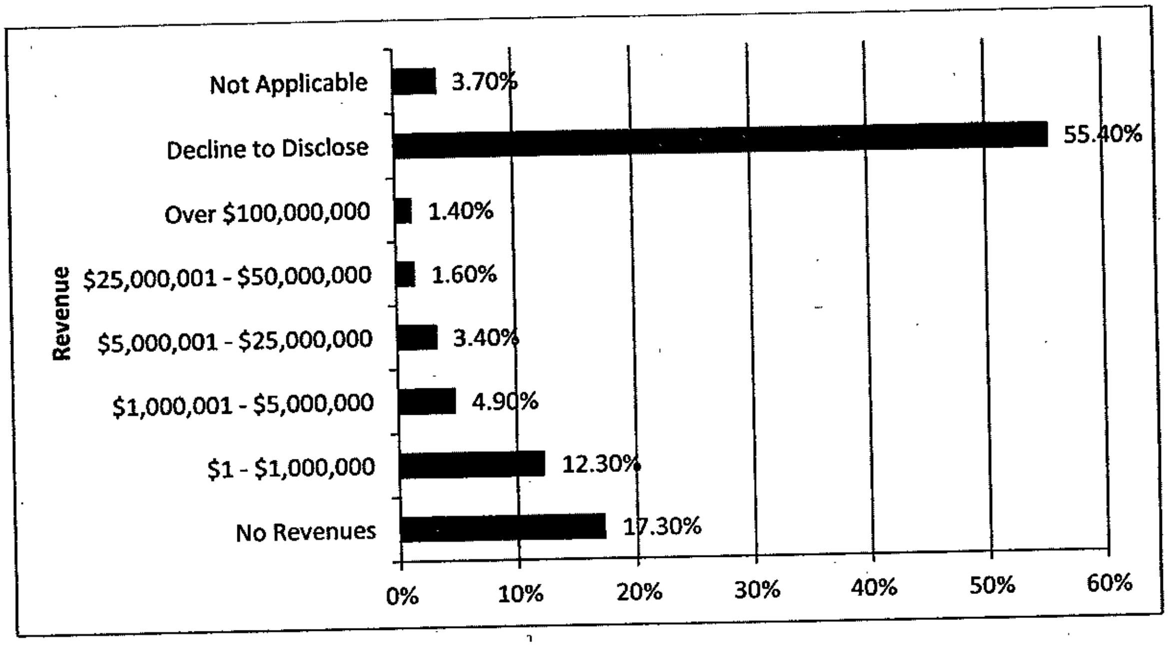
260 See Ivanov/Bauguess Study.

261 See id. The average and median amounts are calculated based on the amounts sold by Regulation D issuers as reported in their Form D filings. A study of unregistered equity offerings by publicly-traded companies over the period 1980-1996 found that the mean offering amount was $12.7 million, whereas the median offering amount was $4.5 million. See M. Hertzel, M. Lemon, J. Linck, and L. Rees, *Long-Run Performance Following Private Placements of Equity*, 57 Journal of Finance (2002), 2595-2617.

262 See Ivanov/Bauguess Study.

raised capital in Regulation D offerings; in 2012, approximately 6% of such companies did so.[263] These public companies tended to be smaller and less profitable than their industry peers, which illustrates the significance of the private capital markets to smaller companies, whether public or private.[264]

Figure 3: Distribution of Non-Pooled Investment Fund Issuers in Regulation D Market by Revenue: 2009-2012



During this period, pooled investment funds conducted approximately 24% of the total number of Regulation D offerings and raised approximately 81% of the total amount of capital raised in Regulation D offerings.[265] More than 75% of pooled investment funds declined to disclose their net asset value range.

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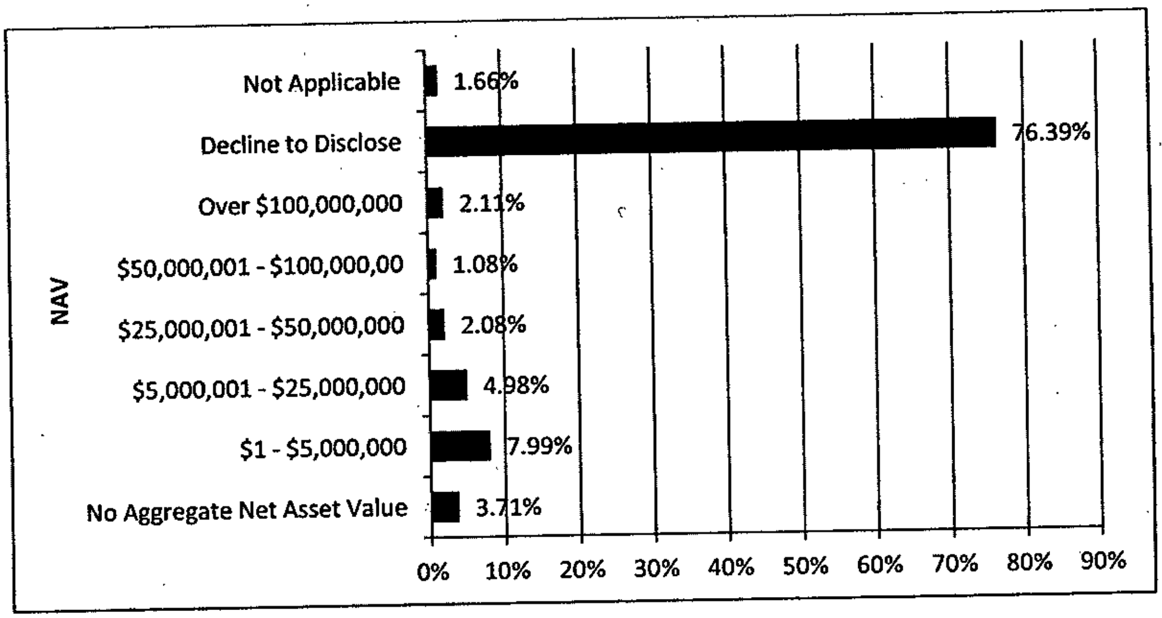
[263] Id. (explaining methodology of using listings in the Standard & Poor's Compustat database and the University of Chicago's Center for Research in Securities Prices database to determine which companies were public companies).

[264] Id.

[265] Id.

Figure 4: Distribution of Pooled Investment Fund Issuers in Regulation D Market by Net Asset Value: 2009-2012



Between 2009 and 2012, approximately 66% of Regulation D offerings were of equity securities, and almost two-thirds of these were by issuers other than pooled investment funds.[266] Non-U.S. issuers accounted for approximately 19% of the amount of capital raised in Regulation D offerings, indicating that the U.S. market is a significant source of capital for these issuers.[267]

b. Investors

We have relatively little information on the types and number of investors in Rule 506 offerings. Form D currently requires issuers in Rule 506 offerings to provide information about the total number of investors who have already invested in the offering and the number of

[266] Id.

[267] Id.

persons who do not qualify as accredited investors.[268] In 2012, approximately 153,000 investors participated in offerings by operating companies, while approximately 81,000 investors invested in offerings by pooled investment funds.[269] Because some investors participate in multiple offerings, these numbers likely overestimate the actual number of unique investors in these reported offerings. In offerings under Rule 506(b), both accredited investors and up to 35 non-accredited investors who meet certain sophistication requirements are eligible to purchase securities. In offerings under new Rule 506(c), only accredited investors will be eligible to purchase securities.

Information collected from Form D filings indicates that most Rule 506 offerings do not involve broad investor participation. More than two-thirds of these offerings have ten or fewer investors, while less than 5% of these offerings have more than 30 investors. Although Rule 506 currently allows for the participation of non-accredited investors who meet certain sophistication requirements, such non-accredited investors reportedly purchased securities in only 11% of the Rule 506 offerings conducted between 2009 and 2012.[270] Only 8% of the offerings by pooled investment funds included non-accredited investors, compared to 12% of the offerings by other issuers.[271]

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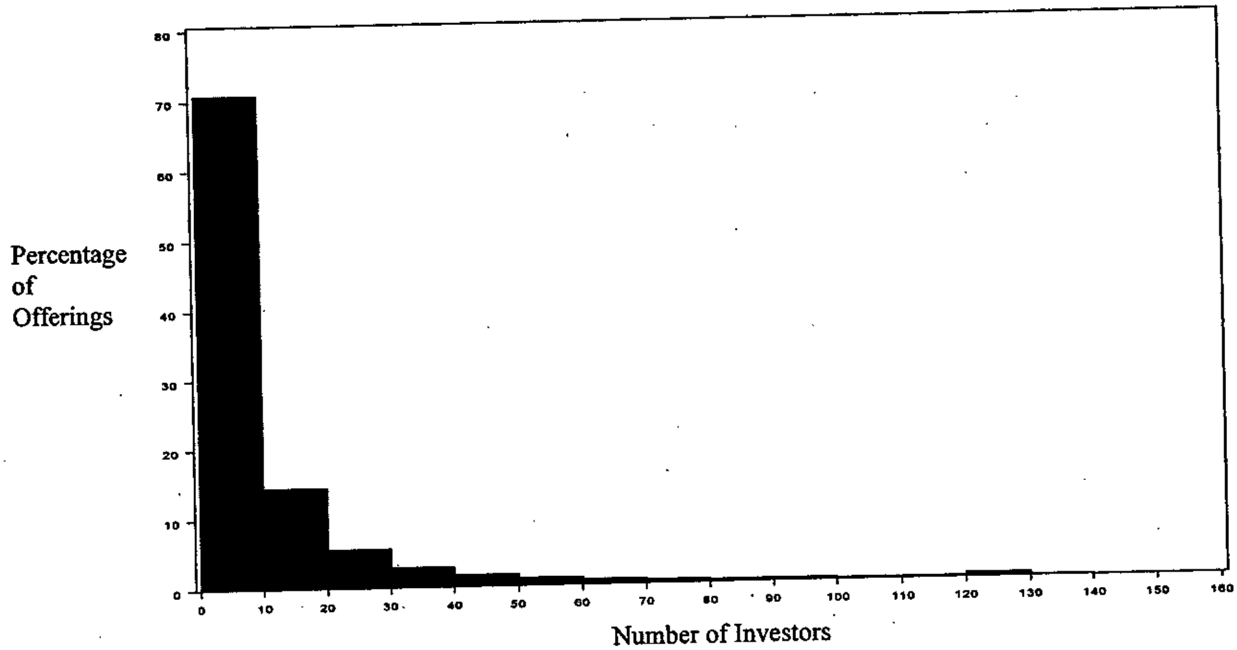
268 See Item 14 of Form D. Form D does not require any other information on the types of investors, such as whether they are natural persons or legal entities.

269 These numbers are based on initial Form D filings submitted in 2012.

270 See Ivanov/Bauguess Study.

271 Id.

Figure 5: Distribution of Regulation D Offerings by Number of Investors: 2009-2012



As stated above, between 2009 and 2012, the size of the median Regulation D offering, based on the information in Form D filings, was approximately $1.5 million. The presence of so many relatively small offerings suggests that a sizable number of current investors in Rule 506 offerings are natural persons or legal entities in which all equity owners are natural persons. This is because smaller offerings may not provide sufficient scale for institutional investors to earn a sizable return. Institutional investors typically have a larger investible capital base and more formal screening procedures compared to investors who are natural persons, and the associated costs of identifying potential investments and monitoring their investment portfolio lead them to make larger investments than natural persons.[272] As for whether natural persons investing in these offerings are accredited investors or non-accredited investors, almost 90% of the Regulation D offerings conducted between 2009 and 2012 did not involve any non-accredited investors.[273]

While we do not know what percentage of investors in Rule 506 offerings are natural persons, the vast majority of Regulation D offerings are conducted without the use of an intermediary,[274] suggesting that many of the investors in Regulation D offerings likely have a pre-existing relationship with the issuer or its management because these offerings would not have been conducted using general solicitation. This category of investors is likely to be much smaller than the total number of eligible investors for Rule 506(c) offerings, which is potentially very large. We estimate that at least 8.7 million U.S. households, or 7.4% of all U.S. households, qualified as accredited investors in 2010, based on the net worth standard in the definition of "accredited investor" (Figure 6).[275]

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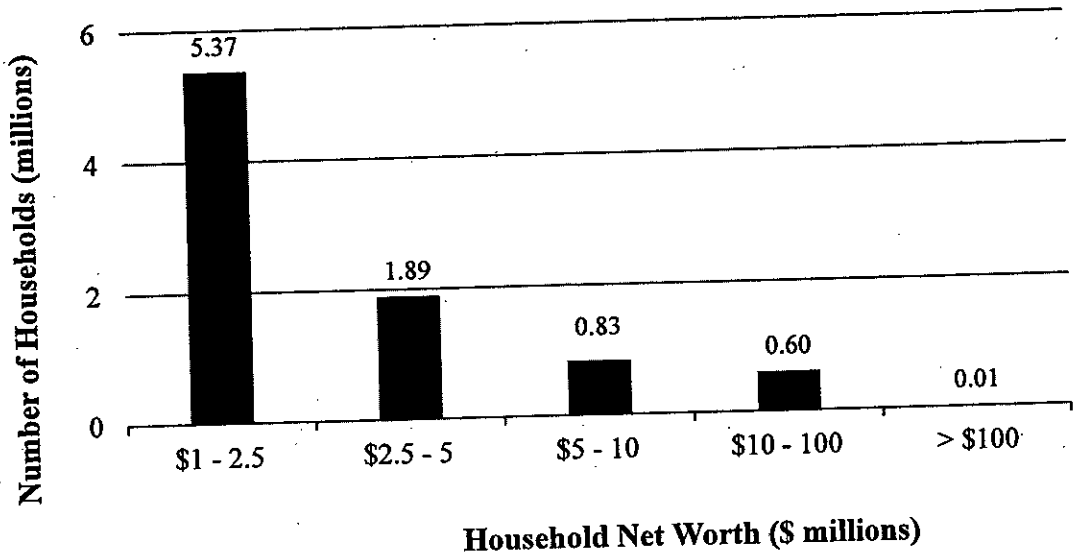
[272] See, e.g., George Fenn, Nellie Liang and Stephen Prowes, The Economics of Private Equity Markets. (1998); Steven Kaplan and Per Stromberg, *Leveraged Buyouts and Private Equity*, Journal of Economic Perspectives (2009).

[273] See Ivanov/Bauguess Study.

[274] An analysis of all Form D filings submitted between 2009 to 2012 shows that approximately 11% of all new offerings reported sales commissions of greater than zero because the issuers used intermediaries. See Ivanov/Bauguess Study. We assume that the lack of a commission indicates the absence of an intermediary.

[275] This estimate is based on net worth and household data from the Federal Reserve Board's Triennial Survey of Consumer Finances ("SCF") 2010. Our calculations are based on 32,410 observations in the 2010 survey.

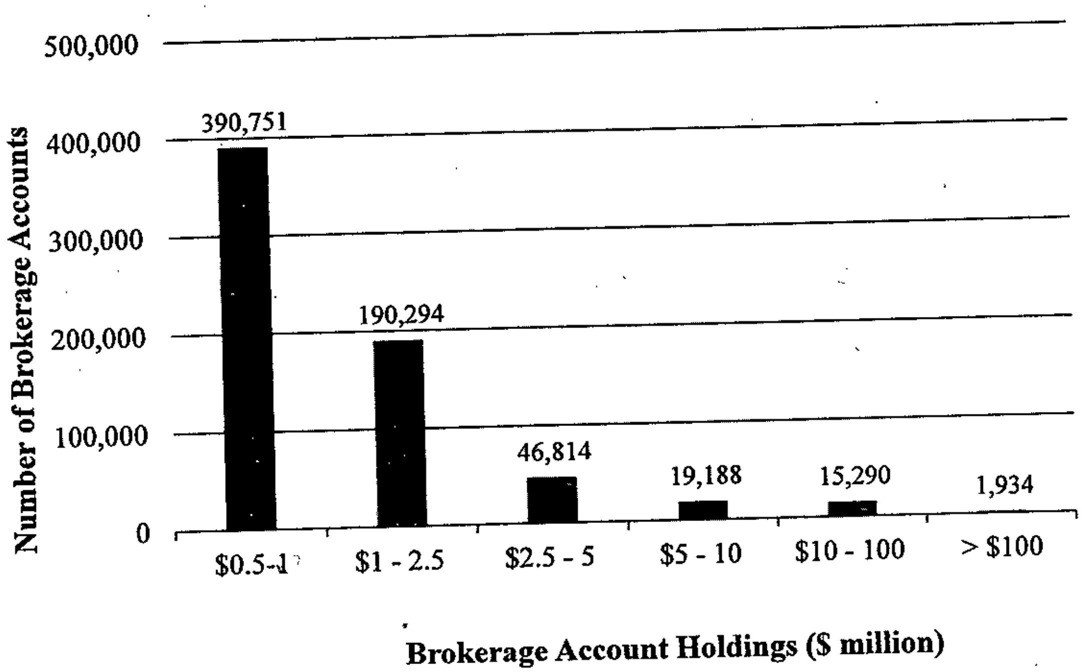
Figure 6: Number of U.S. Households that Qualify as Accredited Investors Based on 2010 Net Worth



Our analysis, however, leads us to believe that only a small percentage of these households are likely to participate in securities offerings, especially exempt offerings. First, as mentioned above, data from Form D filings in 2012 suggests that fewer than 234,000 investors (of which an unknown subset are natural persons) participated in Regulation D offerings, which is small compared to the 8.7 million households that qualify as accredited investors. Second, evidence suggests that only a small fraction of the total accredited investor population has significant levels of direct stockholdings. Based on an analysis of retail stock holding data for 33 million brokerage accounts in 2010, only 3.7 million accounts had at least $100,000 of direct investments in equity securities issued by public companies listed on domestic national securities exchanges, while only 664,000 accounts had at least $500,000 direct investments in such equity

securities (Figure 7).[276] Assuming that investments in publicly-traded equity securities are a gateway to investments in securities issued in exempt offerings, and accredited investors with investment experience in publicly-traded equity securities are more likely to participate in an exempt offering than accredited investors who do not, the set of accredited investors likely to be interested in investing in Rule 506(c) offerings could be significantly smaller than the total accredited investor population.

Figure 7: Direct Stock Holdings of Retail Investors, 2010



[276] This analysis by DERA is based on the stock holdings of retail investors from more than 100 brokerage firms covering more than 33 million accounts during the period June 2010-May 2011.

c. Investment Managers

Based on Form ADVs that were filed with the Commission as of June 2013, there were 7,772 SEC reporting investment advisers that have clients that are private funds, registered investment companies business development companies, or other pooled investment vehicles. These investment advisers include:

- Registered investment advisers. Data filed for 2012 show that there were approximately 5,400 Commission-registered investment advisers with pooled investment fund clients that filed Form ADV with the Commission. These 5,400 investment advisers represent approximately $45.3 trillion total assets under management for pooled investment funds, or average assets under management of $8.4 billion per adviser. Of these, 4,044 investment advisers had clients that were private funds, with total assets under management of $35.2 billion and average assets under management of $8.6 billion.
- Exempt reporting advisers. These are investment advisers that are required to report on Form ADV but not to register with the Commission (for example, investment advisers to venture capital funds). Based on ADV data, there were 2,303 exempt reporting advisers in 2012, all of which had pooled investment funds as clients, with approximately $1.6 trillion of assets under management.

We do not have information regarding investment advisers with assets under management of less than $100 million, which are not generally required to register with the Commission, or investment managers that advise pooled investment funds with respect to investments in assets other than securities, such as commodities or real estate.

d. **Broker-Dealers**

As of December 2012, there were 4,450 broker-dealers registered with the Commission who file on Form X-17A-5, with average total assets of approximately $1.1 billion per broker-dealer. The aggregate total assets of these registered broker-dealers are approximately $4.9 trillion. Of these registered broker-dealers, 410 are dually registered as investment advisers. The dually registered broker-dealers are larger (average total assets of $6.4 billion) than those that are not dually registered. Among the dually registered broker-dealers, we identified 24 that currently have or have had private funds that submitted Form D filings between 2002 and 2012.

3. **Estimated Incidence of "Bad Actors" in Securities Markets Generally**

The economic impact of the rule amendments primarily depends on the extent to which they succeed in reducing fraud in the Rule 506 marketplace. This, in turn, depends on multiple factors, including the incidence of bad actors in Rule 506 offerings, the recidivism rate of such bad actors and the potential deterrent effect of disqualification as a sanction.

The disqualification rules should reduce the participation of both new and existing bad actors in Rule 506 offerings. Offerings will no longer be eligible to rely on Rule 506 if they involve a covered person that becomes a bad actor because of a triggering event that occurs after the new rules take effect. While triggering events existing before effectiveness of the rule will not be disqualifying, issuers will be required to provide disclosure about such events to investors. Participation in Rule 506 offerings by bad actors not disqualified by the rules we adopt today may, therefore, also be limited if issuers or investors are reluctant to transact with bad actors or participate in transactions involving bad actors once they become aware of the bad act through the required disclosure.

The effects of disqualification also depend on the likelihood that participation of bad actors in Rule 506 offerings would lead to the recurrence in perpetration of triggering events. This depends on the recidivism rates among bad actors.

Finally, the passage of the rule, through the deterrent effect of a potential threat of disqualification, could have the indirect impact of reducing the number of bad actors in the securities markets and the conduct resulting in sanctions that trigger disqualification.

Although it is impossible to predict future market participant behavior that may arise in response to the adopted rules, we can quantify, in certain instances, past occurrences of certain triggering events to provide an estimate of the historical incidence of bad actors—as determined under the new rules—in securities markets as a general matter.

Identification of Triggering Events. To assess the incidence in the securities markets of potentially disqualifying "bad actors," we examined the legal proceedings brought by the Commission during the five-year period from 2007 to 2011 in which the sanctions imposed would constitute triggering events under the new rule. We searched records of public proceedings, including case name, defendant name, code section violation, and sanction. To conduct the search, we used search terms pertaining to:

- injunctions and court orders (which we refer to collectively as "injunctions") against conduct or practices in connection with the purchase or sale of a security, involving the making of a false filing with the Commission, or arising out of the conduct of business of certain financial intermediaries, as provided in Rule 506(d)(1)(ii);
- Commission disciplinary orders under Section 15(b) or 15B(c) of the Exchange Act or Section 203(e) or (f) of the Advisers Act that suspend or revoke registration, limit

activities or bar a person from association with a regulated entity or from participation in a penny stock offering, as provided in Rule 506(d)(1)(iv); and

- Commission cease-and-desist orders relating to violations of scienter-based anti-fraud provisions of the federal securities laws or violations of Section 5 of the Securities Act, as provided in Rule 506(d)(1)(v).

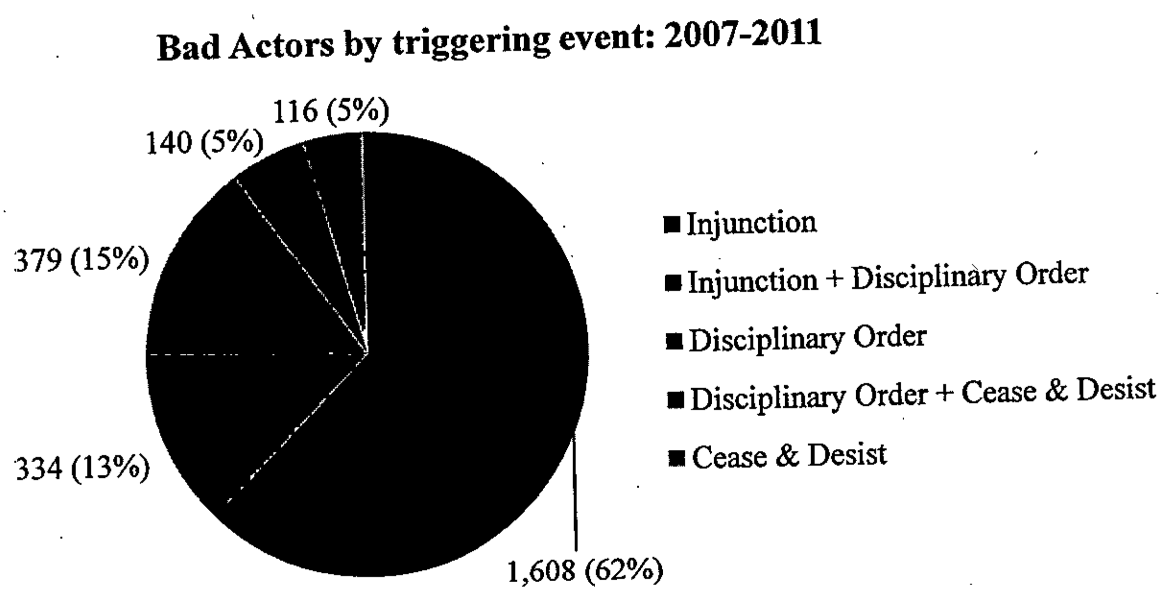
Our analysis did not consider other bad actor triggering events in Rule 506(d)(1), primarily because we do not have a comparable ability to search databases relevant to criminal convictions or the actions of relevant state and other federal regulators.[277] In addition, it is possible that the search techniques used by staff may not have identified all relevant potential triggering events and bad actors. Since our analysis is subject to these limitations, our estimates of the incidence of potential bad actors likely represent a lower bound. On the other hand, not all of the bad actors identified in our search would be expected to be involved with Rule 506 offerings.

Our search of Commission enforcement actions identified a sample of 2,578 persons, including both individuals and entities, that received injunctions, disciplinary orders, and/or cease-and-desist orders, issued in a total of 1,485 enforcement cases over the five-year period. We found that an aggregate of 3,053 disqualifying sanctions (1,943 injunctions, 853 disciplinary orders, and 257 cease-and-desist orders) were imposed upon these persons. In some instances, a person received more than one sanction, which in most cases consisted of a combination of an

[277] We have limited information available on enforcement activity by state securities regulators, discussed at the text accompanying note 283. Our analysis did not cover felony and misdemeanor convictions as provided in Rule 506(d)(1)(i); final orders of state authorities and Federal banking agencies and National Credit Union Association as provided in Rule 506(d)(1)(iii); disciplinary actions by a national securities exchange or an affiliated securities association, as provided in Rule 506(d)(1)(vi); and United States Postal Service orders as provided in Rule 506(d)(vii). We also excluded refusal, stop, or suspension orders pertaining to registration statements or Regulation A offering statements, as provided in Rule 506(d)(1)(vii), because they are too infrequent to affect our analysis.

injunction and a disciplinary order.[278] Each one of these sanctions would have constituted a triggering event under this rule, which would have disqualified any offering from relying on Rule 506 if the person were a "covered person," such as a director or executive officer of the issuer or a financial intermediary. The following chart shows the breakdown of triggering events by type:

Figure 8: Distribution of Bad Actors by Triggering Events, 2007-2011



In the cases we identified, between 70% and 78% of triggering events each year were against individuals, with the remainder against entities. With 83,521 offerings that relied on Rule 506 during the period under review, the incidence of detected bad actors is approximately 0.03 per offering. These numbers represent, however, only enforcement actions brought by the Commission. These numbers do not reflect enforcement action by other authorities (for example, state level regulators), nor do they include undetected bad actors.

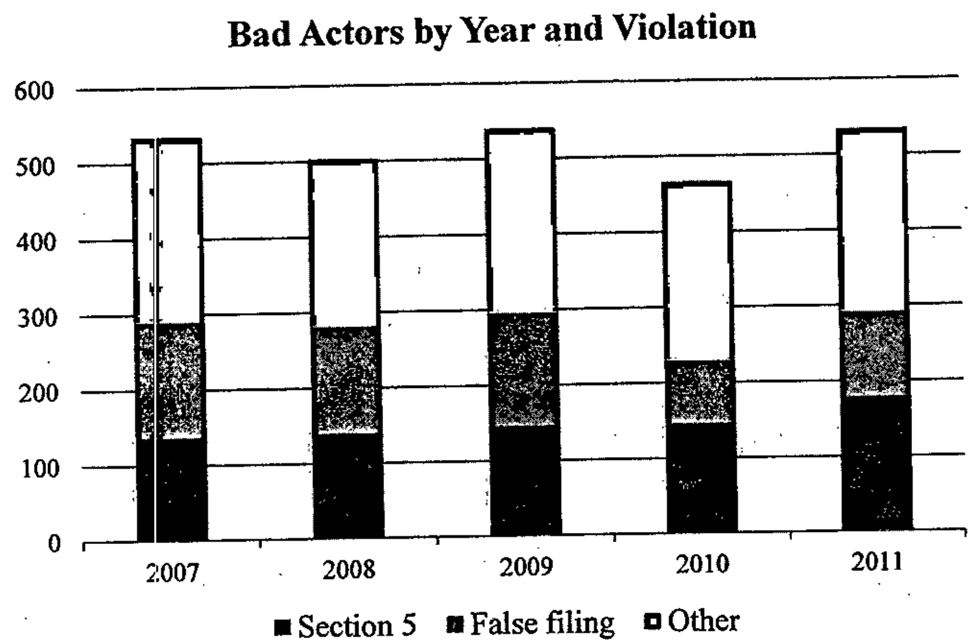
[278] One case involving both an injunction and a cease-and-desist order is not reflected in the chart titled "Triggering Events: 2007-2011" due to rounding.

While all of the 2,578 identified bad actors would disqualify any offering in which they were involved from reliance on Rule 506, not all of the bad actors would be expected to be involved with Rule 506 offerings. Many of the triggering events, such as insider trading, involve bad actors engaged in secondary market transactions. These persons may present a lesser risk of entering primary issuance markets such as Rule 506. Hence, the aggregate number of bad actors may overestimate the incidence of bad actors operating in the Rule 506 market. To more accurately estimate the likelihood that a bad actor might be involved in the issuance of securities, we identify triggering events involving a Section 5 violation.[279] As reflected in the chart "Bad Actors by Year and Violation" below, approximately 29% of the bad actors (a total of 748) were sanctioned for Section 5 violations. A similar percentage, approximately 25%, were sanctioned for the next-largest category of violations, those involving false filings.[280] The remaining bad actors fall into the "Other" category, of which insider trading-related violations represent the largest single sub-category. The following chart shows this breakdown:

[279] Bad actors included in the Section 5 category may have also violated other securities law provisions, such as anti-fraud provisions in Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act. Using Section 5 violations as a proxy for involvement in a securities offering may be under inclusive, as there may be offering-related misconduct without a Section 5 violation.

[280] We define false filing as violations relating to errors and omissions in Commission filings, such as periodic reports, Form BD, Form ADV and beneficial ownership reports.

Figure 9: Bad Actors by Year and Violation, 2007-2011



To assess the quality of the search results, from the 1,485 cases previously identified, we selected a random sample of 190 cases, a sample that is large enough to provide a low margin of error. Because a single case produces multiple triggering events if multiple persons are named, the sample of 190 cases included 529 potential triggering events and allows for a margin of error of less than 5% in our analysis.[281] Commission staff reviewed the orders, releases, and other documentation for all 190 cases to determine whether each potential triggering event actually met the criteria specified in Rule 506(d)(1)(ii), (iv) or (v). The review of the search results showed that the search criteria applied produced relatively accurate results.[282]

[281] The margin of error in these estimates based on the sample size of 529 potential triggering events is approximately 3.6% at the 90% confidence level. Taking these results together, there may be as many as 30 more or 30 fewer disciplinary orders than what is estimated at the 90% confidence level.

[282] The misclassification rate for injunctions, disciplinary orders, and cease and desist orders was 4%, 30%, and 0% respectively. While the misclassification rate for disciplinary orders was high, the sample results for disciplinary orders contained nearly the same number of false positives (events classified as disciplinary orders that did not

Incidence of Bad Actors Potentially Participating in Primary Offerings of Securities. Staff further refined the estimate of the likelihood that triggering events that were related to the Rule 506 market using the random sample of 190 cases. In particular, staff identified whether each of the cases involved an offering of securities by the issuer, which we refer to as a primary offering. For cases involving a primary offering, staff identified whether the offering was registered or unregistered. The review showed that 70 out of the 190 cases (or 37%) involved a primary offering, all of which were unregistered, and of the 529 potential triggering events included in the 190 cases, 251 (or 47%) involved a primary offering.

For purposes of the review, defendants or respondents were categorized as "issuers," "intermediaries," and "other persons." "Issuers" are entities that issue securities and the individuals who were affiliated with that issuer. "Intermediaries" are entities and individuals that facilitate securities offerings and investments, like brokers and non-affiliated investment advisers. "Other persons" are persons who are neither issuers nor intermediaries; the staff found that, in general, these were persons found liable for trading on inside information.

The following table summarizes the staff's findings with respect to these cases:

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actually meet the criteria of Rule 506(d)(1)(iv)) as false negatives (events classified as injunctions and/or cease-and-desist orders that turned out to also include disciplinary orders), so the error in the total number of estimated disciplinary orders based on the sample review is significantly less than 30%. Accounting for offsetting misclassifications – i.e., false positives and false negatives – the error rate in the total number of estimated disciplinary orders falls to 1%.

Summary of Bad Actors and Case Type for 2007 to 2011 Period

	Random sample of enforcement cases	Subset of sample relating to unregistered offerings
Number of cases	190	70 (37%)
Number of triggering events	529	251 (47%)
-issuers	278	160
-intermediaries	189	76
-entities acting as both issuers and intermediaries	17	15
-other persons	45	0

Of the 529 bad actors in the sample, staff found that 278 were issuers, 189 were intermediaries, 17 were entities that could qualify as either an issuer or an intermediary (such as a promoter who is employed by an issuer), and 45 were other persons.

Based on projections from our review of this sample, we estimate that during the 2007 to 2011 review period, 549 cases (37% of the 1,485 total cases) involved an unregistered offering and approximately 1,212 bad actors (47% of the 2,578 total bad actors identified) participated in those unregistered offerings. We consider these estimates as a lower bound for the number of bad actors because our analysis does not take into account bad actor triggering events other than those in subsections (ii), (iv), and (v) of Rule 506(d)(1) or offerings involving bad actors that did not give rise to enforcement activity. Taking those into account, the total number of bad actors is likely to be higher.

We considered other data sources regarding the number of bad actor triggering events not involving Commission action. NASAA's 2012 Enforcement Report presents some data on orders by state securities regulators between 2009 and 2011,[283] which would pertain to

[283] North American Securities Administrators Association, 2012 Enforcement Report, Table 4 (available at

subsection (iii) of Rule 506(d)(1), relating to final orders and bars issued by state securities, insurance and banking regulators, federal banking regulators and the National Credit Union Administration. The report states that, as a result of state securities regulatory actions, 8,744 licenses were withdrawn and 1,952 licenses were denied, revoked, suspended, or conditioned in that three-year period. This data, however, may be over inclusive for purposes of establishing the number of bad actors under Rule 506(d) for a number of reasons. First, not all of the actions appear to be "final orders" under subsection (iii) of Rule 506(d)(1) (*e.g.*, some licenses were withdrawn rather than revoked). In addition, there is potential double counting in the NASAA survey when different states take action against the same person, as well as potential double counting between Commission and NASAA data for bad actors subject to both Commission and state sanctions. The data could also be under inclusive, in that it covers only actions by state securities regulators, whereas under subsection (iii) of Rule 506(d)(1), disqualification may also be triggered by orders of state insurance, banking, savings association and credit union regulators; appropriate federal banking regulators; and the National Credit Union Association. Staff were not able to identify comparable sources of data on these other types of orders.[284]

C. Analysis of Final Rules

Section 926 of the Dodd-Frank Act requires the Commission to adopt rules excluding felons and other bad actors from participation in Rule 506 offerings. The disqualification

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http://www.nasaa.org/wp-content/uploads/2011/08/2012-Enforcement-Report-on-2011-Data1.pdf).

[284] FINRA's BrokerCheck database includes this data for registered broker-dealers and their associated persons, as well as data on investment advisers and their associated persons drawn from the Commission's IARD database. See note 202. BrokerCheck is searchable only by the name of firms and individuals, however, not by the nature of past violations, which makes it impracticable for us to use it as a source of data in this review.

provisions of Rule 506 were intended to[285] and should lead to enhanced investor protection by reducing the number of offering participants who have previously engaged in fraudulent activities or who previously violated securities, insurance, banking or credit union laws or regulations, and by providing an additional deterrent to future fraudulent activities. Currently, persons covered by the disqualification provisions of these rules, such as issuers and compensated solicitors, are subject to a multilayered securities enforcement system that includes the Commission, state securities regulators and, for financial industry participants, FINRA. The disqualification rules we adopt today should alter industry practice by inducing issuers and other covered persons to implement additional measures to restrict bad actor participation in Rule 506 offerings.

In the proposing release, we solicited comment on the costs and benefits of the proposed rules. While no comment letters provided quantitative data or directly addressed the cost-benefit analysis included in the proposing release, a number of commenters did mention potential costs and benefits of the proposed rule. Our response to these comments is discussed in Section II above, and we briefly discuss these comments where they are relevant in the discussion below.

1. Effects of the Statutory Mandate

To the extent the new disqualification provisions result in a reduction of fraud in the Rule 506 offering market, investor losses to fraud will be reduced and investor willingness to participate in the Rule 506 market could increase. This should lower the issuance costs for Rule 506 offerings to the extent that new disqualification standards lower the risk premium

[285] Statement of Senator Christopher Dodd, 156 Cong. Rec. S3813 (daily ed. May 17, 2010).

associated with the presence of bad actors in securities offerings.[286] Lower costs in the Rule 506 offering market could improve conditions for capital formation, benefitting both issuers and investors. In this regard, commenters also emphasized investor protection[287] and increased participation in the private placement market as the main benefits of the rule.[288]

The new disqualification provisions may also benefit investors by reducing the burden of the "due diligence" investigation they conduct on persons and entities involved in the offerings in which they invest. Without bad actor disqualification, investors seeking information about the background of issuers and the people involved with them would have to perform separate investigations due to the cost of coordinating collective action. Requiring issuers to determine whether any persons or entities are subject to an event that triggers disqualification may, for some investors, obviate the need to do their own investigation, which may eliminate some of the redundancies in these separate investigations. Given the issuer's advantage in accessing much of the relevant information, issuers should be able to perform the task at a lower cost than most individual investors.

The disqualification requirements also impose costs on issuers, covered persons and investors. In our analysis under the Paperwork Reduction Act in Part III.B above, we estimate that most issuers will bear an additional cost of $400 to conduct a factual inquiry to determine whether any covered persons had a disqualifying event that occurred before the effective date of

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286 In a related framework, Karpoff et al. (2008) show that the marketplace imposes significant penalties on firms targeted by SEC enforcement actions for financial misrepresentation, where for each dollar of misrepresentation the firm loses an additional $3.08 due to expected legal penalties and loss of reputation. See J. Karpoff, D. Lee & G. Martin, The Cost to Firms of Cooking the Books, 581-611 Journal of Financial & Quantitative Analysis (Sept. 2008).

287 See comment letters from M. Zhu; DTC; Better Markets; NASAA.

288 See comment letter from Better Markets.

the rule amendments.[289] We also estimate that approximately 220[290] Rule 506 issuers will spend $5,200 on average for using in-house and outside professional services in preparing a disclosure statement describing matters that would have triggered disqualification under Rule 506(d)(1) of Regulation D had they occurred on or after the effective date of the rule amendments. These cost estimates are based on assumptions outlined in Part IV.B.3 above and represent lower bound estimates, given that our analysis in Part IV.B.3 did not cover all possible bad actor triggering events. We note, in addition, that the Paperwork Reduction Act analysis is not required to, and does not, consider all potential costs that market participants may incur in complying with Rule 506(d). Further, we cannot predict how issuers will respond to the possibility of having to disclose the participation of a bad actor in an offering; the issuer could disclose, remove the person from the offering, abandon the offering, or conduct an offering that does not require disclosure.

Issuers that are disqualified from reliance on Rule 506 will bear costs to the extent that alternative means of raising capital are unavailable or involve higher transaction costs that result in a higher cost of capital. In some circumstances, issuers may postpone or forgo capital raising, deferring engagement in potentially value-enhancing projects. This could entail forgone investment opportunities for disqualified issuers and for investors who otherwise would have invested in such issuers. Issuers that pursue alternative capital raising methods may incur higher costs associated with their capital raising. For example, all other things being equal, transaction

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289 We assume the cost of in-house attorney services to be $400 per hour. This estimate is based on data provided in the report titled Management and Professional Earnings in the Securities Industry–2012, which is published by the Securities Industry and Financial Markets Association.

290 Staff estimates that there were at least 549 SEC enforcement actions involving an unregistered offering in which someone who would be disqualified as a bad actor participated in the five years from 2007 through 2011. See Part IV.B.3.

costs are likely to be higher for issuers that raise capital in reliance on Section 4(a)(2) of the Securities Act outside of Rule 506 because of higher costs to comply with state securities law requirements and greater legal uncertainty about the requirements of the exemption. In addition, issuers eligible to rely on new Rule 506(c) will be able to use general solicitation and general advertising to find potential investors if all purchasers in their offering are accredited investors and the issuer takes reasonable steps to verify their accredited investor status,[291] whereas issuers seeking an exemption under Section 4(a)(2) outside of Rule 506(c) will continue to be constrained by the incompatibility of a claim of exemption under Section 4(a)(2) and general solicitation or general advertising.[292] This may further differentiate transaction costs and cost of capital between Section 4(a)(2) offerings and Rule 506(c) offerings. Registered securities offerings can also result in higher transaction costs than private offerings, and in addition trigger ongoing reporting responsibilities.[293] As highlighted above, 22% of Rule 506 issuers that reported revenues on Form D indicated that their revenues were less than $1 million. For these and similarly sized issuers, going public through a registered offering may not be a feasible substitute for a Rule 506 offering.[294]

[291] As discussed above, we are adopting new Rule 506(c), 17 CFR 230.506(c), today. See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9415 (July 10, 2013).

[292] Id. at note 42 and accompanying text.

[293] A 2011 report prepared by a group called the "IPO Task Force," which consisted of a group of professionals, including venture capitalists, experienced CEOs, public investors, securities lawyers, academics and investment bankers, estimated that the cost of going and staying public are high. Chart H of the IPO Task Force Report estimates that the average cost to go public is $2.5 million and the annual cost of staying public is $1.5 million. See Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth (publicly available at http://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf).

[294] For example, if an issuer intends to raise a small amount of capital to fund its operations, the costs of conducting a registered offering may make a registered offering impracticable. In addition, private funds that rely on exemptions from investment company registration under Section 3(c)(1) or 3(c)(7) of the Investment Company Act are not permitted to conduct public securities offerings.

Issuers may also incur costs in connection with changes to personnel, governance structures and capital raising plans as a result of disqualification. For example, issuers may incur costs from terminating disqualified individuals or from reassigning them to positions where they will not trigger a disqualification in the context of an offering, and hiring new personnel or retraining existing personnel to replace them. They may also incur costs incident to restructuring their governance and control arrangements if, for example, a general partner, managing member or investment manager of a pooled investment fund issuer is a bad actor whose involvement would result in the disqualification of the offering. Issuers may also incur costs in connection with terminating an engagement with a placement agent or other covered financial intermediary, and entering into a new engagement. Smaller issuers and issuers with limited operating histories may not be able to readily find a new placement agent or other financial intermediary.

The final rule will include as covered persons the beneficial owners of 20% or more of the issuer's outstanding voting equity, calculated on the basis of voting power. This reflects a change from the 10% or more beneficial ownership of any class of the issuer's equity originally proposed. The higher ownership standard, limitation to voting securities and calculation focused on voting power would increase the likelihood that the disqualified investor is more closely affiliated with the issuer and has greater input or control over the management of the issuer.[295] In our judgment, the higher threshold will therefore provide greater certainty that the investor has some level of influence with the issuer. In addition, because issuers cannot necessarily prohibit a bad actor from establishing a large ownership position, particularly when an issuer's security is traded among non-affiliates or in a secondary market, a higher threshold is expected to reduce

[295] It would also be in line with the level at which filing as a passive investor is no longer permitted on Schedule 13G under Regulation 13D-G. See 17 CFR 230.13d-1(c).

the likelihood of a disqualifying event affecting an issuer in cases where a securityholder with a disqualifying bad act meets the beneficial ownership threshold in the rule but does not in fact exercise control or influence over the issuer. Lower uncertainty and relatively fewer "covered persons" arising from the amendment would reduce the costs of monitoring and due diligence for complying with the rule, and should limit the circumstances in which issuers must seek waivers from disqualification based on the involvement of bad actor investors that do not exercise influence or control over the issuer.

At the same time, determining whether a securityholder is covered based on ownership of voting securities, calculating ownership based on voting power across all outstanding securities rather than a single class and raising the threshold from 10% to 20% could reduce investor protection benefits, as securityholders whose ownership does not meet the threshold provided in the final rule, but who exercise control of an issuer, would not be covered. The inclusion of directors, officers and their functional equivalents under the definition of covered persons, however, may mitigate this effect; the rule will cover investors who serve those functions in relation to the issuer, regardless of their level of ownership.

With respect to 20% beneficial owners that are subject to triggering events, issuers may incur costs to buy out or otherwise induce such persons to reduce their ownership positions. Issuers may also incur costs in connection with taking steps to prevent bad actors from becoming 20% beneficial owners, such as exercising rights of first refusal and excluding bad actors from financing rounds. For certain issuers, finding investors to replace the capital represented by these shareholders or potential investors, as the case may be, could be challenging and expensive. Some commenters also expressed concerns about the aggregate costs of the proposed bad actor rule, saying that its provisions are generally unduly complex, unclear or not based on objective, bright-line standards.[296] Others expressed concerns about the potential burdens on capital raising,[297] and that it could undermine the overall utility of Rule 506.[298]

Issuers may also incur costs in connection with seeking waivers of disqualification from the Commission, or determinations by other authorities (such as state securities regulators) that their orders should not give rise to disqualification under Rule 506(d).

The new disqualification standards may also impose costs on other market participants that are subject to triggering events, such as financial intermediaries, by making them ineligible to participate in the market for Rule 506 offerings. For affected individuals, this may result in demotion or termination of employment, limitations on career advancement and fewer employment opportunities generally. For affected firms, this may result in revenue reductions and loss of market share, and could threaten the continued operation of firms that are heavily dependent on Rule 506 offerings as a source of revenue. Firms that are not themselves disqualified but whose officers, directors, general partners and managing members are subject to disqualifying events may incur additional costs from terminating or reassigning such individuals and from hiring new personnel or retraining existing personnel to replace them.

Bad actor disqualification rules may also impose costs on issuers and other market participants beyond the context of Rule 506 offerings. For example, imposing a new disqualification standard only on offerings under Rule 506, rather than on a more uniform basis, may result in higher costs for issuers relying on other exemptive rules, to the extent that differing

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296 See comment letters from ABA Fed. Reg. Comm.; NYCBA; Cleary Gottlieb.

297 See comment letters from B. Nelson; Coy Capital; Five Firms; S&C.

298 See Angel Capital Comment Letter 1; see also comment letters from ABA Fed. Reg. Comm.; Karr Tuttle; SIFMA; S&C.

disqualification standards create confusion and a more difficult compliance regime. Adopting uniform disqualification provisions throughout the Securities Act was cited by some commenters as a benefit, in that it could simplify compliance and increase overall investor protection.[299]

In addition, non-uniform application of the new disqualification standards may encourage bad actors to migrate to offerings under other exemptions. Investors may perceive a higher risk of fraud in such offerings, which would be detrimental to their marketability and result in greater issuance costs of all offerings under the exemptions that are not subject to the new standards, whether or not bad actors are involved. This could have an effect on competition by putting issuers that are not eligible to use Rule 506 at a competitive disadvantage.

Finally, there is a potential cost to investors of overreliance on Rule 506(d) in assessing the risks associated with an offering. Fraud can still occur without prior incidence of bad acting on the part of the issuer or covered persons, and in some cases it is possible that prior bad actions went undetected or did not otherwise result in a sanction, or may have resulted in a sanction that does not constitute a triggering event for disqualification.

2. Discretionary Amendments

The amendments not specifically required under the Section 926 mandate involve costs and benefits as analyzed below.

Reasonable Care Exception. The "reasonable care" exception allows continued reliance on the Rule 506 exemption, despite the existence of a disqualification with respect to a covered person, if the issuer can show that it did not know and, in the exercise of reasonable care, could not have known that the disqualification existed at the time of the sale of securities. We

[299] See comment letters from ABA Fed. Reg. Comm.; C. Barnard; Better Markets; NASAA.

anticipate that the "reasonable care" exception will provide benefits to the efficiency of the private placement and capital formation process by removing a significant disincentive to issuers' use of Rule 506 that would have arisen if disqualification were applied on a strict liability basis. Without a reasonable care exception, issuers might choose not to undertake offerings in reliance on Rule 506, because of the risk of Section 5 or blue sky law violations in circumstances that the issuer cannot reasonably predict or control. In those circumstances, alternative approaches to capital raising may be more costly to the issuer or not available at all. Given that Rule 506 is the most frequently relied-upon Securities Act exemptive rule, the impact of issuers shifting away from it could be significant. We believe that the reasonable care exception provides a measured and balanced approach to preserve the intended benefits of Rule 506, which might otherwise be impaired because of issuer concerns about strict liability for unknown disqualifications.

Commenters uniformly supported the reasonable care exception, but also urged the Commission to provide greater clarity and specificity about what steps would constitute reasonable care. Some commenters raised concerns about compliance costs if the requirements of the "reasonable care" exception are too burdensome.[300] We do not believe it is appropriate to delineate and prescribe specific steps as being necessary or sufficient to establish reasonable care. We believe issuers should consider the totality of the offering taking into account the circumstances of the offering, the covered persons involved in the offering and the rule's requirements, which include specific disqualifying events and covered persons subject to those disqualifying events. The flexibility in permitting issuers to determine their own methodology

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[300] See Angel Capital Comment Letter 1; see also comment letter from S&C.

for factual inquiry is a benefit that promotes efficiency to the extent the issuer is able to tailor its own inquiry without adherence to uniform standards that may not be applicable or appropriate in the context of a particular issuer or particular offering.

A potential cost of a reasonable care exception is that it may increase the likelihood that bad actors will be able to participate in Rule 506 offerings, because issuers may take fewer steps to make inquiry about offering participants than they would if a strict liability standard applied. If this occurs, it will decrease the deterrent effect of the bad actor disqualification rules. To the extent that the reasonable care exception fails to prevent participation by bad actors in Rule 506 offerings, the effectiveness of the new disqualification standard will be impaired.

Issuers may also incur costs associated with conducting and documenting their factual inquiry into possible disqualifications, so they can demonstrate the exercise of reasonable care. The fact that the rule does not specify what steps are required may increase such costs to the extent that issuers do more to conduct and document their inquiry than otherwise may be necessary, because of this uncertainty.

Disclosure Requirement for Triggering Events That Predate the Effectiveness of the Rule Amendments. As adopted, the amendments include a disclosure requirement designed to increase investor protection by requiring disclosure of events that would have been disqualifying had they occurred after the effective date of the amendments. This is a change from the proposal, under which disqualification would have arisen with respect to events that occurred before the amendments took effect.

Under the amendments we are adopting, issuers will be subject to disqualification only for triggering events that occur after the new rules take effect. On one hand, this approach will reduce costs that would otherwise have been incurred by issuers and other market participants subject to pre-existing triggering events, had they been disqualified from participating in Rule 506 offerings. On the other hand, this approach will permit offerings involving past bad actors to proceed under Rule 506, exposing investors to the risks that arise when bad actors are associated with an offering. While it is difficult to determine the net impact of implementing the new disqualification standards in this way, investors will benefit by having access to information about events that would be disqualifying if they had occurred after the effective date. Investors will be able to make their own determination of the relevance and risks associated with past bad acts, including recidivism risk, and can request additional information, elect not to pursue the investment opportunity or negotiate different terms based on this information.

We anticipate that the decision to require disclosure will provide a benefit to issuers and investors. We believe the disclosure requirement will serve as a useful tool to alert investors to the presence of certain participants in offerings under Rule 506 and allow them to make more informed investment decisions. Without a disclosure requirement, investors may have the mistaken impression that bad actors are no longer allowed to participate in Rule 506 offerings. As there is no prescribed format, the disclosure could be inserted in a non-prominent manner, such that an investor who reads the material in a cursory fashion could remain unaware of the participation of bad actors in the offering. Issuers could benefit from having flexibility in the manner of disclosure. In addition, because we have imposed a disclosure requirement rather than disqualification for pre-existing events, issuers will not be required to revisit past negotiated settlements or incur additional costs to request waivers for disqualification. Issuers will, however, incur costs in connection with the factual inquiry to determine whether disclosure is required and, if applicable, in preparing the mandatory disclosure for investors, which we have described in Section III above. Also, rather than provide the mandatory disclosure, we expect some issuers may decide to take steps to avoid having to make a disclosure, such as making changes to personnel or retaining different compensated solicitors, and in that respect may incur costs similar to those associated with avoiding or removing a potential disqualification.

We also recognize that issuers that disclose triggering events may have greater difficulty attracting investors to their offerings and may incur a higher cost of capital as a result. We do not have data with respect to current issuer practices involving disclosure of the participation of persons with a history of regulatory or other legal sanctions for securities law violations and, as such, we are unable to determine the extent to which the disclosure requirement will impact issuers' cost of capital. If investors are unwilling to participate in offerings involving prior bad actors, some issuers and other market participants will, as a practical matter, be excluded from the Rule 506 market and will experience some or all of the impact of disqualification.

Commission Cease-and-Desist Orders Involving Scienter-Based Anti-Fraud Violations and Violations of Securities Act Section 5. Under the rule amendments we adopt today, disqualification will be triggered by Commission cease-and-desist orders based on violations of scienter-based anti-fraud provisions of the federal securities laws or Section 5 of the Securities Act. The addition of these categories of Commission orders as a new triggering event is intended to provide a benefit to investors by screening out additional bad actors, while reducing the risk that disqualification would be imposed on securities law violators who do not pose a significant investor protection concern.

We believe the investor protection benefits of adding Commission cease-and-desist orders to the disqualification provisions of Rule 506 justify the potential costs to issuers and other covered persons. The benefits associated with screening bad actors out of the Rule 506 market should not depend on whether a particular enforcement action is brought in court or through a Commission administrative proceeding. Clearly, the absence of Commission cease-and-desist orders from an investor protection rule that includes federal judicial proceedings addressing the same legal violations, and orders by state and other federal regulators addressing the same conduct, would lead to asymmetry in the administration of disqualification under Rule 506. We also do not believe that the addition of Commission cease-and-desist orders is likely to impose a significant cost to issuers and other covered persons because these groups may already be subject to other disqualifying orders issued by the states, federal banking regulators and the National Credit Union Administration.

It is difficult to predict the extent to which adding these Commission cease-and-desist orders to the list of disqualifying events will increase the number of bad actors subject to disqualification from Rule 506 offerings. In our analysis of disqualifying events from 2007 through 2011 discussed earlier, we attempted to assess the number of individuals or entities that would be disqualified as bad actors based solely on Commission cease-and-desist orders described in subsection (v) of Rule 506(d)(1). We identified 116 cease-and-desist orders against respondents that were not otherwise subject to a disqualifying injunction, disciplinary order or felony conviction during the 2007 to 2011 period.[301] To the extent that these historical levels project future levels of disqualifying Commission cease-and-desist orders, we estimate that on an annual basis, there may be approximately 23 individuals or entities disqualified by cease-and-desist orders and not also by some other triggering event. To provide a context, there were in excess of 83,521 Rule 506 offerings during the period 2007-2011. With 116 cease and desist

[301] As there is no comprehensive database of triggering events, the analysis included a review of litigation releases and other documentation for information on other events that would have disqualified these respondents. Some of these documents provided short disciplinary histories, but they are not comprehensive and in any case would not capture subsequent triggering events.

orders during the same period, the potential disqualification incidence created by Commission cease-and-desist orders would appear to be quite low (using these inputs, less than 0.15%).

In addition, inclusion of Commission cease-and-desist orders as a triggering event for bad actor disqualification may change how settlement negotiations are conducted between respondents and the Commission. Even after the Commission imposes a disqualifying cease-and-desist order upon a covered person, the Commission may grant an appropriate waiver from disqualification based on settlement negotiations or other remedial measures and steps taken by the covered person to comply with the Commission cease-and-desist order. We believe that issuers and other covered persons will be able to consider the practical consequences of a future Commission cease-and-desist order and alter their conduct to avoid committing the behavior causing the violation. Alternatively, they can seek to obtain a waiver of disqualification in enforcement settlement negotiations.

We anticipate that this additional triggering event will add minimal incremental costs for issuers, given the requirement in the rule as adopted to conduct factual inquiry to determine whether the offering is subject to bad actor disqualification. To the extent that the addition of a disqualifying event broadens the type and the number of covered persons who will be disqualified from participation in Rule 506 offerings, it may have a detrimental effect on capital raising activity by delaying or deterring offerings, or causing issuers to incur higher transaction costs.

<u>CFTC Orders</u>. Under the rule amendments we adopt today, disqualification will be triggered by orders issued by the CFTC to the same extent as orders of the regulators enumerated in Section 926 of the Dodd-Frank Act (*e.g.*, state securities, insurance and banking regulators, federal banking agencies and the National Credit Union Administration). We believe that

including orders of the CFTC will result in the treatment of comparable sanctions similarly for disqualification purposes, and should enable the disqualification rules to more effectively screen out felons and bad actors. We note in that regard that the conduct that would typically give rise to CFTC sanctions is similar to the type of conduct that would result in disqualification if it were the subject of sanctions by another financial services industry regulator. In addition, the CFTC (rather than the Commission) has authority over the investment managers of pooled investment funds that invest in commodities and certain derivatives products; unless Rule 506(d) covers CFTC orders, regulatory sanctions against those investment managers are not likely to trigger disqualification.

We have a limited ability to quantify the impact of including CFTC orders as a new disqualification trigger under Rule 506(d). While we have access to general information about CFTC enforcement activity,[302] we have no systematic way to filter CFTC orders for connection to Rule 506 offerings or private placements or to isolate situations in which a participant in a Rule 506 offering would be subject to disqualification solely on the basis of a CFTC order. While registered broker-dealers are required to report CFTC proceedings and orders on Form BD, we have no systematic way to filter Form BD data on that basis or to identify registered broker-dealers that are likely to participate in Rule 506 offerings or private placements.

We were able to review disclosures concerning CFTC orders on Form ADV by registered investment advisers and exempt reporting advisers with pooled investment fund clients. In on our review of 384 Forms ADV (as described in detail below), we found six investment adviser

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[302] See e.g., Commodity Futures Trading Commission Annual Performance Report, Fiscal Year 2012 at Appendix A (available here: http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/2012apr.pdf). A summary of CFTC enforcement proceedings from 2005 through 2008 is available here: http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/file/pbproceedingsbulletin.pdf.

firms associated with pooled investment funds that were subject to CFTC orders that would constitute triggering events under Rule 506(d).

Definition of "final order." The change in the definition of "final order" limiting it to orders under statutory authority that provides for notice and an opportunity for hearing should have marginal economic impact for issuers. We do not believe that the incremental burden of inquiry to determine whether an order was issued under such authority will have a significant impact. The change could have the effect of reducing the number of disqualifying events for which issuers or other market participants might seek waivers which, in cases where the waiver would have been granted, would reduce costs and could facilitate capital formation. The economic impact on investors from this change will depend primarily on the extent to which the additional procedural requirement results in bad actors that would otherwise be disqualified remaining eligible to participate in Rule 506 offerings, and the recidivism rates of those bad actors.

Investment Managers. Under the rule amendments we adopt today, investment managers of issuers that are pooled investment funds (that is, investment advisers of pooled investment funds and persons who provide similar investment advisory services to pooled investment funds with respect to assets other than securities) have been added as a new category of covered person. We believe that this approach will reduce compliance costs, in that it represents a "bright-line" category of presumed control persons based on governance and control structures that are typical for pooled investment fund issuers, replacing a potentially costly fact-intensive inquiry into whether such persons should be deemed the equivalent of "directors" or "executive officers" of an issuer organized in corporate form. The addition of this new category facilitates equivalent treatment of operating companies and pooled investment funds under new Rule 506(d).

Incidence of Bad Actors Among Investment Advisers.

i. Analysis of Triggering Events Based on Enforcement Actions Initiated by the Commission

In the review described above in Section IV.B.3, we found that 47 of the random sample of 529 identified cases involved investment advisers (18 of these 47 were also broker-dealers). None of these 47 investment advisers was sanctioned in connection with a private offering. This, however, would represent only a lower bound for the incidence of bad actor triggering events among investment advisers, as the analysis was based on a random sample drawn from the legal proceedings that were brought before the Commission during the period 2007-2011. In addition, our analysis does not take into account bad actor triggering events other than those in subsections (ii), (iv), and (v) of Rule 506(d)(1) or offerings involving bad actors that did not give rise to enforcement activity.

ii. Form ADV Data

We analyzed all Form ADVs filed by investment advisers for 2012 to determine the reported incidence of disqualification triggering events. We limited our review to forms filed by investment advisers that:

- advise a private fund or have clients that are registered investment companies, business development companies or other pooled investment vehicles;
- provided disclosure reporting pages on their current Form ADV; and
- indicated that some of the disclosure reporting pages are for the adviser itself or its supervised persons.

We considered only orders whose status was reported as final. Based on these criteria, we identified 384 investment advisers that disclosed matters that may have constituted a triggering event under Rule 506(d).

Looking at the cases and the regulatory and court actions involved, we determined whether the reported sanctions would constitute triggering events under Rule 506(d). Most of the sanctions would not because the criteria for providing disclosure reporting pages for Form ADV include many events that do not constitute bad actor triggering events under new Rule 506(d). For example, we excluded cases that were initiated by a foreign court or regulator, cases that involved an affiliate firm or cases that involved an individual employee of an affiliate who is not a control person in the parent advisory firm. We also excluded cases where a sanction fell outside the relevant look-back period, such as a Commission cease-and-desist order that is more than five years old. In addition, we excluded cases in which an action did not meet the relevant substantive criteria, such as Commission cease-and-desist orders for violations other than Section 5 of the Securities Act or a scienter-based anti-fraud provision, or felonies that were unrelated to the criteria of Rule 506(d), such as traffic violations.

After these exclusions, we found that approximately 1% of reporting investment advisers associated with pooled investment funds reported bad actor triggering events in their 2012 Form ADV. The results of our analysis are presented in the table below.[303]

[303] Note that since an investment adviser can be subject a combination of criminal, regulatory and civil sanctions, the sum of the three categories of sanctions may exceed the number of investment advisers that are subject to sanctions.

	Number of investment advisers
Total investment advisers	13,173
Investment advisers advising pooled investment funds	7,772
Pooled investment fund investment advisers with disclosure reporting pages	435
Pooled investment fund investment advisers subject to final orders	384
Pooled investment fund investment advisers with 'bad actor' triggering events	**48**
Criminal sanctions	1
Regulatory sanctions	42
Civil sanctions	11

Analysis of Costs and Benefits. Investment managers play a significant role in the management of pooled investment funds. We have included them in the definition of covered persons so that entities or individuals that exercise control over fund management are subject to bad actor disqualification under Rule 506(d). It will therefore provide consistency for covering 'control persons' of both pooled investment fund issuers and issuers that are not pooled investment funds.

Additional issuer costs arising from the addition of investment managers as covered persons will arise from conducting factual inquiries and, in some cases, restructuring governance and control arrangements, preparing disclosure or obtaining waivers from disqualification for having an investment adviser with a history of bad acting. Our analysis shows that the incidence of disqualifying events is low (less than 1%) for investment advisers. So their inclusion in the list of covered persons should not be generally burdensome for issuers. On the other hand, covering investment managers directly will obviate the need for issuers to conduct a fact-intensive inquiry to determine whether an investment manager would be regarded as a *de facto* director or executive officer of a pooled investment fund, or as a promoter of such fund. As a result, the additional costs from this new category of covered person are not likely to be high.

Narrower Coverage of Officers of Issuers and Financial Intermediaries. Some commenters raised concerns that the compliance costs associated with monitoring a potentially large class of covered persons may be high.[304] The rules we are adopting limit the pool of covered persons by covering only executive officers and officers participating in the offering, rather than all officers, of issuers, underwriters, compensated solicitors and investment managers of pooled investment funds. This should reduce compliance costs by limiting covered persons to a more manageable number who should generally be easier to identify. It should also reduce or eliminate costs, such as lost employment opportunities, for individuals who are subject to potentially disqualifying events but are not executive officers of issuers, compensated solicitors or investment managers to pooled investment fund issuers and are not personally involved in Rule 506 offerings. We do not believe it will significantly compromise the intended investor protection benefits of the rule, because all officers performing policy-making functions or personally involved with the offering will be covered.

No Disqualification Where the Relevant Regulatory Authority Advises that Disqualification is Not Warranted. The amendments we are adopting include a provision under which disqualification will not arise if a state or federal regulator issuing an order advises in writing that Rule 506 disqualification is not necessary under the circumstances. We believe this provision will create cost savings for affected covered persons such as issuers, individuals and compensated solicitors by eliminating the need to seek waivers from the Commission or pursue

[304] See comment letters from SIFMA; NYCBA; Five Firms; S&C.

other means of raising capital. We expect that some issuers and other covered persons will adjust their settlement negotiations to bargain for an express determination that disqualification from Rule 506 is unnecessary.[305] As the provision applies only where state or federal regulators have determined that Rule 506 disqualification is not necessary, we do not believe it is likely to impair the intended investor protection benefits of the bad actor disqualification scheme.

V. FINAL REGULATORY FLEXIBILITY ACT ANALYSIS

This final regulatory flexibility analysis has been prepared in accordance with 5 U.S.C. 603. It relates to amendments to Rule 506 of Regulation D under the Securities Act that disqualify certain offerings where "felons and other 'bad actors'" are participating or present from relying on Rule 506 for an exemption from registration under the Securities Act, or impose disclosure requirements in respect of such offerings.

A. Reasons for, and Objectives of, the Action

The primary reason for the amendments is to implement the requirements of Section 926 of the Dodd-Frank Act. Section 926 requires the Commission to issue rules under which certain offerings where "felons and other 'bad actors'" are participating or present will be disqualified from reliance on Rule 506 under Regulation D for an exemption from registration under the Securities Act. Under the amendments adopted today, offerings will be disqualified for triggering events that occur after the effective date of the amendments, and disclosure to investors will be required in respect of triggering events that occur before the effective date.

Our primary objective is to implement the requirements of Section 926 of the Dodd-Frank Act. In general, the rule we are adopting implements the statutory requirements. We have

[305] See Rule 506(d)(2)(iii).

included a "reasonable care" exception in the final amendments, which we believe will make the rule easier for issuers to use, and should encourage continued use of Rule 506 over exempt transactions outside of Rule 506. We have also added an additional disqualifying event for certain Commission cease-and-desist orders, which we believe will make the overall regulatory scheme more consistent and will increase the investor protection benefits of the amendments. We are requiring disclosure, rather than disqualification, for triggering events occurring before effectiveness of the final amendments as a means of enhancing protection of investors participating in offerings involving bad actors, without giving rise to the fairness and other concerns associated with applying the new disqualification provisions in respect of preexisting events.

B. Significant Issues Raised by Public Comment

In the proposing release, we requested comment on every aspect of the initial regulatory flexibility analysis ("IRFA"), including the number of small entities that would be affected by the proposed amendments, the nature of the impact, how to quantify the number of small entities that would be affected, and how to quantify the impact of the proposed amendments. We did not receive comments specifically addressing the IRFA. One commenter suggested exempting offerings below a certain size from the new disqualification provisions based on concerns about the cost of Securities Act registration if Rule 506 were unavailable,[306] but we do not believe that would be consistent with the requirements of Section 926 of the Dodd-Frank Act.

[306] See comment letter from Burningham.

C. Small Entities Subject to the Rule Amendments

The amendments will affect issuers (including both operating businesses and investment funds that raise capital under Rule 506) and other covered persons, such as financial intermediaries, that are small entities. For purposes of the Regulatory Flexibility Act under our rules, an entity is a "small business" or "small organization" if it has total assets of $5 million or less as of the end of its most recent fiscal year and is engaged or proposing to engage in an offering of securities that does not exceed $5 million.[307] For purposes of the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.

The final amendments will apply to all issuers that conduct offerings under Rule 506 and will affect small issuers (including both operating businesses and pooled investment funds that raise capital under Rule 506) relying on this exemption from Securities Act registration. All issuers that sell securities in reliance on Regulation D are required to file a Form D with the Commission reporting the transaction. For the year ended December 31, 2012, 16,067 issuers made 18,187 new Form D filings, of which 15,208 relied on the Rule 506 exemption. Based on information reported by issuers on Form D, there were 3,958 small issuers[308] relying on the Rule 506 exemption in 2012. This number likely underestimates the actual number of small issuers relying on the Rule 506 exemption, however, because over 50% of issuers declined to report their size.

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[307] 17 CFR 230.157.

[308] Of this number, 3,627 of these issuers are not investment companies, and 331 are investment companies. We also note that issuers that are not investment companies disclose only revenues on Form D, and not total assets. Hence, we use the amount of revenues as a measure of issuer size.

D. Reporting, Recordkeeping and Other Compliance Requirements

The final amendments will impose a disclosure requirement with respect to triggering events that occurred before the effective date of the new disqualification provisions and would have triggered disqualification had they occurred after that date.[309] Such disclosure must be in writing and furnished to each purchaser a reasonable time prior to sale. There is no prescribed form that such disclosure must take..

In addition, we expect that issuers will exercise reasonable care to ascertain whether a disqualification exists with respect to any covered person, and document their exercise of reasonable care. The steps required will vary with the circumstances, but we anticipate would generally include making factual inquiry of covered persons and, where the issuer has reason to question the veracity or completeness of responses to such inquiries, further steps such as reviewing information on publicly available databases. In addition, issuers will have to prepare any necessary disclosure regarding preexisting events. We expect that the costs of compliance would generally be lower for small entities than for larger ones because of the relative simplicity of their organizational structures and securities offerings and the generally smaller numbers of individuals and entities involved.

[309] As discussed in Part II.G of this Release, we are also changing the form of the signature block of Form D.

E. Duplicative, Overlapping or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate, overlap or conflict with the final amendments to Rules 145, 147, 152 and 155; Rules 501 and 506 of Regulation D; and Form D under the Securities Act and to Rule 30-1 of our Rules of Organization and Program Management.

F. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objectives of our amendments, while minimizing any significant adverse impact on small entities. In connection with the final amendments, we considered the following alternatives:

- the establishment of different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- the clarification, consolidation, or simplification of the rule's compliance and reporting requirements for small entities;
- the use of performance rather than design standards; and
- an exemption from coverage of the amendments, or any part thereof, for small entities.

With respect to the establishment of different compliance requirements or timetables under our final amendments for small entities, we do not think this is feasible or appropriate. The amendments are designed to exclude "felons and other 'bad actors'" from involvement in Rule 506 securities offerings, which could benefit small issuers by protecting them and their investors from bad actors and increasing investor trust in such offerings. Increased investor trust could reduce the cost of capital and create greater opportunities for small businesses to raise capital.

Likewise, with respect to potentially clarifying, consolidating, or simplifying compliance and reporting requirements, the amendments do not impose any new reporting requirements. To the extent they may be considered to create a new compliance requirement to exercise reasonable care to ascertain whether a disqualification exists with respect to any offering and to furnish a written description of preexisting triggering events, the precise steps necessary to meet that requirement will vary according to the circumstances. In general, we believe the requirement will more easily be met by small entities than by larger ones because we believe that their structures and securities offerings are generally less complex and involve fewer participants.

With respect to using performance rather than design standards, we note that the "reasonable care" exception is a performance standard.

With respect to exempting small entities from coverage of these final amendments, we believe such an approach would be impracticable and contrary to the requirements of Section 926. Regulation D was designed, in part, to provide exemptive relief for smaller issuers. Exempting small entities from bad actor provisions could result in a decrease in investor protection and trust in the private placement and small offerings markets, which would be contrary to the legislative intent of Section 926. We have endeavored to minimize the regulatory burden on all issuers, including small entities, while meeting our regulatory objectives, and have included a "reasonable care" exception and waiver authority for the Commission to give issuers and other covered persons additional flexibility with respect to the application of these amendments.

VI. STATUTORY AUTHORITY AND TEXT OF AMENDMENTS

We are adopting the amendments to 17 CFR Parts 230 and 239 contained in this document under the authority set forth in Sections 4(a)(2), 19 and 28 of the Securities Act, as amended,[310] and Section 926 of the Dodd-Frank Act.[311] We are adopting the amendments to 17 CFR Part 200 contained in this document under the authority of Sections 4A and 4B of the Securities Exchange Act of 1934.[312]

List of Subjects

17 CFR Part 200

Administrative practice and procedure, Authority delegations (Government agencies), Organization and functions (Government agencies),

Reporting and recordkeeping requirements.

17 CFR Parts 230 and 239

Reporting and recordkeeping requirements, Securities.

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

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

1. The general authority citation for Part 200, Subpart A, continues to read, in part, as follows and the sectional authority for § 312 is removed.

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310 15 U.S.C. 77d(a)(2), 77s and 77z-3.

311 15 U.S.C. 77d note. Although Pub. L. No. 112-106, § 201(a), 126 Stat. 313 (2012) is not an authority for the amendments in this release, it is being included in the instruction below for the general authority citation for Part 230 to ensure that the Code of Federal Regulations is correctly updated for purposes of the final rule also published today.

312 15 U.S.C. 78d-1, 78d-2.

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

* * * * *

2. Section 200.30-1(c) is revised to read as follows:

§ 200.30-1 Delegation of authority to Director of Division of Corporation Finance.

* * * * *

(c) With respect to the Securities Act of 1933 (15 U.S.C. 77a et seq.) and Regulation D thereunder (§ 230.500 et seq. of this chapter), to authorize the granting of applications under §§ 230.505(b)(2)(iii)(C), 230.506(d)(2)(ii), and 230.507(b) of this chapter upon the showing of good cause that it is not necessary under the circumstances that the exemption under Regulation D be denied.

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PART 230—GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

3. The general authority citation for Part 230 is revised to read as follows:

Authority: 15 U.S.C. 77b, 77b note, 77c, 77d, 77d note, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78o-7 note, 78t, 78w, 78ll(d), 78mm, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, and 80a-37, and Pub. L. No. 112-106, § 201(a), 126 Stat. 313 (2012), unless otherwise noted.

* * * * *

4. Amend § 230.145 by:

a. removing the reference to "section 4(2)" in the second paragraph of the Preliminary Note and adding in its place "section 4(a)(2)"; and

b. redesignating Note 1 and Note 2 as Note 1 to § 230.145 and Note 2 to § 230.145, respectively.

5. Amend § 230.147(b)(2) by removing the reference to "section 4(2)" and adding in its place "section 4(a)(2)".

6. Amend § 230.152 by removing the reference to "section 4(2)" and adding in its place "section 4(a)(2)".

7. Amend § 230.155(a) by removing the phrase "preliminary note" from the introductory paragraph and removing the reference to "section 4(2)" and adding in its place "section 4(a)(2)".

8. Amend § 230.501 by:

a. redesignating paragraphs (g) and (h) as paragraphs (h) and (i), respectively, and adding new paragraph (g); and

b. redesignating Notes 1, 2, and 3 at the end of the section as Note 1 to § 230.501, Note 2 to § 230.501, and Note 3 to § 230.501, respectively.

The addition reads as follows:

§ 230.501 Definitions and terms used in Regulation D.

* * * * *

(g) *Final order. Final order* shall mean a written directive or declaratory statement issued by a federal or state agency described in § 230.506(d)(1)(iii) under applicable statutory authority that provides for notice and an opportunity for hearing, , which constitutes a final disposition or action by that federal or state agency.

* * * * *

9. Amend § 230.506 by:

a. redesignating the Note following paragraph (b)(2)(i) as "Note to paragraph (b)(2)(i)";

b. reserving (c); and

c. adding paragraphs (d); and (e).

The additions read as follows:

§ 230.506 Exemption for limited offers and sales without regard to dollar amount of offering.

* * * * *

(c) [Reserved]

(d) *"Bad Actor" disqualification.* (1) No exemption under this section shall be available for a sale of securities if the issuer; any predecessor of the issuer; any affiliated issuer; any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer; any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power; any promoter connected with the issuer in any capacity at the time of such sale; any investment manager of an issuer that is a pooled investment fund; any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities; any general partner or managing member of any such investment manager or solicitor; or any director, executive officer or other officer participating in the offering of any such investment manager or solicitor or general partner or managing member of such investment manager or solicitor:

(i) Has been convicted, within ten years before such sale (or five years, in the case of issuers, their predecessors and affiliated issuers), of any felony or misdemeanor:

(A) In connection with the purchase or sale of any security;

(B) Involving the making of any false filing with the Commission; or

(C) Arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;

(ii) Is subject to any order, judgment or decree of any court of competent jurisdiction, entered within five years before such sale, that, at the time of such sale, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice:

(A) In connection with the purchase or sale of any security;

(B) Involving the making of any false filing with the Commission; or

(C) Arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;

(iii) Is subject to a final order of a state securities commission (or an agency or officer of a state performing like functions); a state authority that supervises or examines banks, savings associations, or credit unions; a state insurance commission (or an agency or officer of a state performing like functions); an appropriate federal banking agency; the U.S. Commodity Futures Trading Commission; or the National Credit Union Administration that:

(A) At the time of such sale, bars the person from:

(*1*) Association with an entity regulated by such commission, authority, agency, or officer;

(*2*) Engaging in the business of securities, insurance or banking; or

(*3*) Engaging in savings association or credit union activities; or

(B) Constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years before such sale;

(iv) Is subject to an order of the Commission entered pursuant to section 15(b) or 15B(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*(b) or 78*o*-4(c)) or section 203(e) or (f) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(e) or (f)) that, at the time of such sale:

(A) Suspends or revokes such person's registration as a broker, dealer, municipal securities dealer or investment adviser;

(B) Places limitations on the activities, functions or operations of such person; or

(C) Bars such person from being associated with any entity or from participating in the offering of any penny stock;

(v) Is subject to any order of the Commission entered within five years before such sale that, at the time of such sale, orders the person to cease and desist from committing or causing a violation or future violation of:

(A) Any scienter-based anti-fraud provision of the federal securities laws, including without limitation section 17(a)(1) of the Securities Act of 1933 (15 U.S.C. 77q(a)(1)), section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)) and 17 CFR 240.10b-5, section 15(c)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*(c)(1)) and section 206(1) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-6(1)), or any other rule or regulation thereunder; or

(B) Section 5 of the Securities Act of 1933 (15 U.S.C. 77e).

(vi) Is suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange or a registered national or affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade;

(vii) Has filed (as a registrant or issuer), or was or was named as an underwriter in, any registration statement or Regulation A offering statement filed with the Commission that, within five years before such sale, was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of such sale, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued; or

(viii) Is subject to a United States Postal Service false representation order entered within five years before such sale, or is, at the time of such sale, subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the United States Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations.

(2) Paragraph (d)(1) of this section shall not apply:

(i) With respect to any conviction, order, judgment, decree, suspension, expulsion or bar that occurred or was issued before [insert date 60 days after publication in the Federal Register];

(ii) Upon a showing of good cause and without prejudice to any other action by the Commission, if the Commission determines that it is not necessary under the circumstances that an exemption be denied;

(iii) If, before the relevant sale, the court or regulatory authority that entered the relevant order, judgment or decree advises in writing (whether contained in the relevant judgment, order or decree or separately to the Commission or its staff) that disqualification under paragraph (d)(1) of this section should not arise as a consequence of such order, judgment or decree; or

(iv) If the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed under paragraph (d)(1) of this section.

Instruction to paragraph (d)(2)(iv). An issuer will not be able to establish that it has exercised reasonable care unless it has made, in light of the circumstances, factual inquiry into whether any disqualifications exist. The nature and scope of the factual inquiry will vary based on the facts and circumstances concerning, among other things, the issuer and the other offering participants.

(3) For purposes of paragraph (d)(1) of this section, events relating to any affiliated issuer that occurred before the affiliation arose will be not considered disqualifying if the affiliated entity is not:

(i) In control of the issuer; or

(ii) Under common control with the issuer by a third party that was in control of the affiliated entity at the time of such events.

(e) *Disclosure of prior "bad actor" events.* The issuer shall furnish to each purchaser, a reasonable time prior to sale, a description in writing of any matters that would have triggered disqualification under paragraph (d)(1) of this section but occurred before [insert date 60 days from publication in the Federal Register]. The failure to furnish such information timely shall not prevent an issuer from relying on this section if the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known of the existence of the undisclosed matter or matters.

Instruction to paragraph (e). An issuer will not be able to establish that it has exercised reasonable care unless it has made, in light of the circumstances, factual inquiry into whether any disqualifications exist. The nature and scope of the factual inquiry will vary based on the facts and circumstances concerning, among other things, the issuer and the other offering participants.

PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

10. The authority citation for Part 239 continues to read, in part, as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77sss, 78c, 78*l*, 78m, 78n, 78*o*(d), 78*o*-7 note, 78u-5, 78w(a), 78*ll*, 78mm, 80a-2(a), 80a-3, 80a-8, 80a-9, 80a-10, 80a-13, 80a-24, 80a-26, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

* * * * *

11. Amend Form D (referenced in § 239.500) by revising the third indented paragraph under the heading "Terms of Submission" in the "Signature and Submission" section following Item 16 to read as follows:

Certifying that, if the issuer is claiming a Regulation D exemption for the offering, the issuer is not disqualified from relying on Regulation D for one of the reasons stated in Rule 505(b)(2)(iii) or Rule 506(d).

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

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: July 10, 2013

Commissioner Paredes
Commissioner Gallagher
Disapproved

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 230 and 239

Release No. 33-9416; Release No. 34-69960; Release No. IC-30595; File No. S7-06-13

RIN 3235-AL46

Amendments to Regulation D, Form D and Rule 156 under the Securities Act

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rules.

SUMMARY: The Securities and Exchange Commission, which today in separate releases amended Rule 506 of Regulation D, Form D and Rule 144A under the Securities Act of 1933 to implement Section 201(a) of the Jumpstart Our Business Startups Act and Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, is publishing for comment a number of proposed amendments to Regulation D, Form D and Rule 156 under the Securities Act. These proposed amendments are intended to enhance the Commission's ability to evaluate the development of market practices in Rule 506 offerings and to address concerns that may arise in connection with permitting issuers to engage in general solicitation and general advertising under new paragraph (c) of Rule 506. Specifically, the proposed amendments to Regulation D would require the filing of a Form D in Rule 506(c) offerings before the issuer engages in general solicitation; require the filing of a closing amendment to Form D after the termination of any Rule 506 offering; require written general solicitation materials used in Rule 506(c) offerings to include certain legends and other disclosures; require the submission, on a temporary basis, of written general solicitation materials used in Rule 506(c) offerings to the Commission; and disqualify an issuer from relying on Rule 506 for one year for

future offerings if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the last five years, with Form D filing requirements in a Rule 506 offering. The proposed amendments to Form D would require an issuer to include additional information about offerings conducted in reliance on Regulation D. Finally, the proposed amendments to Rule 156 would extend the antifraud guidance contained in the rule to the sales literature of private funds.

DATES: Comments should be received on or before [insert date that is 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 email to rule-comments@sec.gov. Please include File Number S7-06-13 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 S7-06-13. This file number should be included on the subject line if email 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: Charles Kwon, Special Counsel or Ted Yu, Senior Special Counsel, Office of Chief Counsel, or Karen C. Wiedemann, Attorney Fellow, Office of Small Business Policy, Division of Corporation Finance, at (202) 551-3500; or, with respect to private funds, Melissa Gainor or Alpa Patel, Senior Counsels, Investment Adviser Regulation Office, Division of Investment Management, at (202) 551-6787, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are proposing amendments to Rule 156,[1] Rules 503,[2] 506[3] and 507[4] of Regulation D,[5] and Form D[6] under the Securities Act of 1933.[7] We are proposing to add Rule 509 and Rule 510T of Regulation D under the Securities Act.

[1] 17 CFR 230.156.

[2] 17 CFR 230.503.

[3] 17 CFR 230.506.

[4] 17 CFR 230.507.

[5] 17 CFR 230.500 through 230.508.

[6] 17 CFR 239.500.

[7] 15 U.S.C. 77a et seq.

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I. INTRODUCTION

We are adopting today, in separate releases, amendments to Rule 506 of Regulation D[8] and to Form D[9] to implement Section 201(a)(1) of the Jumpstart Our Business Startups Act (the "JOBS Act")[10] and Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[11] Rule 506 was originally adopted as a non-exclusive safe harbor under Section 4(a)(2) of the Securities Act of 1933 (the "Securities Act"), the statutory exemption from Securities Act registration for transactions by an issuer "not involving any public offering."[12] To implement Section 201(a)(1) of the JOBS Act, we are adding new paragraph (c) to Rule 506, which permits issuers to use general solicitation and general advertising (collectively, "general solicitation") when conducting an offering pursuant to this new paragraph, provided that all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that such purchasers are accredited investors.[13] We

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[8] 17 CFR 230.506. The Commission adopted Rule 506 and Regulation D in 1982 as a result of the Commission's evaluation of the impact of its rules on the ability of small businesses to raise capital. See Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Release No. 33-6389 (Mar. 8, 1982) [47 FR 11251 (Mar. 16, 1982)]. Over the years, the Commission has revised various provisions of Regulation D in order to address, among other things, specific concerns relating to facilitating capital raising as well as abuses that have arisen under Regulation D. See, e.g., Additional Small Business Initiatives, Release No. 33-6996 (Apr. 28, 1993) [58 FR 26509 (May 4, 1993)] and Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Release No. 33-7644 (Feb. 25, 1999) [64 FR 11090 (Mar. 8, 1999)].

[9] 17 CFR 239.500.

[10] Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313 (Apr. 5, 2012). See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9354 (Aug. 29, 2012) [77 FR 54464 (Sept. 5, 2012)] ("Rule 506(c) Proposing Release").

[11] Pub. L. No. 111-203, § 926, 124 Stat. 1376, 1851 (July 21, 2010) (codified at 15 U.S.C. 77d note).

[12] 15 U.S.C. 77d(a)(2). As with the Section 4(a)(2) statutory exemption, Rule 506 is available only to the issuer of the securities and not to any affiliate of the issuer or to any other person for resales of the issuer's securities. See 17 CFR 230.500(d).

[13] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9415 (July 10, 2013) ("Rule 506(c) Adopting Release"). In addition to

are also adding a new check box to Form D to require issuers to indicate that they are relying on Rule 506(c) for their offering.[14] To implement Section 926 of the Dodd-Frank Act, we are adding new paragraph (d) to Rule 506, which disqualifies issuers and other market participants from relying on Rule 506 if "felons and other 'bad actors'" are participating in the offering.[15] We are also amending the form of the signature block to Form D to include a certification whereby issuers claiming a Rule 506 exemption will confirm that the offering is not disqualified from reliance on Rule 506.

We anticipate that new Rule 506(c) will have a significant impact on Rule 506 offerings and on current capital-raising practices. Among other things, we anticipate that issuers using Rule 506(c) will be able to reach a greater number of potential investors than is currently the case in Rule 506 offerings, thereby increasing their access to sources of capital.[16] As a result, accredited investors may be able to find and potentially invest in a larger and more diverse pool of investment opportunities, which could result in a more efficient allocation of capital by accredited investors. On the other hand, we recognize the concerns raised by a number of commenters that a general solicitation for a Rule 506(c) offering would attract both accredited and non-accredited investors and could

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these requirements, under new Rule 506(c), all terms and conditions of Rule 501 and Rules 502(a) and 502(d) of Regulation D [17 CFR 230.501 and 502(a) and (d)] must be satisfied.

[14] As discussed in Section II.A of this release, Form D is the notice of an offering of securities made without registration under the Securities Act in reliance on an exemption provided by Regulation D or Section 4(a)(5) of the Securities Act.

[15] Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Release No. 33-9414 (July 10, 2013).

[16] Currently, under Rule 506(b) [17 CFR 230.506(b)], an issuer may sell securities, without any limitation on the offering amount, to an unlimited number of "accredited investors," as defined in Rule 501(a) of Regulation D, and to no more than 35 non-accredited investors who meet certain "sophistication" requirements. The availability of Rule 506(b) is subject to the terms and conditions of Rules 501 and 502 and is conditioned on the issuer, or any person acting on its behalf, not offering or selling securities through any form of "general solicitation or general advertising."

result in an increase in fraudulent activity in the Rule 506 market, as well as an increase in unlawful sales of securities to non-accredited investors.

Many comments submitted on the Rule 506(c) Proposing Release, including the comments submitted by the Investor Advisory Committee, urged the Commission to propose or adopt other amendments to Regulation D or to Form D[17] that they believed would be appropriate in connection with the adoption of the amendments to implement Section 201(a) of the JOBS Act.[18] For example, several commenters suggested that we amend Regulation D to provide that the availability of the new Rule 506(c) exemption be conditioned on compliance with the Form D filing requirement,[19] require Form D to be filed in advance of any general solicitation[20] and add to the information requirements of

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[17] To facilitate public input on JOBS Act rulemaking before the issuance of rule proposals, the Commission invited members of the public to make their views known on various JOBS Act initiatives in advance of any rulemaking by submitting comment letters to the Commission's website at http://www.sec.gov/spotlight/jobsactcomments.shtml. The comment letters relating to Section 201(a) of the JOBS Act submitted in response to this invitation are located at http://www.sec.gov/comments/jobs-title-ii/jobs-title-ii.shtml. The comment letters submitted in response to the Rule 506(c) Proposing Release are located at http://www.sec.gov/comments/s7-07-12/s70712.shtml. Many commenters submitted comment letters both before and after the issuance of the Rule 506(c) Proposing Release. Our references to comment letters in this release that are not dated refer to the comment letters submitted in response to the Rule 506(c) Proposing Release. Dated comment letters refer to those submitted before the issuance of the Rule 506(c) Proposing Release or by commenters that submitted multiple letters.

[18] See, e.g., letters from Fund Democracy, Inc. ("Fund Democracy"); North American Securities Administrators Association, Inc. ("NASAA"); Consumer Federation of America ("Consumer Federation"); SEC Investor Advisory Committee ("Investor Advisory Committee"). The Investor Advisory Committee was established in April 2012 pursuant to Section 911 of the Dodd-Frank Act to advise the Commission on regulatory priorities, the regulation of securities products, trading strategies, fee structures, the effectiveness of disclosure, initiatives to protect investor interests and to promote investor confidence and the integrity of the securities marketplace. The Dodd-Frank Act authorizes the Investor Advisory Committee to submit findings and recommendations for review and consideration by the Commission.

On October 12, 2012, the Investor Advisory Committee unanimously approved and submitted recommendations to the Commission titled, Recommendations of the Investor Advisory Committee Regarding SEC Rulemaking to Lift the Ban on General Solicitation and Advertising in Rule 506 Offerings: Efficiently Balancing Investor Protection, Capital Formation and Market Integrity. The recommendations are available at http://www.sec.gov/spotlight/investor-advisory-committee-2012/iac-general-solicitation-advertising-recommendations.pdf.

[19] See, e.g., letters from Investor Advisory Committee; NASAA; AARP; Consumer Federation.

[20] See, e.g., letters from Office of the Secretary of the Commonwealth of Massachusetts Securities Division ("Massachusetts Securities Division") (July 2, 2012); NASAA; Securities Division, Nevada

Form D.[21] In light of the fact that the financial thresholds in the definition of "accredited investor" that relate to natural persons have not been updated since their adoption in 1982,[22] some commenters recommended that the Commission also amend the definition of "accredited investor" as it relates to natural persons.[23] Other commenters suggested that we propose rules governing the content and manner of general solicitations used in offerings conducted pursuant to the new Rule 506(c) exemption, particularly with respect to offerings by private funds.[24] Several commenters also recommended that we require the filing or submission of general solicitation materials used pursuant to the new Rule

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Secretary of State ("Nevada Securities Division"); Ohio Division of Securities; Securities Commissioner, State of South Carolina ("South Carolina Securities Commissioner"); State Corporation Commission, Division of Securities and Retail Franchising, Commonwealth of Virginia ("Virginia Division of Securities").

[21] See, e.g., letters from AARP; AFL-CIO and Americans for Financial Reform ("AFR"); Consumer Federation; Massachusetts Securities Division (July 2, 2012); NASAA.

[22] See Release No. 33-6389. For natural persons, Rule 501(a) defines an accredited investor as a person whose individual net worth, or joint net worth with that person's spouse, exceeds $1 million, excluding the value of the person's primary residence (the "net worth test") or who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year (the "income test").

Although the Dodd-Frank Act did not change the amount of the $1 million net worth test, it did change how that amount is to be calculated – by excluding the value of a person's primary residence. This change took effect upon the enactment of the Dodd-Frank Act, and in December 2011, we amended Rule 501 to incorporate this change into the definition of accredited investor. See Net Worth Standard for Accredited Investors, Release No. 33-9287 (Dec. 21, 2011) [76 FR 81793 (Dec. 29, 2011)].

[23] See, e.g., letters from AARP; Consumer Federation; Investment Company Institute ("ICI"); Investor Advisory Committee; Massachusetts Securities Division (July 2, 2012); Ohio Division of Securities (July 3, 2012). Several commenters noted that under the Commission's proposal in 2007 to partially lift the prohibition on general solicitation for offerings sold only to "large accredited investors," such investors who were natural persons would have been required to have at least $400,000 in annual income or $2.5 million in investments. See letters from AFL-CIO and AFR; Fund Democracy; AARP. One commenter, however, opposed increasing the thresholds for accredited investor status. See letter from National Small Business Association (June 12, 2012).

[24] See, e.g., letters from ICI; AFL-CIO and AFR; Consumer Federation; Investor Advisory Committee; Independent Directors Council ("IDC"); NASAA; Sens. Reed, Levin, Durbin, Harkin, Lautenberg, Franken and Akaka.

506(c) exemption, whether to the Financial Industry Regulatory Authority ("FINRA"),[25] to an electronic "drop box" to be created by the Commission specifically to receive general solicitation materials[26] or as an exhibit to Form D.[27]

In light of these comments and the magnitude of the change that the elimination of the prohibition against general solicitation represents to the Rule 506 market, we are proposing today a number of amendments in conjunction with the adoption of new Rule 506(c). These amendments are intended to enhance the Commission's understanding of the Rule 506 market by improving compliance with Form D filing requirements, expanding the information requirements of Form D, primarily with respect to Rule 506 offerings, and requiring the submission, on a temporary basis, of written general solicitation materials used in Rule 506(c) offerings to the Commission. We believe that the elimination of the prohibition against general solicitation for Rule 506(c) offerings will have a significant impact on the Rule 506 market, including the types of issuers that raise capital using Rule 506, the investors who are solicited and ultimately purchase securities in the offerings, the intermediaries that participate in this market, the practices employed by issuers and intermediaries and the amount of capital that will be raised. To review and analyze these changes more effectively, and to facilitate the assessment of the effects of such changes on investor protection and capital formation, the Commission staff will need better tools to evaluate this changing market than are currently provided

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[25] See letters from AFL-CIO and AFR; BetterInvesting (recommending that "the SEC require all public solicitation materials under Rule 506 to be independently reviewed for compliance (perhaps by an independent authority such as FINRA, which already reviews broker-dealer advertising) before or after the public solicitation" (emphasis omitted)); ICI.

[26] See letters from Investor Advisory Committee; Consumer Federation.

[27] See letters from Massachusetts Securities Division (July 2, 2012); Ohio Division of Securities (July 3, 2012).

by the existing filing and information requirements of Form D. Further, we believe that the proposed changes to the filing and information requirements of Form D could assist the enforcement efforts of both federal and state regulators, which rely on Form D as an important source of information about the private offering market.

Specifically, with respect to Form D and to Regulation D as it relates to Form D, we are proposing to:

- amend Rule 503 of Regulation D to require: (1) the filing of a Form D no later than 15 calendar days in advance of the first use of general solicitation in a Rule 506(c) offering; and (2) the filing of a closing Form D amendment within 30 calendar days after the termination of a Rule 506 offering;
- amend Form D to require additional information primarily in regard to offerings conducted in reliance on Rule 506; and
- amend Rule 507 of Regulation D to disqualify an issuer from relying on Rule 506 for one year for future offerings if the issuer, or any predecessor or affiliate[28] of the issuer, did not comply, within the last five years, with all of the Form D filing requirements in a Rule 506 offering.

In addition, in light of the ability of issuers to publicly advertise Rule 506(c) offerings, we are concerned that prospective investors may not be sufficiently informed as to whether they are qualified to participate in these offerings, the type of offerings being conducted and certain potential risks associated with such offerings. To address these concerns, we are proposing new Rule 509 of Regulation D, which would require

[28] An "affiliate" is defined in Rule 501(b) of Regulation D [17 CFR 230.501(b)] as a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified.

issuers to include prescribed legends in any written communication that constitutes a general solicitation in any offering conducted in reliance on Rule 506(c) ("written general solicitation materials"). Private funds would also be required to include a legend disclosing that the securities being offered are not subject to the protections of the Investment Company Act of 1940 ("Investment Company Act") and additional disclosures in written general solicitation materials that include performance data so that potential investors are aware that there are limitations on the usefulness of such data and provide context to understand the data presented.[29] We are proposing to disqualify an issuer from relying on Rule 506 for future offerings if such issuer, or any predecessor or affiliate of the issuer, has been subject to any order, judgment or court decree enjoining such person for failure to comply with proposed Rule 509.

We are also proposing to amend Rule 156 under the Securities Act,[30] which interprets the antifraud provisions of the federal securities laws in connection with sales literature used by investment companies, to apply to the sales literature of private funds because we believe it is important for private funds to consider the Commission's views on the applicability of the antifraud provisions to their sales literature. We are also soliciting comment on a recommendation made by commenters on the Rule 506(c) Proposing Release to mandate additional manner and content restrictions on written general solicitation materials used by private funds.

As the Commission will need to be aware of developments in the Rule 506 market

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[29] A private fund is an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act, but for the exclusion from the definition of "investment company" in Section 3(c)(1) or Section 3(c)(7) of that Act. We also refer in this release to "pooled investment funds" because that term is used in Form D. Issuers that rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act are a subset of pooled investment funds.

[30] 17 CFR 230.156.

after the effectiveness of Rule 506(c), we are proposing Rule 510T to require issuers, on a temporary basis, to submit any written general solicitation materials used in their Rule 506(c) offerings to the Commission no later than the date of the first use of these materials. Such materials would be required to be submitted through an intake page on the Commission's website. We are not proposing, at this time, that these materials would be available to the public; therefore, issuers would not file their written general solicitation materials through the Commission's EDGAR system. We are proposing to disqualify an issuer from relying on Rule 506 for future offerings if such issuer, or any predecessor or affiliate of the issuer, has been subject to any order, judgment or court decree enjoining such person for failure to comply with proposed Rule 510T.

We also appreciate the need to undertake a broader effort to review and analyze the market impact and developing market practices resulting from permitting general solicitation in connection with offerings relying on new Rule 506(c). Accordingly, we will evaluate the use of Rule 506(c) by issuers and market participants, and, in particular, the steps they take to verify that the purchasers of the offered securities are accredited investors. We have directed the Commission staff to execute a comprehensive work plan upon the effectiveness of Rule 506(c) to review and analyze the use of Rule 506(c) (the "Rule 506(c) Work Plan"), which will involve a coordinated effort of staff from the Division of Corporation Finance, the Division of Economic and Risk Analysis ("DERA"), the Division of Investment Management, the Division of Trading and Markets, the Office of Compliance Inspections and Examinations ("OCIE") and the Division of Enforcement. The Commission staff will, among other things:

- evaluate the range of purchaser verification practices used by issuers and other participants in these offerings, including whether these verification practices are excluding or identifying non-accredited investors;
- evaluate whether the absence of the prohibition against general solicitation has been accompanied by an increase in sales to non-accredited investors;
- assess whether the availability of Rule 506(c) has facilitated new capital formation or has shifted capital formation from registered offerings and unregistered non-Rule 506(c) offerings to Rule 506(c) offerings;
- examine the information submitted or available to the Commission on Rule 506(c) offerings, including the information in Form D filings and the form and content of written general solicitation materials submitted to the Commission;
- monitor the market for Rule 506(c) offerings for increased incidence of fraud and develop risk characteristics regarding the types of issuers and market participants that conduct or participate in Rule 506(c) offerings and the types of investors targeted in these offerings to assist with this effort;
- incorporate an evaluation of the practices in Rule 506(c) offerings in the staff's examinations of registered broker-dealers and registered investment advisers;[31] and
- coordinate with state securities regulators on sharing information about Rule 506(c) offerings.

[31] OCIE currently examines multiple types of market participants that have involvement in private offerings, including registered broker-dealers that advise issuers on private placements and registered investment advisers that advise clients investing in private placements or advise private funds that offer fund interests pursuant to private offerings.

Implementation of the Rule 506(c) Work Plan will assist the Commission in evaluating the development of market practices in Rule 506(c) offerings. The amendments we propose today would, if adopted, support the Rule 506(c) Work Plan by enhancing the timeliness, quality and completeness of information on the issuers, investors and financial intermediaries that participate in the Rule 506 market and by requiring the submission of written general solicitation materials to the Commission. The proposed amendments would also assist the Commission's efforts to protect investors and to evaluate the development of market practices in Rule 506(c) offerings and would support future Commission consideration of any additional changes related to Rule 506(c), consistent with the Commission's mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation.

In addition, many commenters stated, and we agree, that the definition of accredited investor as it relates to natural persons should be reviewed and, if necessary or appropriate, amended. The Commission staff has begun a review of the definition of accredited investor as it relates to natural persons, including the need for any changes to this definition following the effectiveness of Rule 506(c). We further discuss the definition of accredited investor, and request comment on the definition, in Section V of this release.

II. PROPOSED AMENDMENTS RELATING TO FORM D

A. Background

Form D is the notice of an offering of securities conducted without registration under the Securities Act in reliance on Rule 504, 505 or 506 of Regulation D.[32] Under Rule 503 of Regulation D, an issuer offering or selling securities in reliance on Rule 504, 505 or 506 of Regulation D must file a notice of sales on Form D with the Commission for each new offering of securities no later than 15 calendar days after the first sale of securities in the offering.[33] Form D is currently organized around 16 numbered items or categories of information. The information required to be provided in a Form D filing includes basic identifying information, such as the name of the issuer of the securities and the issuer's year and place of incorporation or organization; information about related persons (executive officers, directors and promoters); the exemption or exemptions being claimed for the offering; and factual information about the offering, such as the duration of the offering, the type of securities offered and the total offering amount. Although the requirement to file a Form D pursuant to Rule 503 was a condition of Rules 504, 505 and 506 when all of these rules were originally adopted,[34] it is currently not a condition of those rules. Instead, under Rule 507 of Regulation D, an issuer will be disqualified from

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[32] Regulation D contains separate exemptions for limited offerings in Rules 504, 505 and 506. Rule 504 [17 CFR 230.504] exempts the offer and sale of up to $1 million of securities in a 12-month period by issuers that are not subject to reporting requirements under the Securities Exchange Act of 1934 (the "Exchange Act"). Rule 505 [17 CFR 230.505] exempts offerings by issuers of up to $5 million of securities in a 12-month period. Form D also applies to offerings of securities without registration in reliance on the exemption contained in Section 4(a)(5) of the Securities Act [15 U.S.C. 77d(a)(5)].

[33] This 15-day time frame has remained unchanged since the adoption of Regulation D in 1982. In 2008, we revised Rule 503 to provide that when a Form D filing otherwise would be due on a weekend or holiday it will be deemed due on the next business day. Electronic Filing and Revision of Form D, Release No. 33-8891 (Feb. 6, 2008) [73 FR 10592 (Feb. 27, 2008)].

[34] In 1988, the Commission proposed to eliminate the requirement to file a Form D as a condition to the availability of the Regulation D exemptions, noting that "[c]ommenters have frequently criticized" this condition. Regulation D, Release No. 33-6759 (Mar. 3, 1988) [53 FR 7870 (Mar. 10, 1988)]; Regulation D, Release No. 33-6812 (Dec. 20, 1988) [54 FR 309 (Jan. 5, 1989)] (reproposing the elimination of Rule 503 as a condition of the Regulation D exemptions after commenters expressed concern over the effect of the proposals on enforcement efforts and potential impairment of private rights of action). In 1989, the Commission removed the filing of Form D as a condition to the Regulation D exemptions. Regulation D, Release No. 33-6825 (Mar. 15, 1989) [54 FR 11369 (Mar. 20, 1989)].

using Regulation D if it, or a predecessor or affiliate, is enjoined by a court for failure to comply with Rule 503.[35] The Commission can waive any such disqualification upon a showing of good cause.[36]

At the time the Commission adopted Regulation D and Form D in 1982, the Form D filing requirements in Rule 503 were intended to serve an important data collection function, including, among other things, for the Commission's rulemaking efforts.[37] Until 2008, however, issuers made Form D filings in paper format, making the extraction of information for large-scale statistical analysis problematic.[38] In 2008, we adopted rule and form amendments that mandated the electronic filing of Form D on the Commission's Electronic Data Gathering, Analysis and Retrieval (EDGAR) system in a structured format.[39] As a result of these amendments, which were phased in from

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[35] See Release No. 33-6759 ("As proposed, the filing obligation under Rule 503 would continue but would no longer be a condition to the exemption. In order to provide an incentive for filing the Form D in a timely manner, the Commission is proposing new Rule 507, which would disqualify an issuer from the use of the Regulation D exemptions if it had been found to have violated Rule 503."); Release No. 33-6825 (adopting Rule 507 as proposed).

[36] Rule 507(b) [17 CFR 230.507(b)].

[37] We stated in the proposing release for Regulation D:

> An important purpose of the notice ... is to collect empirical data which will provide a basis for further action by the Commission either in terms of amending existing rules and regulations or proposing new ones .... Further, the proposed Form will allow the Commission to elicit information necessary in assessing the effectiveness of Regulation D as a capital raising device for small businesses.

Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Release No. 33-6339 (Aug. 7, 1981) [46 FR 41791, 41799 (Aug. 18, 1981)].

[38] In 1996, we proposed to eliminate the Form D filing requirement entirely and replace it with an issuer obligation to complete a Form D and retain it for a period of time. Phase Two Recommendations of Task Force on Disclosure Simplification, Release No. 33-7301 (May 31, 1996) [61 FR 30405 (June 14, 1996)]. After reviewing comments on the proposal, we decided to retain the requirement because the information collected in Form D filings was still useful to us "in conducting economic and other analyses of the private placement market." Phase Two Recommendations of Task Force on Disclosure Simplification, Release No. 33-7431 (July 18, 1997) [62 FR 39755, 39756 (July 24, 1997)].

[39] See Release No. 33-8891. At that time, we substantially revised Form D to simplify and restructure the form, eliminate outdated information requirements and update and supplement other information requirements. For example, we added requirements to provide revenue range information for the issuer, or

September 2008 to March 2009, Form D filings are now machine-readable, and the Commission, its staff, other securities regulators and the public at large now have a greater ability to analyze the Regulation D offering market through the information supplied in electronic Form D filings. In addition, the information in Form D filings has been useful for a number of other purposes, such as serving as a source of information for investors[40] and facilitating the enforcement of the federal securities laws and the enforcement efforts of state securities regulators and FINRA.[41] For example, state securities regulators typically rely on Form D as their sole notice that a Rule 506 offering is being conducted because securities issued in Rule 506 offerings are "covered securities" under Section 18(b)(4)(D) of the Securities Act[42] and therefore are exempt from state blue sky registration requirements.

We understand that some issuers are not making a Form D filing for Rule 506 offerings because the filing of Form D is not a condition of Rule 506. In addition, we are limited in our ability to gather information about Rule 506 offerings at the commencement of these offerings because Form D currently is not required to be filed until 15 calendar days after the first sale of securities in the offerings; and the absence of

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net asset value range information in the case of pooled investment funds (subject to an option in both cases to decline to disclose); more specific information on the registration exemption claimed as well as information on any exclusion claimed from the definition of "investment company" under the Investment Company Act; information on the date of first sale in the offering; and information on whether the offering is expected to last over a year.

[40] Id. (noting that the Commission's website "advises potential investors in Regulation D offerings to check whether the company making the offering has filed a Form D notice and advises that '[i]f the company has not filed a Form D, this should alert you that the company might not be in compliance with the federal securities laws'").

[41] Id. (stating that "[t]he staffs of state securities regulators and [FINRA] also use Form D information to enforce securities laws and the rules of securities self-regulatory organizations").

[42] 15 U.S.C. 77r(b)(4)(D). Although Securities Act Section 18 preempts state registration and review of offerings of "covered securities," the states have investigated and brought a number of enforcement actions alleging fraud and deceit in Rule 506 offerings. See, e.g., letter from NASAA (stating that, in 2011, "state regulators took more than 200 enforcement actions related specifically to Rule 506 offerings").

a closing filing requirement means that the Commission does not have a complete picture of Rule 506 offerings, such as the total amount of capital actually raised in these offerings. Other than the newly adopted requirement for issuers to indicate in Form D whether they are relying on Rule 506(c), Form D does not require information specific to Rule 506(c) offerings, such as information about the issuer's plans to engage in general solicitation, any practices used to satisfy the verification requirement in Rule 506(c) and the types of investors participating in Rule 506(c) offerings.

Accordingly, we are proposing a number of amendments to Regulation D and Form D. These amendments would require the advance filing of Form D for Rule 506(c) offerings, require the filing of an amendment to Form D after termination of a Rule 506 offering, expand the information requirements in Form D for offerings conducted under Rule 506 and disqualify issuers from using Rule 506 for future offerings until one year has elapsed after the required Form D filings are made if they, or their predecessors or affiliates, failed to comply, within the past five years, with the Form D filing requirements for a Rule 506 offering.

B. Timing of the Filing of Form D

We are proposing to amend Rule 503 to require issuers that intend to engage in general solicitation for a Rule 506(c) offering to file an initial Form D in advance of conducting any general solicitation activities. Currently, Rule 503 requires an issuer to file a Form D not later than 15 calendar days after the first sale of securities in a Regulation D offering. Under the proposed amendment, if an issuer has not otherwise filed a Form D for a Rule 506(c) offering, it would be required, at least 15 calendar days before commencing general solicitation for the offering, to file an initial Form D that includes the information required by the following items of Form D (the "Advance Form D"):

- Item 1. Basic identifying information on the issuer;
- Item 2. Information on the issuer's principal place of business and contact information;
- Item 3. Information on related persons;
- Item 4. Information on the issuer's industry group;
- Item 6. Identification of the exemption or exemptions being claimed for the offering;
- Item 7. Indication of whether the filing is a new filing or an amendment;
- Item 9. Information on the type(s) of security to be offered;[43]
- Item 10. Indication of whether the offering is related to a business combination;
- Item 12. Information on persons receiving sales compensation;[44] and
- Item 16. Information on the use of proceeds from the offering.

After the filing of an Advance Form D, the issuer would be required to file an amendment providing the remaining information required by Form D within 15 calendar days after the date of first sale of securities in the offering, as is currently required by Rule 503.[45]

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[43] An issuer would be required to include the information required by Item 9 only to the extent that the information is known at the time of filing the Advance Form D.

[44] An issuer would be required to include the information required by Item 12 only to the extent that the information is known at the time of filing the Advance Form D.

[45] An issuer that has already filed a Form D containing complete information with respect to a Rule 506(c) offering would not be required to file an Advance Form D. This could occur, for example, when the use of

A number of commenters on the Rule 506(c) Proposing Release, including numerous state securities regulators and several investor organizations, suggested that the Commission require Form D to be filed in advance of any general solicitation in Rule 506(c) offerings.[46] Some of these commenters stated that the advance filing of Form D would enable state securities regulators and investors, after seeing an advertisement or other notice for an offering, to more easily determine whether an issuer is at least attempting to comply with Rule 506(c).[47] One commenter noted that state securities regulators routinely review Form D filings to ensure that the offerings actually qualify for an exemption under Rule 506 and to look for "red flags" that may indicate that an offering may be fraudulent.[48] Other commenters stated that, with the advance filing of Form D, state securities regulators would be in a better position to ensure that no bad

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general solicitation begins after the offering is underway and the first sale of securities has occurred for which a Form D has been filed more than 15 calendar days before the commencement of general solicitation in the offering.

[46] See, e.g., letters from AARP; AFL-CIO and AFR; Consumer Federation; Commissioner of Securities, State of Hawaii ("Hawaii Commissioner of Securities"); Indiana Securities Division; Massachusetts Securities Division (July 2, 2012) (noting that an advance filing requirement for Form D "will notify federal and state regulators that these offerings are in the marketplace, and they will give potential investors an opportunity to obtain basic information about the issuer and the offering"); Commissioner of Securities, State of Missouri ("Missouri Commissioner of Securities"); Commissioner of Securities and Insurance, State of Montana ("Montana Commissioner of Securities"); NASAA (noting that without an advance filing requirement for Form D and a filing requirement that is a condition of the exemption, "[a]n investigator who sees an advertised offering will have no simple way of knowing whether the issuer is engaged in a compliant Rule 506 offering or is merely advertising an unregistered, non-exempt public offering"); Fund Democracy, Consumer Action, Consumer Federation, AFL-CIO and AFR (May 24, 2012); Nevada Securities Division; Ohio Division of Securities; South Carolina Securities Commissioner; Virginia Division of Securities.

The Investor Advisory Committee recommended that the Commission require issuers to file either a new "Form GS" or a revised version of Form D as a precondition for relying on Rule 506(c). See letter from Investor Advisory Committee.

[47] See, e.g., letters from NASAA; Missouri Commissioner of Securities; Nevada Securities Division.

[48] See letter from NASAA. See also letter from Missouri Commissioner of Securities (stating that "filing the Form D better equips the state securities regulators to ensure compliance with Federal and state securities laws").

actors are participating in a Rule 506 offering[49] and to answer questions from investors who contact them after seeing an advertised offering.[50]

On the other hand, one commenter stated that the current 15-calendar day time frame to file a Form D following a sale provides a reasonable period for an issuer to prepare and submit the form while providing appropriate notice to regulators of a new Regulation D offering.[51] This commenter also argued that an issuer may not be certain of whether it will rely on Rule 506(b) or Rule 506(c) ahead of time.[52]

We appreciate these recommendations and recognize the concerns as well. We believe that requiring issuers to file an Advance Form D would assist the Commission's efforts to evaluate the use of Rule 506(c). Although the Commission does not anticipate that its staff will review each Advance Form D filing as it is being made, the Advance Form D would be useful to the Commission and the Commission staff, as it would enhance the information available to the Commission to analyze offerings initiated under Rule 506(c), including issuers that initiated Rule 506(c) offerings but were unsuccessful in selling any securities through these offerings or chose alternative forms of raising capital. Currently, Form D is required to be filed only after the first sale of securities, which means that issuers that offered securities, but did not complete a sale, are not required to file a Form D, thereby limiting the Commission's ability to determine which issuers are facing challenges raising capital under Rule 506(c) and whether further steps by the Commission are needed to facilitate issuers' ability to raise capital under

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[49] See letter from Ohio Division of Securities (July 3, 2012).

[50] See, e.g., letters from Missouri Commissioner of Securities; NASAA.

[51] See letter from Managed Funds Association ("MFA") (Mar. 22, 2013).

[52] See letter from MFA (Sept. 28, 2012).

Rule 506(c). We also understand that the Advance Form D would be useful to state securities regulators and to investors in gathering timely information about Rule 506(c) offerings and the use of Rule 506(c).

We appreciate the sensitivity that some issuers may have regarding the disclosure of detailed information about a contemplated offering before the issuer has made a final decision to raise capital in a Rule 506(c) offering or before the first sale of securities has occurred. For this reason, we propose that the Advance Form D for Rule 506(c) offerings require only the information set forth above, with a requirement to file an amendment to the Form D that includes the remainder of the information required by Form D (including information regarding the terms of the offering that may not have been known at the time of the filing of the Advance Form D and therefore omitted from the Advance Form D, such as those called for by Item 9 and Item 12 of Form D) following the completion of a sale of securities in a Rule 506(c) offering on the timetable currently required under Rule 503. An issuer that wishes to provide all of the information required by Form D in the Advance Form D may do so, obviating the need to file an additional amendment unless otherwise required under Rule 503. An issuer could also file an Advance Form D without contemplating a specific offering, in order to have the flexibility to conduct an offering using general solicitation. We believe that this approach would allow the Commission to gather the information that it needs through Advance Form D filings without unnecessarily burdening issuers or requiring issuers to disclose specific information about capital-raising plans before these plans have been determined.

Request for Comment

1. We are proposing that issuers file an Advance Form D no later than 15 calendar days before the commencement of general solicitation in a Rule 506(c) offering. Is such an advance filing useful and appropriate for an effective analysis of the Rule 506(c) market? Should the 15-calendar day period be increased or decreased? Why or why not? Should the filing deadline be tied to the commencement of general solicitation or the commencement of the offering, whether or not general solicitation is used?

2. What should the consequences be for failing to timely file an Advance Form D for a Rule 506(c) offering? Should the filing of the Advance Form D be a condition to Rule 506(c) so that failure to file results in the immediate loss of Rule 506(c) as an exemption from Securities Act registration for the offering at issue?

3. We are proposing to require the filing of an Advance Form D no later than 15 calendar days before the first use of general solicitation in a Rule 506(c) offering. We recognize, however, the possibility that a communication could be inadvertently disseminated beyond the intended audience without the issuer's knowledge or authorization. What should be the consequences for the issuer under such circumstances? Should there be a different filing deadline for the Advance Form D when there is an inadvertent general solicitation? For example, under Rule 100(a)(2) of Regulation FD,[53] the information in a non-intentional selective disclosure must be publicly disclosed "promptly" after the issuer knows (or is reckless in not knowing) that the information selectively disclosed was both

[53] 17 CFR 243.100(a)(2).

material and non-public. Should a similar filing deadline be considered for an inadvertent general solicitation?

4. Should issuers be permitted to file an Advance Form D even if no specific offering is contemplated? Why or why not? How would this impact the usefulness of the Advance Form D data? We have identified certain information that we believe should be included in the Advance Form D. Is the information proposed for the Advance Form D the appropriate information to be provided at that point of the offering? Is there other information that issuers should provide in the Advance Form D? Would it be more difficult for issuers to provide certain information in an Advance Form D? If so, which information?

5. We are proposing that an issuer have the option of either filing an Advance Form D for Rule 506(c) offerings to provide certain information required by Form D, with the complete Form D information provided in a subsequent amendment to Form D filed no later than 15 calendar days after the first sale of securities, or providing all of the required Form D information in the Advance Form D, if known at that point in the offering. Should issuers be provided this option? Or should issuers be limited to providing certain specified information in the Advance Form D and required to file a subsequent amendment, after the first sale of securities, to provide the remainder of the information required by Form D? Would allowing issuers to have the option of providing all of the information required by Form D no later than 15 calendar days before they commence general solicitation (as compared to the current requirement of no later than 15 calendar days after the first sale of securities) affect the quality or usefulness of the Form D

information for purposes of the Commission's efforts to analyze the Rule 506 market? For example, what is the likelihood that issuers will be in a position to provide all of the information required by Form D no later than 15 calendar days before the commencement of general solicitation?

6. What would be the benefits of requiring the Advance Form D for Rule 506(c) offerings? What would be the costs to issuers, market participants and other parties? Would the requirement to file an Advance Form D deter issuers from conducting Rule 506(c) offerings? Would the requirement to file an Advance Form D have differing or unique effects on certain types of issuers, such as Exchange Act reporting companies, non-reporting companies, foreign companies or private funds?

7. Would potential investors or other market participants review Advance Form D filings on a real-time basis? If so, how would they use the information in the filings? How would state securities regulators use the Advance Form D filings?

8. Are there situations in which an Advance Form D filing should not be required? If so, what are these situations?

9. Should an Advance Form D filing be required before or at the commencement of all offerings under Rule 506, or all offerings under Regulation D? If not, why?

10. Are any other rule amendments necessary if the Commission were to require the advance filing of Form D for Rule 506(c) offerings, as proposed?

C. Form D Closing Amendment for Rule 506 Offerings

We are also proposing to amend Rule 503 to require the filing of a final amendment to Form D within 30 calendar days after the termination of any offering conducted in reliance on Rule 506. Regulation D does not currently contain a requirement to file a final amendment to Form D. When Regulation D was originally adopted, issuers were required to amend the Form D filing every six months during the course of an ongoing offering and were required to make a final Form D filing within 30 days of the final sale of securities in the offering.[54] In 1986, we eliminated these requirements, anticipating that removing the final Form D filing requirement would have negligible consequences for investors and would result in some savings for both issuers and the Commission.[55]

A number of commenters on the Rule 506(c) Proposing Release suggested that the Commission reinstate a closing Form D filing requirement to enhance the flow of information to the Commission, other regulators and investors, and to improve the ability of the Commission and others to track the use of Rule 506.[56] For example, one commenter stated that the "information provided in a closing amendment will be invaluable to the Commission and states in determining the extent to which issuers are making exempt public offerings."[57]

In order to gather more complete information about the size and characteristics of the Rule 506 offering market, we believe that it would be appropriate to propose requiring the filing of a closing amendment for offerings conducted in reliance on Rule 506. The proposed requirement would be in addition to the existing provisions of Rule 503 that require the filing of an amendment to Form D to correct a material mistake

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[54] See Release No. 33-6389.

[55] We noted at the time that "[t]he information contained in the original notification has proved sufficient for the Commission's enforcement surveillance for compliance with the requirements of Regulation D." Form D and Regulation D, Release No. 33-6663 (Oct. 2, 1986) [51 FR 36385, 36386 (Oct. 10, 1986)].

[56] See letters from NASAA; Ohio Division of Securities (July 3, 2012); Massachusetts Securities Division (July 2, 2012).

[57] Letter from Ohio Division of Securities (July 3, 2012).

of fact or error in a previously filed Form D, to reflect a change in information provided in a previously filed Form D except in certain instances, and on an annual basis for offerings that are ongoing. The filing of a separate closing amendment within 30 days after termination of the offering would not be required if all of the information that would be included in such an amendment has already been provided in a Form D filing and the issuer has checked the box for a closing filing in such filing.

As noted above, the Commission today has a greater ability to analyze the Regulation D offering market due to electronically-filed Forms D. In recent years, the Regulation D market has also grown considerably in size and significance.[58] These factors suggest that collecting information upon the termination of Rule 506 offerings would provide greater benefits than it did in 1986, when this requirement was eliminated.

We propose to require the filing of a closing amendment to Form D for offerings under both Rule 506(b) and Rule 506(c). This is, in part, to enable more complete analysis and comparison of the use of long-standing Rule 506(b) and new Rule 506(c). In addition, because the overwhelming majority of Regulation D offerings are conducted in reliance on Rule 506, and these offerings account for substantially all of the capital reported as being raised under Regulation D, this approach should provide the Commission with substantially complete information about the Regulation D market

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[58] See Vladimir Ivanov and Scott Bauguess, Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009-2012 (July 2013), available at http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf ("Ivanov/Bauguess Study").

without imposing additional compliance burdens on smaller offerings conducted in reliance on Rule 504 or Rule 505.[59]

A closing Form D amendment, in conjunction with changes to Form D to require additional information on Rule 506 offerings, as discussed below, would provide the Commission with more complete information about Rule 506 offerings. For example, under current rules, information about the amount of capital raised in a Regulation D offering is limited to the "total amount sold" as of the date of the last Form D filing. Any amounts sold between the date of the last Form D filing and the date the offering is terminated are not currently required to be reported on Form D. As a result, the actual amount of capital raised at the time the offering is terminated cannot be conclusively determined.[60]

Under our proposal, the closing amendment would be due no later than 30 calendar days after termination of the offering;[61] in contrast, Rule 503 formerly required a closing amendment to be made no later than 30 days "after the last sale of securities" in the offering.[62] Our proposed change addresses the potential concern that issuers may not know, at the time a sale is made, that such sale will be the last sale of securities in the offering. As proposed, the closing amendment must be filed when the issuer terminates the offering, whether after the final sale of securities in the offering or upon the issuer's determination to abandon the offering. Until the closing amendment is filed, the offering

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[59] See id. (in 2012, approximately 95% of Regulation D offerings claimed reliance on Rule 506; these offerings accounted for approximately 99% of capital reported as being raised under Regulation D for the year).

[60] For example, in 2010, issuers sought to raise $1.2 trillion in reported Regulation D offerings, but only $905 billion was reported as sold at the time of the initial filing. See id.

[61] See Proposed Rule 503(a)(4)(v).

[62] See Release No. 33-6389.

is deemed to be ongoing and the issuer would be subject to the current Rule 503 requirements to file amendments to Form D at least annually and otherwise as needed to reflect changes in previously filed information and to correct material mistakes and errors.[63]

Request for Comment

11. Should we require a closing Form D amendment for Rule 506 offerings, as proposed? Why or why not? Should the closing amendment requirement apply to all Regulation D offerings, as was the case when Regulation D was originally adopted? Alternatively, should the closing amendment requirement apply only to offerings under new Rule 506(c)? Are there situations where a closing amendment to Form D should not be required? If so, what are these situations? For example, should no closing amendment be required if no sales of securities have been made?

12. As proposed, a closing Form D amendment would be required to be filed not later than 30 calendar days after the termination of a Rule 506 offering. Should we use a different time frame for the filing of the closing Form D amendment? If so, why and how long?

13. We have not proposed that the filing of a closing amendment be a condition of Rule 506. If the closing amendment were a condition of Rule 506 and an issuer failed to make the required filing, the issuer would lose the exemption for the entire offering at issue, including sales that were made while the issuer was in

[63] 17 CFR 230.503(a)(3).

compliance with Rule 503. Should the filing of a closing Form D amendment be a condition to Rule 506(b) or Rule 506(c)?

14. As proposed, the closing amendment must be filed within 30 calendar days after the issuer terminates the offering. Should we provide a more detailed explanation of what constitutes the termination of an offering?

15. What would be the costs to issuers of filing a closing Form D amendment? Would a requirement to file a closing Form D amendment deter issuers from conducting Rule 506 offerings? Are there any costs or benefits that we have not discussed? If so, please specify.

16. What are the alternatives to requiring a closing amendment to Form D? For example, rather than requiring a closing amendment to Form D for all Rule 506 offerings, should the Commission only require an amendment when an issuer sells an amount of securities in excess of a certain percentage (for example, 10%) above the amount reported as sold in the last Form D or Form D amendment previously filed for the offering?

17. Rule 503(a)(3)(ii) currently requires issuers to file an amendment to a previously filed Form D to reflect changes in the information provided, subject to certain enumerated exceptions. Should the proposed closing amendment to Form D serve as a substitute for this type of Form D amendment? If the proposed closing amendment requirement is adopted, should Rule 503(a)(3)(ii) be eliminated or simplified, so that only certain changes (e.g., the size of the offering) would trigger the obligation to amend Form D?

18. Alternatively, in light of the proposal to impose disqualification from reliance on Rule 506 for failures to comply with Rule 503, as discussed in Section II.E below, should the Commission further amend Rule 503(a)(3)(ii), or provide additional guidance, in regard to the circumstances in which an amendment to Form D is or is not required? For example, should the Commission amend Rule 503 to set forth additional situations in which an amendment to Form D would not be required to reflect a change in the information provided in a previously filed Form D? Conversely, should the Commission amend Rule 503 to require the filing of an amendment to Form D to reflect a change in information where such amendment is not currently required under Rule 503?

19. As discussed in Section II.D below, we are proposing amendments to Form D to require additional information, primarily with respect to Rule 506 offerings. After an issuer files a Form D that includes this additional information, any change to this information (for example, a change in the number of purchasers who qualified as accredited investors or the methods used to verify accredited investor), would generally require the filing of an amendment to Form D under current Rule 503. Should the Commission amend Rule 503 so that an amendment to Form D would not be required when there is a change to some or any of this information? If so, which information and why?

20. Should issuers conducting ongoing offerings pursuant to Rule 506(c) be required to amend their Form D filings more frequently than on an annual basis to provide, to the extent that such information has not already been provided in a previous Form D filing, updated information regarding the dollar amount of any securities

sold during such period pursuant to such offering, and any other securities of the same class (or any securities convertible into or exercisable or exchangeable for securities of the same class) sold during such period pursuant to an exemption from the registration requirements of the Securities Act? If yes, how frequently? For example, on a semi-annual basis or a quarterly basis?

21. Rule 503 requires an amendment to a previously filed Form D to correct a material mistake of fact or error "as soon as practicable after discovery of the mistake or error" and an amendment to a Form D to reflect a change in the information previously provided, except in certain situations, "as soon as practicable after the change." Would such non-specific filing deadlines make it difficult for market participants to determine whether an issuer is disqualified from reliance on Rule 506 for failure to comply with Form D filing obligations, including the determination of when a cure period expires? Should the Commission consider amending Rule 503 to set forth more specific time frames for filing these amendments to Form D?

22. Should the Commission amend Rule 503 so that an annual amendment for an ongoing offering is required to be filed on a specified date, such as the one-year anniversary of the initial filing of a Form D or Advance Form D?

23. Should the Commission provide additional guidance on what constitutes a "material mistake of fact or error" that would necessitate the filing of a Form D amendment?

24. Rule 503(a)(4) currently requires an issuer that files an amendment to a previously filed Form D to provide current information in response to all

requirements of the form regardless of why the amendment is filed. Should the Commission amend this requirement in Rule 503? If so, how? What are the costs and benefits associated with this requirement?

25. Should the presentation of information in a closing Form D amendment be different than in an initial Form D filing or in other Form D amendments? If so, how?

26. If an issuer filed an Advance Form D but subsequently terminated the offering without selling any securities, what information should the issuer be required to provide regarding the offering in its closing amendment?

27. Are any other rule amendments necessary if the Commission were to require the filing of a closing amendment, as proposed? If so, please specify.

D. Proposed Amendments to the Content Requirements of Form D

We are proposing revisions to Form D to add information requirements primarily for Rule 506 offerings, which would enable the Commission to gather additional information on the use of Rule 506 and thereby assist the Commission in evaluating the impact of Rule 506(c) on the existing Rule 506 market.[64] We believe that such additional information may also be useful to state securities regulators and to investors. In the Rule 506(c) Adopting Release, we adopted a revision to Form D to add a separate field or check box in Item 6 of Form D for issuers to indicate whether they are relying on Rule

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[64] In April 2010, we proposed numerous changes to our rules related to offerings of asset-backed securities. See Asset-Backed Securities, Release No. 33-9117 (Apr. 7, 2010) [75 FR 23328 (May 3, 2010)]. That proposal included proposed revisions to Form D for offerings of structured finance products. Those proposed changes are still outstanding and are not being addressed in this release.

506(b) or Rule 506(c).[65] We believe that requiring issuers to indicate in Form D that they are relying on Rule 506(c) will provide important information to assist in our efforts to evaluate the use of general solicitation in Rule 506(c) offerings and the size of this offering market as well as provide notice to state regulators and investors about issuers seeking to rely on Rule 506(c). The proposed revisions to Form D set forth below would require additional information on Rule 506 offerings, including information specific to Rule 506(c) offerings, such as the types of general solicitation used and the methods used to verify the accredited investor status of purchasers, which we also believe will be useful.

A number of commenters on the Rule 506(c) Proposing Release recommended that the Commission further expand the information requirements of Form D in regard to offerings under Rule 506(c).[66] Some commenters stated that they supported amending Form D to require more information about the issuer's plans to engage in general solicitation and how the issuer plans to verify that purchasers are accredited investors.[67] The Investor Advisory Committee recommended that the Commission adopt either a new form or a revised version of Form D that would elicit information on, among other things, the control persons of the issuer, counsel representing the issuer (if any), the issuer's

[65] We also revised Item 6 of Form D by renaming the check box for "Rule 506," which will be renamed "Rule 506(b)," and the check box for "Section 4(5)," which will be renamed "Section 4(a)(5)" to update the reference to former Section 4(5) of the Securities Act.

[66] See, e.g., letters from AARP; AFL-CIO and AFR; Consumer Federation; Investor Advisory Committee; NASAA (referring to the recommendations in its July 3, 2012 letter); Massachusetts Securities Division (referring to the recommendations in its July 2, 2012 letter).

[67] See letters from AARP; AFL-CIO and AFR (stating that "the Commission should … expand Form D to require additional information regarding both planned general solicitation and advertising activities and plans for verification of accredited investor status"); Consumer Federation (stating that "[i]f the Commission wishes to monitor [accredited investor verification] practices, and we believe it must, it can best achieve that by requesting information on Form D regarding the issuer's verification plans.").

accountants or auditors (if any), the amount sought to be raised, a brief description of the issuer's general solicitation plans and a brief description of the issuer's proposed business and use of proceeds.[68] Another commenter proposed a list of expanded information requirements for Form D, including disclosure of the issuer's website; if the issuer is selling interests in a pooled investment fund, disclosure of any adviser to the fund and whether the adviser is registered as an investment adviser or is otherwise exempt; a warning that finder's fees may trigger state and federal salesperson and broker-dealer registration requirements; and certification that the offering is not disqualified under the proposed bad actor rules.[69] One commenter stated that Form D should be revised to indicate whether an offering will be conducted by means of an Internet platform, and if so, the identity of the Internet platform.[70] A number of commenters stated that the Commission should consider requiring additional information in Form D about the issuers that propose to engage in general solicitation activities under Rule 506.[71]

In contrast, one commenter urged the Commission not to require additional disclosures in Form D on the issuer's proposed business and use of proceeds. This commenter asserted that Form D currently requires appropriate information on the identity of the issuer and a factual description of the offerings.[72]

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68 See letter from Investor Advisory Committee.

69 See letter from NASAA (referring to suggested revisions to Form D in its July 3, 2012 letter).

70 See letter from Massachusetts Securities Division (July 2, 2012).

71 See, e.g., letters from Consumer Federation (stating that "[t]he Form D filing requirement could provide greater benefit to investors as well if its content was expanded to include basic information about the issuer"); Fund Democracy, Consumer Action, Consumer Federation, AFL-CIO and AFR (May 24, 2012) (stating that "[t]he Commission should also consider requiring disclosure of additional information in Form D about issuers that propose to engage in [general solicitation] activities").

72 See letter from MFA (Mar. 22, 2013). This commenter also recommended that investment advisers be permitted to comply with any information requirement on Form D by either providing a reference to a publicly available Form ADV applicable to a private fund or to any publicly available information filed

We believe that amending Form D to require additional information on Rule 506 offerings would enable the Commission to better analyze the impact on the existing Rule 506 market of eliminating the prohibition against general solicitation in Rule 506(c) offerings. This information would enhance the ability of the Commission to evaluate the use of Rule 506(c) by requiring information in Form D on the types of investors that participate in Rule 506(c) offerings, the issuer's plans to engage in general solicitation and methods used to satisfy the verification requirement in Rule 506(c). This information may also be useful to investors seeking to learn more about an offering being conducted pursuant to Rule 506(c) or about the types of issuers conducting these offerings. Finally, this information may be useful in facilitating enforcement efforts should any fraud or other securities law violations occur in these offerings. As discussed below, we propose to revise existing Item 2, Item 3, Item 4, Item 5, Item 7, Item 9, Item 14 and Item 16 of Form D and to add new Items 17 through 22 to Form D.

Item 2, which requires the issuer to provide principal place of business and telephone contact information, would be amended to require the identification of the issuer's publicly accessible (Internet) website address, if any. We are proposing this change because issuers are increasingly using their public websites as vehicles for the dissemination of information to investors, while many investors are turning to company websites as sources of information to aid in their investment decisions.[73] We believe that the identification of the issuer's public website address in Form D would be useful in gathering additional information on the issuers that conduct offerings under Regulation

with a state regulator, depending on whether the investment adviser is registered with the Commission or with a state.

[73] See, e.g., Commission Guidance on the Use of Company Web Sites, Release No. 34-58288 (Aug. 1, 2008) [73 FR 45862 (Aug. 7, 2008)].

D. This proposed amendment would apply to offerings under Rule 504, Rule 505, Rule 506 and Section 4(a)(5).

Item 3, which requires information about "related persons" (executive officers, directors, and persons performing similar functions for the issuer, as well as persons who have functioned as a promoter of the issuer within the prior five years), would be amended to require, when the issuer is conducting a Rule 506(c) offering, the name and address of any person who directly or indirectly controls the issuer in addition to the information currently required for "related persons." We believe that more comprehensive information about persons who exercise control over the issuer would be helpful in obtaining a more complete picture of the issuers and other market participants that are involved in Rule 506(c) offerings.

In 2008, we deleted the requirement in Item 3 to identify as "related persons" owners of 10% or more of a class of the issuer's equity securities. In proposing this change to Item 3, we stated, among other things, that "we believe we can collect sufficient information to satisfy the regulatory objectives of Form D by requiring only the identification of executive officers, directors, and promoters."[74] We also noted that "issuers that are not reporting companies have raised privacy concerns with respect to the requirement to identify 10% equity owners who are not executive officers, directors, or promoters because they do not already have to disclose this information, and the widespread availability of the information on our website may raise additional privacy concerns for these companies as they seek to raise capital through a private offering."[75]

[74] Release No. 33-8891.

[75] Id.

While we continue to recognize these privacy concerns for issuers that conduct offerings under Rules 504, 505 and 506(b), we believe that this additional information on controlling persons who are not "related persons" could assist us in developing a more comprehensive understanding of the market participants in the Rule 506(c) market.

Item 4, which requires the issuer to identify its industry group from a specified list, would be amended to require the issuer to fill in a "clarification" field if the issuer checks the "Other" box. Though Item 4 currently includes a number of different industry group classifications, we believe that requiring the issuer to further describe its industry group when it is not included in the pre-established list will enhance our understanding of the types of issuers that are seeking to rely on Regulation D, while imposing a minimal burden on the issuer. This information will assist us in having more complete information regarding the range of industries of the companies using Rule 506. Without this additional requirement, conclusions drawn regarding industry trends would exclude all those issuers who checked "Other." This proposed amendment would apply to offerings under Rules 504, Rule 505, Rule 506 and Section 4(a)(5).

Item 5, which requires information on issuer size, would be amended to replace the "Decline to Disclose" option with a "Not Available to Public" option. We are proposing this change because we believe that an operating company that includes information about its revenues, or a hedge fund or other investment fund that includes information about its net asset value, in general solicitation materials for a Rule 506(c) offering, or that otherwise makes such information publicly available, should be required to provide revenue range or net asset value range information, as applicable, in Form D. If, however, the issuer does not include this information in general solicitation materials for a Rule 506(c) offering, does not otherwise make the information publicly available and otherwise uses reasonable efforts to maintain the confidentiality of such information, we believe that the issuer should have the option of not providing such information by choosing a "Not Available to Public" checkbox. This proposed amendment would also apply to Rule 504 and Rule 505 offerings, as well as offerings under Section 4(a)(5). Requiring issuers to include this information, to the extent they otherwise publicly disclose it, would be useful to the Commission's staff in evaluating the type or size of issuers using these exemptions.

Item 7, which requires the issuer to state whether a Form D is an initial filing or an amendment to a previously filed Form D, would be amended to add separate fields or check boxes for issuers to indicate whether they are filing an Advance Form D or a closing Form D amendment. We are proposing this change in connection with our proposals to require the filing of an Advance Form D for Rule 506(c) offerings and the filing of a final amendment to Form D after the termination of any offering conducted in reliance on Rule 506. The addition of these check boxes would require issuers to identify clearly in a Form D whether the Form D is an Advance Form D or a closing Form D amendment and could provide information about the beginning and ending of offerings that could be useful in analyzing the market.

Item 9, which requires information on the types of securities offered, would be amended to require information, to the extent applicable, on the trading symbol and a generally available security identifier ("security identifier") for the offered securities.[76]

[76] We recognize that the CUSIP number is in common use domestically for this purpose, but anticipate that other suitable identifiers may become available in the future.

In general, this amendment would be relevant only to issuers that have securities of the same class as the offered securities traded on a national securities exchange, alternative trading system ("ATS") or any other organized trading venue. We are proposing this change because we believe that requiring these types of issuers to provide the trading symbol and security identifier for the securities being offered, if any, would provide useful information on the nature of the securities being offered in Rule 506 offerings, as well as assist us in additional data gathering with respect to these offerings, without placing an undue burden on issuers.[77] This proposed amendment would also apply to offerings under Rule 504, Rule 505 and Section 4(a)(5).

Item 14, which elicits information on whether securities have been or may be sold to non-accredited investors and the number of investors who have already invested in the offering, would be amended to add a table requiring, with respect to Rule 506 offerings, information on the number of accredited investors and non-accredited investors that have purchased in the offering, whether they are natural persons or legal entities and the amount raised from each category of investors. We believe that this additional information would be useful in determining, among other things, the composition of investors who invest in Rule 506 offerings, the respective amounts they have invested, and the types of offerings and issuers in which each category of investors invests.

Item 16, which requires information on the amount of the gross proceeds of the offering that the issuer used or proposes to use for payments to related persons, would be

[77] We note that, in 2007, we requested comment on whether it would be appropriate to require information on CUSIP numbers and trading symbols in Form D and that we did not require this information in Form D in connection with the Form D amendments we adopted in 2008. See Electronic Filing and Simplification of Form D, Release No. 33-8814 (June 29, 2007) [72 FR 37376 (July 9, 2007)] and Release No. 33-8891. In light of the adoption of Rule 506(c), we are proposing to require this information in Form D at this time because we believe that this information would enable us to engage in expanded analysis of the Form D data for Rule 506 offerings.

amended to require information on the percentage of the offering proceeds from a Rule 506 offering that was or will be used: (1) to repurchase or retire the issuer's existing securities; (2) to pay offering expenses; (3) to acquire assets, otherwise than in the ordinary course of business; (4) to finance acquisitions of other businesses; (5) for working capital; and (6) to discharge indebtedness. This additional information requirement would apply only to Rule 506 offerings by issuers that are not pooled investment funds. This information would enable the Commission and investors to better understand why issuers are seeking to raise capital using Rule 506.

The proposed new items of Form D – Items 17 through 22 – would require issuers to provide the following additional information with respect to offerings conducted pursuant to Rule 506:

- the number and types of accredited investors that purchased securities in the offering (e.g., natural persons who qualified as accredited investors on the basis of income or net worth);
- if a class of the issuer's securities is traded on a national securities exchange, ATS or any other organized trading venue, and/or is registered under the Exchange Act, the name of the exchange, ATS or trading venue and/or the Exchange Act file number and whether the securities being offered under Rule 506 are of the same class or are convertible into or exercisable or exchangeable for such class;
- if the issuer used a registered broker-dealer in connection with the offering, whether any general solicitation materials were filed with FINRA;

- in the case of a pooled investment fund advised by investment advisers registered with, or reporting as exempt reporting advisers[78] to, the Commission, the name and SEC file number for each investment adviser who functions directly or indirectly as a promoter[79] of the issuer;
- for Rule 506(c) offerings, the types of general solicitation used or to be used (e.g., mass mailings, emails, public websites, social media, print media and broadcast media);[80] and
- for Rule 506(c) offerings, the methods used or to be used to verify accredited investor status (e.g., principles-based method using publicly available information, documentation provided by the purchaser or a third party, reliance on verification by a third party, or other sources of information; one of the methods in the non-exclusive list of verification methods in Rule 506(c)(2)(ii); or another method).

Some of this additional information would be specific to Rule 506(c) offerings and would enable the Commission to develop a greater understanding of the new Rule 506(c)

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[78] An exempt reporting adviser is an investment adviser that qualifies for the exemption from registration under Section 203(l) of the Investment Advisers Act of 1940 (the "Advisers Act") [15 U.S.C. 80b-3(l)] because it is an adviser solely to one or more venture capital funds, or under Rule 203(m)-1 under the Advisers Act [17 CFR 275.203(m)-1] because it is an adviser solely to private funds and has assets under management in the United States of less than $150 million. See Glossary of Terms to Form ADV.

[79] The definition of promoter in Rule 405 [17 CFR 230.405] includes any person who, acting alone or in conjunction with one or more other persons, directly or indirectly takes initiative in founding and organizing the business or enterprise of an issuer or any person who, in connection with the founding and organizing of the business or enterprise of an issuer, directly or indirectly receives in consideration of services or property, or both services and property, 10 percent or more of any class of securities of the issuer or 10 percent or more of the proceeds from the sale of any class of such securities. However, a person who receives such securities or proceeds either solely as underwriting commissions or solely in consideration of property shall not be deemed a promoter within the meaning of this paragraph if such person does not otherwise take part in founding and organizing the enterprise.

[80] We expect that the categories of social media, print media and broadcast media would be limited to efforts by the issuer, or an agent of the issuer, to directly communicate to potential investors, such as paid advertisements.

market. Other additional information requirements would apply to all Rule 506 offerings. As stated above, the adoption of Rule 506(c) has increased the need for information on Rule 506 offerings in general, in order to assess not only the nature and characteristics of the new Rule 506(c) market but also the changing nature of the Rule 506 market as a whole. We believe that requiring this additional information for all Rule 506 offerings would be useful to the Commission, investors and state regulators.

Although the proposed revisions to Form D primarily require additional information with respect to Rule 506 offerings, we note that the proposed revisions to Item 2, Item 4, Item 5 and Item 9 would require additional information on offerings under Rule 504, Rule 505 and Securities Act Section 4(a)(5). For the same reasons stated above, we believe that if an issuer has made information on its size publicly available, or does not take reasonable efforts to maintain such information as confidential, the issuer should be required to provide this information under Item 5 of Form D for offerings under the other Regulation D exemptions or under Section 4(a)(5). Similarly, we believe that the proposed additional information in Item 2, Item 4 and Item 9 would provide useful information on the nature of the issuers and the offered securities in regard to offerings under Rule 504, Rule 505 or Section 4(a)(5), while any additional burden on issuers in providing this information would be minimal.

Request for Comment

28. Should we require issuers to provide additional information in Form D filings as we have proposed? Should this additional information be required only for Rule 506(c) offerings? If so, why and what should that information be? For example, should the Commission require issuers to provide information in

Form D about counsel representing the issuer (if any) or the issuer's accountants or auditors (if any), as some have suggested? If the additional information were required only for Rule 506(c) offerings, what impact would this requirement have on the use of Rule 506(c) as compared to the use of Rule 506(b)? Are there particular items of information that do not provide sufficiently useful information or would be especially burdensome for issuers to provide? Should some of the additional information that we propose to require in Form D not be required for offerings under Rule 506(b)? If so, which requirements and why? Would the additional information that we propose to request in Form D provide useful information to state securities regulators in responding to inquiries from constituents about offerings conducted under Rule 506 and in enforcement efforts?

29. What are the costs or burdens on issuers in providing the additional information in Form D, as proposed? Are there ways to reduce any costs or burdens on issuers? Would the requirement to provide this additional information result in issuers choosing not to rely on Rule 506 to raise capital?

30. Should some of the additional information that we propose to require in Form D be required only in the closing amendment to Form D?

31. Should the Commission define what it means for an issuer to make information publicly available for purposes of Item 5, or to take reasonable efforts to maintain such information as confidential? For instance, would confidential information about an issuer that is publicly disseminated by a third party in violation of a duty to keep such information confidential be deemed to be publicly available?

32. Should the Commission amend Item 5 to require an issuer that conducts a Rule 506(c) offering to provide information on its revenue range or aggregate net asset value range, as applicable, regardless of whether the issuer has otherwise made this information publicly available (for example, by including this information in general solicitation materials)?

33. Should the Commission amend Form D to include a check box for issuers to indicate whether they are filing an Advance Form D or a closing amendment to Form D, as proposed? Should there be other changes to Form D to indicate that an issuer is filing an Advance Form D or a closing amendment?

34. Should the Commission amend Form D to provide a checkbox to indicate that the issuer is required to provide disclosure of prior "bad actor" events under Rule 506(b)(2)(iii)?

35. Should pooled investment funds be required to provide additional or different information in connection with Rule 506(c) offerings? Should the Commission require a pooled investment fund to disclose its investment adviser's CRD[81] number rather than (or in addition to) its adviser's SEC registration number? Item 3 of Form D asks for the identity of the issuer's promoter. Should information on a pooled investment fund's investment adviser be added to Item 3, rather than the proposed Item 20? Does the proposed amendment to Item 3, requiring disclosure of any controlling persons, raise any particular concerns for pooled investment funds?

[81] A Central Registration Depository ("CRD") number is a system identification number assigned to each investment adviser that registers or files reports with the SEC or a state through the Investment Adviser Registration Depository website. The website facilitates registration of investment advisers and reporting by exempt reporting advisers. CRD numbers also are assigned to broker-dealers.

36. Should the Commission require issuers to provide more or less specific information in Form D about the methods of general solicitation used in Rule 506(c) offerings? Do certain methods of general solicitation raise particular concerns from an investor protection standpoint? For example, are some methods of general solicitation more likely to result in an increased risk of fraud or manipulation or more likely to reach non-accredited investors? Should we require additional information in Form D with respect to these methods of general solicitation? If so, what information should we require issuers to provide regarding these solicitation methods?

37. Should the Commission require issuers to provide more or less specific information on Form D about the methods used to verify accredited investor status? If so, what information should the Commission require issuers to provide regarding verification practices? For example, should we require issuers to identify any registered broker-dealers, registered investment advisers, attorneys, certified public accountants or other third parties that assisted the issuer with the verification process?

E. Proposed Amendment to Rule 507

We are proposing an amendment to Rule 507 of Regulation D that is intended to improve Form D filing compliance in connection with Rule 506 offerings. Rule 507 currently only disqualifies an issuer from using Regulation D if the issuer, or a predecessor or affiliate, has been enjoined by a court for violating the filing requirements in Rule 503. We propose to amend Rule 507 so that, in addition to the existing disqualification from Rules 504, 505 and 506 of Regulation D that arises from a court injunction, an issuer would be disqualified automatically from using Rule 506 in any new offering for one year if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the past five years, with Form D filing requirements in a Rule 506 offering; provided that such one-year period would commence following the filing of all required Form D filings or, if the offering has been terminated, following the filing of a closing amendment.

When Regulation D was originally adopted in 1982, compliance with Form D filing obligations was a condition of Rules 504, 505 and 506. In 1989, the Commission amended Regulation D to eliminate the filing of Form D as a condition to those rules.[82] The Commission did so with the expectation that the concurrent adoption of Rule 507 would provide an incentive for issuers to file Form D.[83] In fact, the disqualification provision of Rule 507 has rarely been invoked since its adoption,[84] and we understand that some issuers are not filing a Form D for Rule 506 offerings.[85]

A number of commenters on the Rule 506(c) Proposing Release, including the

[82] See Release No. 33-6825.

[83] See id.

[84] In order to invoke the Rule 507 disqualification provision, the Commission must first bring a civil injunctive action in a federal district court and receive a court order enjoining the defendant from future violations of Rule 503. The Commission has brought few such enforcement actions. See SEC v. Printz Capital Management, No. 10-7379 (E.D. Pa. Mar. 15, 2011) (order enjoining defendants from, among other things, failing to file a Form D for a Regulation D offering).

[85] Many commenters have asserted that non-compliance with Form D filing obligations is widespread. See, e.g., letters from Investor Advisory Committee (stating that "[i]t is generally acknowledged that a significant number of issuers do not currently file Form D..."); AARP (stating that "[s]imply adding a checkbox to a form that too often goes unfiled and then only after the fact is inadequate to the task at hand."); AFL-CIO and AFR (stating that "many issuers today flout the Form D filing requirement for such offerings, further limiting the Commission's ability to provide effective oversight"). See also Securities and Exchange Commission, Office of Inspector General, Regulation D Exemption Process (Mar. 31, 2009) ("OIG Report"), available at http://www.sec-oig.gov/Reports/AuditsInspections/2009/459.pdf (stating that while the Commission staff "strongly encourage companies to comply with Rule 503, they are aware of instances in which issuers have failed to comply with Rule 503…"). Based on its analysis of the filings required by FINRA Rules 5122 and 5123 during the period of December 3, 2012 to February 5, 2013, DERA estimates that as much as 9% of the offerings represented in the FINRA filings for Regulation D or other private offerings that used a registered broker-dealer did not have a corresponding Form D filing. See Section IX.B.4.a of this release.

Investor Advisory Committee, urged us to require the filing of Form D as a condition to Rule 506(c), so that the failure to file a Form D would result in the loss of the exemption for the offering.[86] One commenter stated that it generally supported conditioning the availability of Regulation D on the filing of Form D, provided that an issuer that filed a Form D in good faith but with inadvertent technical errors would have an adequate opportunity to cure its mistake while relying on Regulation D.[87]

Other commenters argued against conditioning Rule 506(c) on the filing of a Form D.[88] One commenter stated that such a condition would have potential negative effects on the private placement market.[89] Another commenter argued that if Rule 506(c) were conditioned on the filing of a Form D, the consequences of losing the exemption would be significantly disproportionate to the harm of failing to file the Form D, including the loss of "covered security" status under Section 18 of the Securities Act.[90] One commenter maintained that conditioning the availability of the exemption on the filing of a Form D would be inappropriate in light of the purpose of Form D to enable the Commission to better understand and analyze how Regulation D is being used.[91]

We believe it is appropriate to strengthen the incentives for issuers to comply with Rule 503, which would make it more likely that the Commission will obtain Form D data

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[86] See letters from Investor Advisory Committee (stating that "[t]he filing of Form D should be made a condition for relying on the Regulation D exemption."); Massachusetts Securities Division (referring to the recommendations in its July 2, 2012 letter); NASAA; Consumer Federation; AARP.

[87] See letter from MFA (Mar. 22, 2013).

[88] See letters from Committee on Securities Regulation of the New York City Bar Association; Federal Regulation of Securities Committee, Business Law Section of the American Bar Association ("ABA Fed. Reg. Comm."); Securities Regulation Committee, Business Law Section of the New York State Bar Association ("SRC of NYSBA"); Linklaters LLP.

[89] See letter from Linklaters LLP.

[90] See letter from SRC of NYSBA.

[91] See letter from ABA Fed. Reg. Comm.

that provides a more complete perspective on Rule 506(c) offerings and the Rule 506 marketplace as a whole, thereby facilitating efforts by both the Commission and state securities regulators to analyze developments in that marketplace. Further, we believe that an effective incentive for issuers to comply with the Form D filing requirement is one that results in meaningful consequences for failing to file the form, without requiring action on the part of the Commission or the courts. We are nonetheless mindful that the incentive should be commensurate to the obligation so that the failure to comply does not give rise to disproportionate consequences.

Although we considered requiring compliance with Rule 503 as a condition of Rule 506, or at least Rule 506(c), we have determined not to propose making Form D filing a condition of Rule 506. We are reluctant to impose a sanction on an issuer as severe as the loss of a Securities Act exemption, which would give purchasers rescission rights and result in loss of "blue sky" pre-emption,[92] for failure to file a form that is intended primarily to provide information to the Commission. If compliance with Rule 503 were reinstated as a condition to Rule 506, then non-compliance at any stage of an offering could result in the entire offering being held to violate Section 5 of the Securities Act and applicable state securities laws. For example, in the case of a continuous or long-lived offering, this could mean that an issuer's failure to file an annual amendment or closing amendment would trigger loss of the Securities Act exemption, which would give purchasers rescission rights and result in loss of blue sky pre-emption

[92] Section 18 of the Securities Act exempts "covered securities" from state review and registration requirements. Under Section 18(b)(4)(D), "covered securities" is defined to include securities offered or sold in transactions pursuant to Commission rules issued under Section 4(a)(2). Thus, if an offering fails to comply with Rule 506, the securities offered and sold in the offering would not be "covered securities," and the issuer would violate state law unless it had complied with applicable review and registration requirements or could avail itself of a state law exemption.

for offers and sales that occurred, in certain cases, years before the failure to file a Form D triggered the loss of an exemption. We believe that the consequences of a Section 5 violation would be disproportionate in those circumstances. More generally, we are concerned about possible disruptions in the Rule 506 market if market participants could not be certain of the availability of Rule 506 for an offering until after the offering was terminated and all filings required under Rule 503 were made. We are, however, soliciting comment on whether Rule 506 should be conditioned on Form D filing compliance.

Instead of making the Form D filing a condition to Rule 506, we propose to amend Rule 507 by adding new paragraph (b), under which issuers would be disqualified from using Rule 506 for future offerings if they, or their predecessors or affiliates, had failed to comply within the past five years with the Form D filing requirements of Rule 503 in connection with an offering under Rule 506.[93] Under proposed Rule 507(b), disqualification would end one year after the required Form D filings are made or, if the offering has been terminated, one year after a closing amendment is made.[94] We believe that a one-year disqualification period, which would not commence until the required filings are made, should create a significant incentive to file Form D on a timely basis without unduly burdening market participants.

The proposed disqualification would not affect offerings of an issuer or an affiliate that are ongoing at the time of the filing non-compliance, including the offering for which the issuer failed to make a required filing, and these offerings could continue to

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[93] Existing Rule 507(b) would be redesignated as Rule 507(c).

[94] See Proposed Rule 507(b).

rely on Rule 506 as long as the conditions of Rule 506 continue to be met. Disqualification would apply only to future offerings. We further propose that disqualification from using Rule 506 for future offerings would be subject to a cure period and the waiver provisions in Rule 507, as discussed below. As with the proposed closing amendment requirement and for the same reasons, we propose to apply new Rule 507(b) to all offerings under Rule 506.

Under the proposal, disqualification would arise only with respect to non-compliance with Rule 503 that occurred after the effectiveness of new Rule 507(b). We considered whether to apply the disqualification for failure to comply with the filing requirement before the effective date of the rule. We are not proposing such a requirement. We are proposing to include a five-year look-back period, so that non-compliance that occurred more than five years before the commencement of a Rule 506 offering would not trigger disqualification, even if the required Form D filings had not been made. We believe that this limitation would avoid potential burdens on market participants that might otherwise be created, such as the possibility of indefinite disqualification in situations where it is not possible for the required Form D filings for a previous offering to be made, without undermining the incentive for issuers in Rule 506 offerings to comply with their Form D filing obligations. A look-back period would also reduce the cost of confirming whether an issuer is disqualified from reliance on Rule 506, and could reduce the number of delinquent filings required to be made before the one-year disqualification period starts to run. The look-back period would not extend past the effective date of the rule, so issuers seeking to conduct a Rule 506 offering would assess compliance with Rule 503 by looking back only to the effective date of the disqualification rule.

Disqualification would arise based on non-compliance with Rule 503 by the issuer and its predecessors and affiliates, as provided in current Rule 507. We believe that proposed Rule 507(b) should be structured in this manner so that an issuer cannot avoid disqualification by simply conducting future offerings through a successor or other affiliated entity. We are soliciting comment on whether this approach is appropriate for all issuers.

Because this approach creates potentially significant consequences for an issuer's future capital-raising activities based on its failure to file or amend the form for a current or prior offering, we anticipate that proposed Rule 507(b), if adopted, could significantly reduce non-compliance with Form D filing requirements for Rule 506 offerings. We further believe that disqualification from using Rule 506 for a one-year period after all required Form D filings have been made is a sufficient period of time to incentivize compliance with Rule 503 while at the same time not serving as a disproportionate penalty for the failure to file or amend Form D.

When we amended Regulation D to remove Rule 503 compliance as a condition to Rules 504, 505 and 506, we noted that the Form D filing condition was subject to frequent criticism.[95] As discussed above, however, the usefulness of Form D filings has increased significantly since we required them to be filed in electronic form on EDGAR. In addition, the proposed amendment differs from the prior Rule 503 condition in that the amendment would impose disqualification only prospectively and would not apply to any offerings that are ongoing at the time of filing non-compliance. Disqualification would

[95] See Release No. 33-6759.

also be limited to one year after all Form D filing requirements have been satisfied, and the look-back period for Rule 506 offerings that were not in compliance with Rule 503 would be limited to five years and would not extend to non-compliance that occurred prior to the effective date of proposed Rule 507(b).

The proposed amendment also includes mitigating provisions that were not applicable when compliance with Rule 503 was a condition to Regulation D. As discussed below, under the proposal, there would be a cure period for late filings, as well as recourse to the waiver provision of Rule 507, under which disqualification may be waived by the Commission for good cause shown. We believe that these provisions should help address concerns regarding the disproportionality and consequences of inadvertent failures to file or amend Form D.

Cure period. We propose that, solely for purposes of determining whether disqualification under Rule 507 would arise, issuers would generally be regarded as having complied with the Rule 503 filing deadlines for a Form D or Form D amendment if they filed the relevant filing within a cure period after the filing is due under Rule 503.

A number of commenters expressed concern about the possibility that an issuer could be unfairly penalized for inadvertent technical errors relating to its Form D filing and recommended that the Commission provide an opportunity for the issuer to correct such errors.[96] We recognize this concern and therefore propose a cure period of 30

[96] See, e.g., letters from MFA (Mar. 22, 2013) (stating that "[w]e generally support the filing of Form D being made a condition to relying on Regulation D, provided that an issuer that filed the Form in good faith but with inadvertent technical errors in the Form would have sufficient opportunity to cure its mistake while maintaining its reliance on Regulation D.... Upon notice of such an error, a fund manager or issuer should be provided a reasonable period of time to file a corrected Form D."); Investor Advisory Committee (stating that "[i]n implementing this recommendation [to condition a Regulation D exemption on the filing of Form D], which is intended to encourage broad compliance with the filing requirement, the Committee encourages the Commission also to consider incorporating measures to ensure that it does not impose

calendar days, which would be available in the case of an issuer's failure to file a Form D or Form D amendment on a timely basis. This provision is intended to allow an additional period of time in which issuers could detect a failure to file or amend Form D (for example, due to clerical error or technological problem) and make the requisite filing. We believe that 30 calendar days is a sufficient period of time for issuers to address an inadvertent error and that a longer period may have the effect of encouraging a greater degree of non-compliance with the deadlines for Form D filings. By including a cure period of 30 calendar days, we would provide issuers with certainty that the benefits of Rule 506 would remain available so long as a failure to file Form D was corrected during the specified time frame.

The proposed cure period would be available only for an issuer's first failure to file timely a Form D or Form D amendment in connection with a particular offering. We believe that permitting issuers to repeatedly rely on the 30-day cure period for Form D filings for the same offering would undermine incentives to comply with the filing deadlines specified in Rule 503.

Waiver. Rule 507 currently provides that disqualification under the rule may be waived by the Commission if the Commission determines "upon a showing of good cause, that it is not necessary under the circumstances that exemption be denied."[97] This formulation is substantially the same as the waiver provision included in new Rule 506(d), the bad actor disqualification provisions for Rule 506 adopted today.[98] We believe that the Commission should have the ability to waive disqualification in situations

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undue penalties for inadvertent violations by small, unsophisticated issuers.").

[97] Rule 507(b).

[98] See Rule 506(d)(2)(ii).

where an issuer or its predecessors or affiliates have failed to comply with Rule 503, provided that the issuer can demonstrate good cause that it is not necessary to deny the exemption. For example, a waiver may be appropriate if an issuer can show that the persons who controlled the issuer at the time of the failure to file no longer exercise influence over it, or if curing the failure is impossible (for example, because a defaulting affiliate no longer exists and therefore cannot make the missing Form D filings or amendments) and good cause can otherwise be shown that it is not necessary in the circumstances to deny the exemption.

Under current rules, the Commission has delegated authority to the Director of the Division of Corporation Finance to grant disqualification waivers under Rule 507.[99] We anticipate that, if the proposal were adopted, we would similarly delegate authority for waivers of disqualification under new Rule 507(b).

Request for Comment

38. Is disqualifying issuers and their affiliates and successors from reliance on Rule 506 for future offerings an appropriate sanction to incentivize compliance with Form D filing requirements? Why or why not? How would these amendments affect the Rule 506 market?

39. Proposed Rule 507(b) would not impose any consequences with respect to the offering for which an issuer failed to file or amend a Form D as required, or for other offerings that were ongoing at the time of the failure to file. Would disqualification from reliance on Rule 506 for future offerings be a sufficient incentive for issuers to comply with Form D filing requirements? Why or why

[99] See Rule 30-1(c) of the Commission's Rules of Organization and Program Management [17 CFR 200.30-1(c)].

not? Should an issuer engaged in an ongoing offering be permitted to continue relying on Rule 506 if it or an affiliate failed to comply with the filing requirements of Rule 503?

40. Should the result be the same for failure to comply with all parts of Rule 503? For example, should the result be the same when the issuer does not file an amendment to a Form D as it would when the issuer does not make an Advance Form D filing or an initial Form D filing? Should there be a distinction between annual amendments to Form D and amendments required to correct a material mistake of fact or error or to reflect a change in information?

41. As proposed, outside of the cure period, disqualification under Rule 507(b) would not be lifted until one year after all required Form D filings are made or, in the case of offerings that had been terminated, a closing amendment is made. Is this an appropriate requirement? If not, what are the alternatives?

42. What would be an appropriate disqualification period as an alternative to the proposal, such that issuers would be sufficiently incentivized to comply with Form D filing obligations without unduly burdening capital formation under Regulation D? Is the proposed one-year disqualification period appropriate, or should the disqualification period be shorter or longer? Why?

43. Under the proposal, disqualification would not be triggered by any failure to comply with Rule 503 that occurred more than five years before the offering. Is it appropriate to include a look-back period in this way? Why or why not? If so, is the five-year period proposed appropriate, or should it be shorter or longer? If so, why?

44. The look-back period would not extend to the period prior to the effective date of proposed Rule 507(b). Is it appropriate not to consider these filings before the effective date of the rule? Why or why not?

45. Are there particular situations where disqualification under Rule 507(b) should not be triggered for failure to file a required Form D or Form D amendment?

46. As proposed, issuers would be disqualified from using Rule 506 based on noncompliance with Rule 503 within the past five years in connection with a Rule 506 offering by their predecessors and affiliates. Is it appropriate to disqualify issuers for non-compliance by their predecessors and affiliates? If not, would it be too easy to avoid disqualification by using an affiliate or successor entity to conduct a Rule 506 offering? How should the Commission address this concern?

47. Would portfolio companies that are affiliates of a private fund be unduly affected by any disqualification triggered by noncompliance of the private fund, its predecessors and its affiliates with Rule 503? If so, should the Commission treat portfolio companies of private funds differently for disqualification purposes? If yes, how?

48. Is it appropriate to prohibit a private fund or its successors or affiliates from engaging in a subsequent offering under Rule 506 if the private fund failed to comply with Rule 503? For instance, if a private fund issuer fails to file its Form D or the appropriate amendments in accordance with the filing requirements of Rule 503, is it a disproportionate response to prohibit any private funds affiliated with the private fund from relying on Rule 506? Should proposed

Rule 507(b) contain an express provision that excludes affiliated private funds from such consequences?

49. Is it appropriate to include a cure period for noncompliance with Rule 503? Would the benefits of including a cure period justify the potential detriments, such as undercutting issuers' incentive to comply with the existing Rule 503 filing deadlines? If a cure period is included, should it apply to all required Form D filings, or only some? For example, should there be a cure period for the closing amendment only? Or for amendments, but not the initial filing? Should the Advance Form D have a cure period? Instead of providing a cure period, should we move back the deadlines for Form D filings? Are there other alternatives to a cure period or further provisions that the Commission should consider?

50. The cure period is not available if the issuer has previously failed to comply with a Form D filing deadline in connection with the same offering. Is this condition appropriate? Why or why not? Should the cure period be available if the issuer has failed to timely file a Form D or Form D amendment more than once in connection with the same offering? If so, how many times in a single offering or otherwise how frequently should an issuer be able to invoke the cure period? Should the cure period become available again after a certain amount of time, such as five years, has elapsed since the issuer previously failed to comply with a Form D filing deadline?[100] Should we impose additional requirements or conditions on an issuer's ability to take advantage of the cure period? For

[100] For example, should an issuer, such as a private fund, that is conducting a continuous offering be permitted to have a cure period if five or more years have elapsed since the initial failure to timely file a Form D?

example, should the cure period be unavailable if the failure to file Form D was intentional? Would additional guidance be necessary to explain what constitutes intentional or repeated failures to file? Should the issuer have to indicate that the filing is late and state the reason for its being late? Should there be more specific requirements to rely on the cure, such as the issuer suffered an intervening event (for example, a clerical or technological problem)? Alternatively, should the cure period be automatically available to all issuers without other conditions or qualifications? Are there other events that should make the cure period unavailable to an issuer?

51. Should a cure period be available for repeated or intentional failures to comply with Rule 503? If yes, should there be a look-back period for determining whether failures to comply with Rule 503 are repeated?

52. If a cure period is included, is the 30-day period we propose appropriate? Should the cure period be shorter or longer? Should it be the same for all types of filings, or should the Commission vary the cure period for different filings? For example, should there be a shorter or longer cure period provided for the Advance Form D filing, the closing amendment or other amendments, compared to other Form D filings?

53. As an alternative or in addition to a cure period, should we amend Rule 507 so that disqualification can be triggered by a Commission cease-and-desist order as well as court injunction? Should we add a provision similar to existing Rule 508,[101] under which insignificant deviations from the requirements of Rule 503

[101] 17 CFR 230.508. Under Rule 508, the failure to comply with a term, condition or requirement of

would not result in disqualification under proposed Rule 507(b) if the issuer could demonstrate good faith and a reasonable attempt to comply with filing requirements?

54. Should we amend Rule 507 to disqualify an issuer from relying on Rule 506 for future offerings if such issuer, or any predecessor or affiliate of the issuer, has been subject to a Commission order requiring such person to cease-and-desist from committing or causing any violation or future violation of proposed Rule 509 or proposed Rule 510T, both of which are discussed below?

55. Should the Commission amend Form D to provide a checkbox to indicate that the issuer is relying on the proposed cure period?

56. Is it appropriate to amend Rule 507's existing waiver provision so it applies to proposed Rule 507(b)? Should we provide guidance regarding factors that the Commission may take into account when considering whether to grant a waiver?

57. Are there other methods for improving compliance with Rule 503 that the Commission should consider? For example, should there be other consequences for non-compliance with Form D filing requirements? Would the combination of proposed Rule 507(b) and increased enforcement of existing Rule 503, which could result in monetary penalties or imposition of disqualification under existing Rule 507, provide a sufficient incentive to comply with these requirements?

Rule 504, Rule 505 or Rule 506 will not result in the loss of the exemption from the registration requirements of Section 5 for any offer or sale of securities to a particular individual or entity, if the person relying on the exemption shows the failure to comply did not pertain to a term, condition or requirement directly intended to protect that particular individual or entity; the failure to comply was insignificant with respect to the offering as a whole; and a good faith and reasonable attempt was made to comply with all applicable terms, conditions and requirements of Rule 504, Rule 505 or Rule 506. Id.

58. As an alternative to proposed Rule 507(b), should the availability of Rule 506 be conditioned on compliance with Rule 503, as was the case when Regulation D was originally adopted? If so, should compliance with Rule 503 be a condition to both Rule 506(b) and Rule 506(c), as well as to Rules 504 and 505? Alternatively, should compliance with Rule 503 be a condition to reliance on new Rule 506(c) only? Should the availability of Rule 506 be conditioned on compliance with all of the filing requirements of Rule 503 or should it be conditioned on compliance with only some of the filing requirements of Rule 503 (and if so which filing requirements)? If compliance with Rule 503 is a condition to Rule 506, should there be a mechanism for issuers to request a waiver from Form D filing requirements? If so, how should that mechanism work? Are any other rule amendments necessary if the Commission were to require compliance with Form D filing requirements as a condition to reliance on Rule 506? If so, what amendments?

III. PROPOSED RULE AND RULE AMENDMENTS RELATING TO GENERAL SOLICITATION MATERIALS

We are proposing new requirements and amendments to address investor protection concerns arising from the ability of issuers, including private funds, to generally solicit for their Rule 506(c) offerings. First, we propose to add new Rule 509 to require all issuers to include: (i) legends in any written general solicitation materials used in a Rule 506(c) offering; and (ii) additional disclosures for private funds if such materials include performance data. Second, we propose amendments to Rule 156 under the Securities Act that would extend the guidance contained in the rule to the sales literature of private funds. Each of these proposals is discussed in greater detail below.

Finally, we request comment on manner and content restrictions for general solicitation materials of private funds, a subject on which we received a number of comments and suggestions.

A. Mandated Legends and Other Disclosures for Written General Solicitation Materials

In light of issuers' ability to generally solicit their Rule 506(c) offerings, we are proposing requirements for issuers to better inform potential investors as to whether they are qualified to participate in these offerings, the type of offerings being conducted and certain potential risks associated with such offerings. A number of commenters on the Rule 506(c) Proposing Release recommended that the Commission adopt content restrictions or other requirements with respect to general solicitation materials used by issuers, such as private funds, in Rule 506(c) offerings.[102] For example, the Investor Advisory Committee recommended that the Commission "take steps to ensure that any performance claims in materials used as part of general solicitations are based on appropriate performance reporting standards."[103] Some commenters also recommended that the Commission require the inclusion of legends, warning labels or mandatory risk disclosures in general solicitation materials used in these offerings.[104]

While we believe that further consideration following experience with offerings

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[102] See, e.g., letters from AFL-CIO and AFR; Investor Advisory Committee; Sen. Levin; CFA Institute; Consumer Federation; Hawaii Commissioner of Securities; ICI; IDC; L. Neumann; Montana Commissioner of Securities; NASAA; Nevada Securities Division; Ohio Division of Securities; P. Turney; Sens. Reed, Levin, Durbin, Harkin, Lautenberg, Franken and Akaka; South Carolina Securities Commissioner; Virginia Division of Securities.

[103] Letter from Investor Advisory Committee.

[104] See letters from P. Rutledge (recommending a legend stating that all sales in the offering will be to accredited investors); CFA Institute (recommending a prominent "surgeon's general"-type warning label and mandated disclosures that address the potential risks of Rule 506(c) offerings); BetterInvesting (recommending mandatory risk disclosure language that would appear at the beginning of all general solicitation materials).

under new Rule 506(c) is needed with respect to potential content restrictions for issuers' general solicitation materials, we are proposing new Rule 509, which would require all issuers to include the following prominent legends in all written general solicitation materials:

- The securities may be sold only to accredited investors, which for natural persons, are investors who meet certain minimum annual income or net worth thresholds;[105]
- The securities are being offered in reliance on an exemption from the registration requirements of the Securities Act and are not required to comply with specific disclosure requirements that apply to registration under the Securities Act;
- The Commission has not passed upon the merits of or given its approval to the securities, the terms of the offering, or the accuracy or completeness of any offering materials;
- The securities are subject to legal restrictions on transfer and resale and investors should not assume they will be able to resell their securities; and
- Investing in securities involves risk, and investors should be able to bear the loss of their investment.

We believe that such legends would better inform potential investors as to whether they are qualified to participate in Rule 506(c) offerings and certain potential risks that may be associated with such offerings. Written general solicitation materials

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[105] This part of the legend may be modified in accordance with any higher standards that may be applicable to the issuer, such as qualified clients (as defined by Rule 205-3 under the Advisers Act [17 CFR 275.205-3]) or qualified purchasers (as defined by Section 2(a)(51) of the Investment Company Act [15 U.S.C. 80a-2(a)(51)]).

ore of these required statements in a single sentence, provided that
isclosures is clear and easy to understand. Similarly, written
naterials may use any wording that clearly communicates the
d to be disclosed. Compliance with the proposed legend
vever, does not relieve an issuer from the requirement to take reasonable
at purchasers in a Rule 506(c) offering are accredited investors.
recognize the specific concerns that commenters have expressed
vate funds' ability to advertise to the general public, especially in light of the
private funds raise a significant amount of capital in Rule 506 offerings.[106] Under Rule 506(c), private funds, such as hedge funds, venture capital funds and private equity funds, will be permitted to engage in general solicitation in compliance with the rule without losing the exclusions from the definition of "investment company" under Section 3(c)(1)[107] or Section 3(c)(7)[108] of the Investment Company Act.[109] Several commenters on the Rule 506(c) Proposing Release recommended that we impose additional conditions on private funds that rely on Rule 506(c). In particular, these commenters believed that general solicitation materials of private funds should be subject

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[106] See Ivanov/Bauguess Study.

[107] 15 U.S.C. 80a-3(c)(1) (excluding from the definition of "investment company" any "issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities").

[108] 15 U.S.C. 80a-3(c)(7) (excluding from the definition of "investment company" any "issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities"). The term "qualified purchaser" is defined in Section 2(a)(51) of the Investment Company Act [15 U.S.C. § 80a-2(a)(51)] and the rules thereunder.

[109] See Rule 506(c) Adopting Release, at Section II.E (discussing the effect of Section 201(b) of the JOB Act, which provides that "[o]ffers and sales exempt under [amended Rule 506] shall not be deemed publi offerings under the Federal securities laws as a result of general advertising or general solicitation").

to some form of content requirements and/or restrictions.[110] For example, some believed that private funds engaging in general solicitation should be held to performance and advertising standards that are analogous to mutual fund standards.[111] One of these commenters suggested that the Commission develop a rule tailored to the manner in which private funds calculate and present performance, rather than extending mutual fund performance rules to private funds.[112] Some commenters made other suggestions, such as requiring each private fund relying on Rule 506(c) to disclose that the private fund is not registered with the Commission and should not be confused with a registered fund, such as a mutual fund.[113]

In response to these concerns, we are proposing that an additional legend and disclosures be required for private fund written general solicitation materials. First, we propose that private funds include a legend on any written general solicitation materials that the securities offered are not subject to the protections of the Investment Company Act.[114] We believe it is appropriate to include a legend regarding a private fund's status

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[110] See, e.g., letters from AFL-CIO and AFR; Consumer Federation; Rep. Waters (supporting the establishment of standards for reporting performance and fees by private funds); ICI (recommending the imposition of content restrictions on private fund advertising and requiring certain disclosures in private fund advertisements to avoid investor confusion with mutual funds).

[111] See, e.g., letters from Fund Democracy; ICI; IDC; Sen. Levin; NASAA.

[112] See letter from ICI (stating that "[w]e do not recommend that the content rule applicable to mutual fund performance advertisements . . . be extended to private funds. We strongly recommend, rather, that the Commission develop a rule tailored to the ways private funds calculate and present performance.").

[113] See, e.g., letters from Consumer Federation (stating that the Commission should require private fund advertisements to include "a clear, prominent warning that they are not mutual funds and carry special risks."); Fund Democracy (stating that the Commission should "require explicit, large-font disclaimers that hedge funds are not mutual funds and present special risks."); ICI (recommending that the Commission require disclaimers regarding the performance figures or measures displayed in any private fund advertisements).

[114] Private funds could combine the legend regarding the Investment Company Act with the legend regarding disclosure obligations under the Securities Act to simply state that the securities offered are not subject to the protections of the Investment Company Act or required to comply with specific disclosure requirements that apply to registration under the Securities Act.

under the Investment Company Act because the Act provides important protections that are not applicable to private funds or their investors. For example, the Investment Company Act includes limitations on self-dealing, affiliated transactions and leverage and requirements regarding independent board members, none of which apply to private funds, and the proposed legend would serve to alert investors and the broader general public to this fact. The legend also may help address any misimpression regarding the level of statutory and regulatory protections that apply to investors in a private fund.

Second, we propose that Rule 509 require private funds to include certain disclosures in any written general solicitation materials that include performance data. These disclosures are similar to certain disclosures required by Rule 482 under the Securities Act for advertisements and other sales materials of registered investment companies.[115] Specifically, proposed Rule 509(c) would require any private fund written general solicitation materials that include performance data to include a legend disclosing that:

- performance data represents past performance;
- past performance does not guarantee future results;
- current performance may be lower or higher than the performance data presented;

[115] 17 CFR 230.482. We note that the Commission proposed amendments to Rule 482, which have not yet been adopted, as part of its recent money market fund reform proposals. The proposed amendments would require money market funds to include certain disclosure statements on advertisements and sales materials designed to inform investors about the risks of investing in money market funds and the risks of a floating net asset value, if applicable. See Money Market Fund Reform; Amendments to Form PF, Release No. 33-9408 (June 5, 2013) [78 FR 36834 (June 19, 2013)].

We are requesting comment on the extent to which "liquidity funds," which are private funds that seek to maintain a stable net asset value (or minimize fluctuations in their net asset values) and thus can resemble money market funds, should be required to include similar disclosure statements in written general solicitation materials.

- the private fund is not required by law to follow any standard methodology when calculating and representing performance data; and
- the performance of the fund may not be directly comparable to the performance of other private or registered funds.

The proposed rule would also require the legend to identify either a telephone number or a website where an investor may obtain current performance data.

We believe that many investors, both sophisticated and unsophisticated, consider performance to be a significant factor when selecting investments, including when selecting private funds.[116] As such, we believe that the proposed disclosures are a meaningful way to highlight that there are limitations on the usefulness of past performance data, as well as the inherent difficulty of comparing performance of a private fund with other private funds and with registered products, such as mutual funds.

Further, we are proposing to require that if a private fund's written general solicitation materials include performance data, then such data must be as of the most recent practicable date considering the type of private fund and the media through which the data will be conveyed, and the private fund would be required to disclose the period for which performance is presented.[117] Because investors consider performance to be one of the most significant factors when evaluating investments, we are concerned that

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[116] See Study Regarding Financial Literacy Among Investors (Aug. 30, 2012), available at http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf (Commission staff study indicating that retail investors find information regarding investment performance to be useful and relevant before purchasing an investment product); see also Proposed Amendments to Investment Company Advertising Rules, Release No. 33-8101 (May 17, 2002) [67 FR 36712 (May 24, 2002)].

[117] We are not proposing that private funds provide performance data for a specific period (e.g., as of the most recently completed month) because we understand that the investment strategies employed by private funds vary. For instance, the most recent practicable date for which performance data is available may differ between a hedge fund with liquid assets and a private equity fund with illiquid and hard-to-value assets.

private funds presenting non-current performance data may confuse, and even mislead, investors regarding the fund's current performance, particularly if the fund's performance has changed significantly after the period reflected in the advertisement. In addition, by proposing to require disclosure of either a telephone number or a website where an investor may obtain current performance data, we seek to address the concern that a potential investor may be reviewing written general solicitation materials with performance data that, although at the time it was published was as of the most recent practicable date, could now be considered non-current because more current performance data is available.[118]

We are also proposing to require private funds that include performance data that does not reflect the deduction of fees and expenses in their written general solicitation materials to disclose that fees and expenses have not been deducted and that if such fees and expenses had been deducted, performance may be lower than presented. We believe it is important for investors to be informed about whether performance information presented reflects the deduction of fees and expenses.

As proposed, the requirement to include these legends and other disclosures, as applicable, would not be a condition of the Rule 506(c) exemption. Therefore, the failure to include legends or other disclosures in any written general solicitation materials as required by Rule 509 would not render Rule 506(c) unavailable for the offering. We recognize the potentially disproportionate consequences that would result if an inadvertent error in, or omission of, the legends or disclosures results in a violation of

[118] Under the proposed rule, we intend current performance data to mean as of the last date on which the private fund customarily determined the valuation of its portfolio securities. We do not expect a private fund to value its portfolio for the sole purpose of providing updated current performance under proposed Rule 509.

Section 5 of the Securities Act, as well as state securities laws and the uncertainty that issuers would have regarding the availability of Rule 506(c) for their offerings.

Instead, we are proposing to amend existing Rule 507(a) so that Rule 506 would be unavailable for an issuer if such issuer, or any of its predecessors or affiliates, has been subject to any order, judgment or court decree enjoining such person for failure to comply with Rule 509. We believe that the possibility of disqualification from reliance on Rule 506 would provide issuers with sufficient incentive to comply with the requirements of Rule 509, without penalizing them unduly for an inadvertent error in, or the omission of, a legend or other required disclosure in written general solicitation materials.

We recognize the Commission's experience with Rule 507 as it relates to compliance with the Form D filing requirements of Rule 503 and our belief today that the incentives for compliance with these requirements must be strengthened.[119] We have decided, however, not to propose that non-compliance with Rule 509 would result in disqualification from reliance on Rule 506 without requiring action on the part of the Commission or the courts. We recognize this differs from our treatment of non-compliance with Rule 503 under proposed Rule 507(b); however, we are concerned that such a disqualification provision could result in disproportionate consequences for inadvertent errors or omissions, particularly in light of the large amounts of written communications that many issuers may use during the course of a Rule 506(c) offering that could be viewed as written general solicitation materials triggering proposed Rule 509. Consideration of an approach similar to proposed Rule 507(b) may be more

[119] See Section II.E of this release.

appropriate after first assessing the level of compliance Rule 509 once it is in effect. In this regard, we believe that it is reasonable to expect a higher level of compliance with proposed Rule 509, which would require limited, standardized information about Rule 506(c) offerings, than the current level of compliance with Rule 503, which requires the public filing of a Form D that notifies the market of the occurrence of an offering and contains issuer- and offering-specific information. As a result, including the required legends and other disclosures in written general solicitation materials would seem less likely to raise any concerns for issuers. We believe that Rule 507(a), with its provision that disqualification would occur only if a court takes injunctive action, may be better suited for addressing the varied facts and circumstances that may cause an issuer not to include the required legends and other disclosures in its written general solicitation materials and for determining whether disqualification for this failure is appropriate. While we are not proposing that compliance with Rule 509 be a condition to Rule 506(c) or that non-compliance trigger disqualification without action on the part of the Commission or courts, we are soliciting comment on both of these alternative approaches.

We also are requesting comment on whether content restrictions should apply to private fund general solicitation materials, but we are not proposing to prohibit private funds from including performance information in general solicitation materials at this time. The presentation of performance information, like other information used in general solicitation and other materials, is subject to the antifraud provisions of the federal securities laws.[120] Compliance with the proposed legend and disclosure requirements does not relieve an issuer from the obligation to comply with these antifraud requirements. We note that performance data for certain private funds are available from other sources and that material deviations between reported performance and performance included on general solicitation materials could be misleading.[121] Furthermore, as we noted in the Rule 506(c) Adopting Release, we believe it is appropriate for advisers to private funds to review their compliance policies and procedures and make appropriate updates to such policies and procedures, particularly if the private funds intend to engage in general solicitation activity.[122]

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[120] See, e.g., In the Matter of Oppenheimer Asset Management Inc. and Oppenheimer Alternative Investment Management, LLC, Release No. IA-3566 (Mar. 11, 2013); In the Matter of Sentinel Investment Management Corp., Release No. IA-3556 (Feb. 22, 2013) (settled enforcement action alleging that adviser misrepresented to investors that client's investments in private limited partnerships were growing and performing well); In the Matter of Calhoun Asset Management, LLC, et al., Release No. IA-3428 (July 9, 2012) (settled enforcement action alleging that hedge fund adviser disseminated marketing materials that contained misrepresentations about performance and unsupported performance returns); In the Matter of Belal K. Faruki, Release No. IA-3405 (May 17, 2012) (settled enforcement action alleging hedge fund adviser made material misrepresentations to an investor regarding the fund's track record); In the Matter of GMB Capital Management LLC, et al., Release No. IA-3399 (Apr. 20, 2012) (settled enforcement action alleging hedge fund adviser made misrepresentations in marketing materials, meetings with potential investors, and a website interview that the adviser subsequently reprinted and distributed to investors and potential investors regarding the funds' historic performance).

[121] For instance, performance information must be reported to the Commission in a non-public filing on Form PF. Question 17 of Form PF requires certain registered investment advisers managing private funds to report to the Commission the private fund's performance information as reported to current and prospective investors. While Question 17 instructs advisers to provide the most representative performance results if the fund reports different performance results to different groups of investors, we would expect an adviser to be able to explain and justify the difference between performance information included in any written communications used in a Rule 506(c) offering and that which is reported in such adviser's Form PF report, if applicable. Private funds may also voluntarily report performance data to publicly-available databases.

[122] See Rule 506(c) Adopting Release, at Section II.E (noting that "[w]e believe that investment advisers that have implemented appropriate policies and procedures regarding, among other things, the nature and content of private fund sales literature, including general solicitation materials, are less likely to use materials that materially mislead investors or otherwise violate the federal securities laws.").

Request for Comment

59. Should we require all issuers to include the proposed legends in written general solicitation materials? Why or why not? Are accredited investors already aware of the information included in the proposed legends? Would the proposed legends be effective in reducing the incidence of non-accredited investors participating in Rule 506(c) offerings?

60. Is it appropriate for the Commission to provide for disqualification from reliance on Rule 506 for non-compliance with Rule 509? How would this affect the Rule 506(c) market? Should the Commission amend Rule 507 to also include Commission cease-and-desist and administrative proceedings? Would another mechanism provide a better incentive for issuers to include legends and other disclosures in written general solicitation materials that relied on a simpler enforcement mechanism but did not impose an immediate disqualification?

61. Should the Commission condition Rule 506(c) on compliance with the proposed requirements of Rule 509? What effect would such a condition have on the Rule 506 market? If compliance with Rule 509 were a condition of Rule 506(c), should the Commission provide for a cure mechanism for inadvertent errors in, or the omission of, legends or other required disclosure in the written general solicitation materials?[123] If so, what should be the parameters of this cure mechanism?

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[123] For example, Securities Act Rule 164 [17 CFR 230.164] permits an issuer or an offering participant to cure an unintentional or immaterial failure to include the specified legend in any free writing prospectus, as long as a good faith and reasonable effort is made to comply with the legend condition and the free writing prospectus is amended to include the specified legend as soon as practicable after discovery of the omitted or incorrect legend. In addition, if a free writing prospectus has been transmitted to potential investors without the specified legend, the free writing prospectus must be retransmitted with the appropriate legend

62. Do the proposed legends and required disclosures appropriately inform potential investors as to whether they are qualified to participate in Rule 506(c) offerings, the type of offerings being conducted and the potential risks that may be associated with such offerings? If not, how could they be revised to do so? Should additional legends or disclosures be required and, if so, what should these additional legends or disclosures be?

63. Should we have specific requirements for the legends and disclosures, such as for type size, type style, location and proximity? If so, what should they be? Alternatively, should we require the legends and disclosures to be presented in any manner reasonably calculated to draw investor attention to them?

64. Should we define the types of communications that constitute written general solicitation materials for purposes of the proposed requirements of Rule 509? If so, how should we define written general solicitation materials? For example, should we refer to the definition of "written communications" in Rule 405 under the Securities Act?[124] Should we specify that the term includes any electronic communications?

65. Should comparable disclosure be required to be provided in oral communications used in a Rule 506(c) offering that constitute general solicitations? Why or why

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by substantially the same means as, and directed to substantially the same investors to whom, it was originally transmitted. Securities Act Rule 163 [17 CFR 230.163] provides a similar cure provision.

[124] Rule 405 defines "written communications" as, except as otherwise specifically provided or the context otherwise requires, any communication that is written, printed, a radio or television broadcast, or a graphic communication. Rule 405 defines "graphic communication" as including all forms of electronic media, including, but not limited to, audiotapes, videotapes, facsimiles, CD-ROM, electronic mail, Internet websites, substantially similar messages widely distributed (rather than individually distributed) on telephone answering or voice mail systems, computers, computer networks and other forms of computer data compilation. "Graphic communication" does not include a communication that, at the time of the communication, originates live, in real-time to a live audience and does not originate in recorded form or otherwise as a graphic communication, although it is transmitted through graphic means.

not? Should the legends and required disclosures be required to be included in all offering materials or just the materials used in connection with general solicitation activities? How would issuers provide such disclosure?

66. Are there alternative methods for encouraging important explanatory information regarding performance to be given sufficient prominence in written general solicitation materials? Would mandated legends be helpful in mitigating concerns regarding fraudulent statements in written general solicitation materials?

67. The proposed amendments do not specify the precise wording of any required legends. Is that appropriate? Or should we require specific wording? If so, what would that be?

68. Should we specifically require disclosure of the date as of which any performance data included in the written general solicitation materials was calculated? Should we require all such performance data to be current as of the most recent practicable date? To give issuers certainty, should we provide more specific guidance as to what constitutes the most recent practicable date? Should we require performance data to be provided for a specific period (e.g., for the last one, five, and ten year periods)? Should we require such performance data to be updated at specified intervals? If so, what interval or intervals would be appropriate? Should we require a private fund to provide narrative disclosure regarding the methodology used to calculate performance data? Will such required disclosure become standardized or unwieldy and, therefore, less useful to investors?

69. If all pu... n an offering receive a private placement memorandum that ...e required legends, is it necessary that other materials also in... egends?

...nt do issuers, including private funds, currently use legends similar ...posed in this release (for example, in the private placement ...da given to the potential investors)? To what extent do they use other ...? Does this differ depending on the type of document used? For example, ...vate placement memoranda contain more extensive legends than other ...eting materials?

As proposed, private funds would be required to include a telephone number or a website where an investor may obtain current performance data. Is this requirement appropriate? Should private funds be required to provide performance information on a website? Should private funds be allowed to restrict access to such website through the use of passwords or other measures?

72. Do the proposed disclosures relating to performance data appropriately inform investors that there are limitations on the usefulness of past performance data and the difficulty of comparing the performance of one private fund to other funds, particularly in light of the fact that private funds are not required by law to calculate or present performance pursuant to a standard methodology? If so, how? If not, why not?

73. If the amendments to Rule 482 proposed in the money market fund reform proposals are adopted,[125] should we require liquidity funds to include similar

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[125] See Release No. 33-9408.

disclosure statements in written general solicitation materials? For example, should we require liquidity funds to include a statement that the fund's sponsor has no legal obligation to provide financial support to the fund, and that an investor should not expect that the sponsor will provide financial support to the fund at any time? Why or why not?

74. Rule 506(c) may cause certain types of issuers that have historically registered offerings under the Securities Act to instead conduct offerings under Rule 506(c). These issuers also may use performance data in written general solicitation materials. For example, non-traded REITs, which have historically included prior performance data in Securities Act registration statements and sales literature, may instead conduct Rule 506(c) offerings and provide similar data in written general solicitation materials. Should we adopt legends or other disclosure requirements that are tailored to additional types of issuers, such as non-traded REITs? If so, which types of issuers should be required to include legends or other required disclosure in their written general solicitation materials? What information should be required?

75. What are the costs or burdens on issuers in providing the legends and other required disclosures, as proposed? Are there ways to reduce any costs or burdens on issuers?

76. Should we adopt additional or different legends or disclosure requirements for written general solicitation materials used by private funds in Rule 506(c) offerings when performance data is included?

B. Proposed Amendments to Rule 156

We are also proposing to amend Rule 156 under the Securities Act to apply the guidance contained in the rule to the sales literature of private funds.[126] We are proposing the amendments because we believe it is important to provide guidance to private funds in developing sales literature that is neither fraudulent nor misleading, particularly in light of the Commission's adoption of Rule 506(c).[127] We are of the view that private funds should now be considering the principles underlying Rule 156 to avoid making fraudulent statements in their sales literature.

Rule 156 provides guidance on the types of information in investment company sales literature that could be misleading for purposes of the federal securities laws, including Section 17(a) of the Securities Act[128] and Section 10(b) of the Exchange Act[129] and Rule 10b-5 thereunder.[130] Under these provisions, whether a statement involving a material fact is misleading depends on an evaluation of the context in which it is made. Rule 156 outlines certain situations in which a statement could be misleading. These include certain general factors that could cause a statement to be misleading,[131] as well as circumstances where representations about past or future investment performance[132] and

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[126] The term "private fund" would be defined in Rule 156 as an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act (15 U.S.C. 80a–3), but for Section 3(c)(1) or 3(c)(7) of that Act. See proposed Rule 156(d). Rule 156(c) under the Securities Act defines "sales literature" to include "any communication (whether in writing, by radio, or by television) used by any person to offer to sell or induce the sale of securities of any investment company."

[127] See Rule 506(c) Adopting Release.

[128] 15 U.S.C. 77q(a).

[129] 15 U.S.C. 78j(b).

[130] 17 CFR 240.10b-5.

[131] A statement could be misleading because of other statements being made in connection with the offer of sale or sale of the securities in question; the absence of explanations, qualifications, limitations, or other statements necessary or appropriate to make such statement not misleading; or general economic or financial conditions or circumstances. See Rule 156(b)(1).

[132] Representations about past or future investment performance about an investment company could be misleading because of statements or omissions made involving a material fact, including situations where portrayals of past income, gain, or growth of assets convey an impression of the net investment results

statements involving a material fact about the characteristics or attributes of an investment company[133] could be misleading.[134]

The Commission adopted Rule 156 as an interpretive rule to provide guidance in certain areas which, based on the Commission's regulatory experience with investment company sales literature, had proven to be particularly susceptible to misleading statements.[135] Just as the antifraud provisions of the Securities Act and the Exchange Act apply to the offer and sale of securities issued by an investment company, those same

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achieved by an actual or hypothetical investment which would not be justified under the circumstances, including portrayals that omit explanations, qualifications, limitations, or other statements necessary or appropriate to make the portrayals not misleading; and representations, whether express or implied, are made about future investment performance, including: (a) representations, as to security of capital, possible future gains or income, or expenses associated with an investment; (b) representations implying that future gain or income may be inferred from or predicted based on past investment performance; or (c) portrayals of past performance, made in a manner which would imply that gains or income realized in the past would be repeated in the future. See Rule 156(b)(2).

[133] A statement involving a material fact about the characteristics or attributes of an investment company could be misleading because of statements about possible benefits connected with or resulting from services to be provided or methods of operation which do not give equal prominence to discussion of any risks or limitations associated therewith; exaggerated or unsubstantiated claims about management skill or techniques, characteristics of the investment company or an investment in securities issued by the company, services, security of investment or funds, effects of government supervision; or other attributes; and unwarranted or incompletely explained comparisons to other investment vehicles or to indexes. See Rule 156(b)(3).

[134] We note that the Commission proposed amendments to Rule 156, which have not yet been adopted, to address concerns that emanated from target date funds but are applicable to all investment companies. The proposed amendments would provide that a statement suggesting that securities of an investment company are an appropriate investment could be misleading in two circumstances: (i) a statement could be misleading because of the emphasis it places on a single factor as the basis for determining that an investment is appropriate; or (ii) a statement suggesting that securities of an investment company are an appropriate investment could be misleading because of representations that investing in the securities is a simple investment plan or that it requires little or no monitoring by the investor. See Investment Company Advertising: Target Date Retirement Fund Names and Marketing, Release No. 33-9126 (June 16, 2010) [75 FR 35920 (Jun. 23, 2010)].

If the Commission were to adopt those amendments, we anticipate that such amendments would also apply to private fund sales literature because we believe the descriptions of what statements could be misleading (for example, a statement emphasizing a single factor as the basis for determining that an investment is appropriate) would apply equally to statements made in the sales literature of private funds.

[135] See Mutual Fund Sales Literature Interpretive Rule, Release No. 33-6140 (Oct. 26, 1979) [44 FR 64070 (Nov. 6, 1979)].

provisions apply to the offer and sale of securities issued by a private fund.[136] We note that some commenters on the Rule 506(c) Proposing Release requested that the Commission clarify whether the interpretive guidance in Rule 156 also applies to private funds.[137] Accordingly, the Commission believes it is important to provide interpretive guidance to private funds regarding the types of information in sales literature that could be fraudulent or misleading.

While the adoption of Rule 506(c) is the impetus for proposing amendments to Rule 156 to extend its guidance to private funds, the proposed amendments would apply to all private funds, including private funds engaged in general solicitation activity under Rule 506(c). This reflects our view that statements or representations have the potential to mislead investors regardless of the type of offering, investors' level of sophistication or whether such materials are used in a general solicitation.[138]

Rule 156 does not prohibit or permit any particular representations or presentations. The circumstances in which statements or representations in investment company sales materials may be viewed as misleading appear to be similar to the circumstances in which statements or representations in private fund sales materials may be viewed as misleading. Based on enforcement and regulatory experience regarding private funds, we believe that the areas identified in Rule 156 as being vulnerable to misleading statements in investment company sales literature are similarly vulnerable

[136] In addition, statements by an investment adviser to any investor or prospective investor in a private fund that are fraudulent or materially misleading also violate Section 206 of the Advisers Act [15 U.S.C. 80b-6(4)] and Rule 206(4)-8 under the Advisers Act [17 CFR 275.206(4)-8].

[137] See letters from ICI and NASAA.

[138] For example, misleading statements or representations could be made in materials for an offering pursuant to Rule 506(b).

with respect to private fund sales literature. For example, the Commission has brought enforcement actions against private fund advisers and others for material misrepresentations to investors and prospective investors regarding past or future investment performance and characteristics or attributes of the private fund. Such actions have included instances in which defendants were charged with misrepresenting a private fund's prior investment performance,[139] exaggerating their personal employment history and qualifications,[140] omitting information regarding their disciplinary history,[141] misrepresenting information about the holdings of the fund's investment portfolio, [142] making fraudulent claims that the fund was performing better than the major stock indexes,[143] and falsely valuing the fund's investments.[144]

As the Commission previously described in connection with amendments to Rule 156, we have been particularly concerned that representations regarding past performance or future investment performance could be misleading given that many investors consider performance to be one of the most significant factors when selecting or evaluating mutual funds.[145] The Commission explained that it was concerned that past performance information that did not contain an adequate explanation of other facts may

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[139] See, SEC v. Alero Odell Mack, Jr., Steven Enrico Lopez, Sr., Easy Equity Asset Management, Inc., Easy Equity Management, L.P., Easy Equity Partners, L.P., Alero Equities the Real Estate Company, L.L.C., and Alero I.X. Corp., Litigation Release No. 21731 (Nov. 4, 2010) (settled action).

[140] See id.; SEC v. Jean Baptiste Jean Pierre, Gabriel Toks Pearce, and Darius L. Lee, Litigation Release No. 17303 (Jan. 10, 2002) (settled action).

[141] See In the Matter of LeadDog Capital Markets, LLC, f/k/a LeadDog Capital Partners, Inc., Chris Messalas and Joseph Larocco, Esq., Administrative Proceeding File No. 3-14623, Initial Decision Release No. 468 (Sept. 14, 2012) (Finality Order, Release No. 34-68205 (Nov. 12, 2012)).

[142] See id.; In the Matter of Michael Lauer, Administrative Proceeding File No. 3-13265 (Jan. 29, 2009) (settled action).

[143] See id.

[144] See id.

[145] See Release No. 33-8101.

create unrealistic investor expectations or mislead potential investors.[146] The amendments were intended to address concerns about: (i) advertising performance without providing adequate disclosure of unusual circumstances that have contributed to fund performance; (ii) advertising performance without providing adequate disclosure of the performance period or that more current information about performance is available and it may be lower than advertised performance; and (iii) advertising performance based on selective time periods without providing disclosure that would permit an investor to evaluate the significance of performance that is based on selective time periods.[147] The Commission also highlighted how some funds addressed these concerns through narrative disclosure when performance presentations were provided.[148]

Request for Comment

77. Are there certain types of private funds that will find it difficult to apply the guidance in Rule 156 to their sales literature? If so, which types of private funds and why? Are there changes to the guidance in Rule 156 that would be appropriate to consider in connection with the extension of the guidance to private funds?

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[146] See Amendments to Investment Company Advertising Rules, Release No. 33-8294 (Sept. 29, 2003) [68 FR 57760 (Oct. 6, 2003)].

[147] See Release No. 33-8101.

[148] For example, the Commission noted that such narrative disclosures were designed to inform investors that: (i) the advertised performance was achieved through the fund's use of particular investment strategies under specified circumstances that are not likely to recur (e.g., disclosing that a significant portion of the advertised performance was attributable to the allocation of an initial public offering of securities to the fund but indicated that such allocation would not likely continue in the future); (ii) the advertised performance is not the fund's current performance and that due to market volatility or other factors, the fund's performance changes over time or that the fund's current performance may be lower than the advertised performance; or (iii) the fund's performance may be volatile or that the advertised performance is not representative of the fund's historical performance. Id.

78. Are there additional amendments to Rule 156 that would help to clarify the obligations of private funds under the antifraud provisions?

79. If the amendments to Rule 156 proposed in the target date fund rulemaking are adopted,[149] we anticipate making such amendments also applicable to sales literature of private funds. Is there any reason such guidance should not apply to sales literature of private funds?

80. Would antifraud guidance be useful regarding issues that may arise with respect to sales literature disseminated by other types of issuers in connection with offerings pursuant to Rule 506(c), such as non-traded REITs? Would similar guidance be appropriate for other types of issuers, such as statements that sales material should present a balanced discussion of risk and reward, and be consistent with representations in offering documents? What are the expected costs and benefits with respect to any such guidance?

C. Request for Comment on Manner and Content Restrictions for Private Funds

As noted above, some commenters have expressed particular concern that eliminating the prohibition against general solicitation may create more opportunities for private funds to distribute misleading and fraudulent information.[150] Commenters recommending content restrictions expressed concern that general solicitation materials for private funds raise a substantial risk of investor confusion, and may cause an investor to draw unwarranted conclusions when comparing the performance of private funds, which are not subject to standardized performance calculation and reporting

149 See Release No. 33-9126.

150 See, e.g., letters from AFL-CIO and AFR; Consumer Federation; ICI; IDC.

requirements, to the performance of other funds.[151] Commenters also noted that, among other things, private fund portfolios tend to be more illiquid and difficult to value than registered investment companies, which may result in misleading performance data due to faulty valuations.[152] Some commenters have also suggested that, until the Commission can develop standardized performance methodologies, private funds should be prohibited from including performance data in general solicitation materials.[153] Other commenters, however, have stated that the risk of investor harm is limited because only accredited investors can purchase private funds offered under Rule 506(c).[154]

With respect to performance calculations for private funds, we note that the methodologies can vary for a number of reasons, such as the type of the fund,

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[151] See, e.g., letters from ICI (noting that comparisons may be particularly difficult when a private fund is compared to a mutual fund, which is subject to specific calculation methodologies for performance data); and IDC (stating that "[i]nvestors viewing mutual fund advertisements and private fund advertisements may see wide variations in performance information, without any explanation or way to understand the bases for the differences").

[152] See, e.g., letters from NASAA (explaining that "the investment strategies of private funds are typically more opaque, risky, and illiquid than those of mutual funds"); ICI (May 21, 2012) (noting that private funds often "invest in securities that are difficult to value or relatively illiquid" and citing a 2003 NASD sweep of broker-dealers that found several areas of concern in hedge fund advertisements and sales literature, including with respect to the presentation of performance data). Commission staff in our Office of Investor Education and Advocacy also recently issued an investor bulletin regarding hedge funds, advising investors that "[h]edge funds do not need to follow any standard methodology when calculating performance, and they may invest in securities that are relative illiquid and difficult to value." See Office of Investor Education and Advocacy, Investor Bulletin: Hedge Funds (Oct. 2012), available at http://sec.gov/investor/alerts/ib_hedgefunds.pdf.

[153] See, e.g., letters from ICI (recommending a prohibition on use of performance advertising by private funds until the Commission can develop a new rule regarding such advertising); IDC; Consumer Federation (recommending that "the Commission should at the very least adopt clear standards for the reporting of performance and fees by private funds, and delay their eligibility from engaging in general solicitation and advertising until such time as those standards are in place.").

[154] See, e.g., letters from BlackRock (stating its belief that "the requirement that only sophisticated institutions and individuals may ultimately purchase interests in these funds . . . eliminates the risk that investors could be harmed as a result of a manager engaging in general advertising or solicitation") and MFA (Sept. 28, 2012) (stating that "only sophisticated investors may purchase interests in hedge funds, including those that in the future are offered and sold in reliance on revised Rule 506"). See also letter from MFA (June 20, 2013) (asserting that the Dodd-Frank Act and the Commission's regulatory implementation of the Dodd-Frank Act have significantly strengthened regulatory oversight of investment advisers to hedge funds).

assumptions underlying the calculations and investor preferences. Given that legitimate reasons may result in different approaches to calculating performance for private funds, we have determined not to propose standardized calculation methodologies for performance of private funds without further study.

We believe that the antifraud provisions of the federal securities laws, and the requirement that purchasers of a private fund offered under Rule 506(c) be accredited investors, provide a level of investor protection and thus we are not proposing to prohibit or restrict the use of performance data at this time. We are soliciting specific comment on this issue as well as on whether other manner and content restrictions related to the removal of the prohibition against general solicitation are necessary or appropriate for Rule 506(c) offerings by private funds or other issuers. As stated previously, we have directed the Commission staff to review and analyze developments in the new Rule 506(c) market, including the form and content of written general solicitation materials submitted to the Commission.[155]

Request for Comment

81. Commenters have expressed concern about private funds including performance information in general solicitations materials. Should the Commission apply any content restrictions to performance advertising by private funds? Why or why not? Should the Commission apply content standards to specific types of performance advertising (e.g., model or hypothetical performance)? Why or why not? Are there current practices that would be affected? If the performance information is otherwise truthful and not misleading, what should the

[155] See Section I of this release.

Commission consider in deciding whether any content restriction is appropriate or necessary? Does the fact that investors in a private fund engaged in a Rule 506(c) offering must be accredited to purchase securities suggest a level of financial sophistication such that content restrictions in general, or certain content restrictions specifically, should not be required?

82. How do the different types of private funds (e.g., hedge funds, private equity funds, venture capital funds, and securitized asset funds) calculate and present performance? Should private funds be subject to standardized performance reporting? If so, what reporting standard(s) should apply? Is there any standard that is widely used by private funds and should we consider requiring the use of such standard? Would one standardized performance reporting methodology be appropriate for different types of private funds?

83. Should the use of performance claims by a private fund as part of a general solicitation be conditioned on a requirement that the private fund be subject to an audit by an independent public accountant? Would such a requirement provide some level of protection that the performance claims were at least based on valuations of assets audited by an independent third party? To what extent do private funds typically have such an audit?

84. Is there a concern that, without content restrictions, materials used as part of general solicitations may vary depending upon who is selling the product (e.g., a broker-dealer's material subject to FINRA rules may differ from an issuer's materials)?

85. Is investor confusion (or confusion by the general public) a concern with respect to a private fund's general solicitation materials? If so, what is the specific nature of that confusion given that ultimately only accredited investors may invest in private funds engaged in a Rule 506(c) offering?

86. Should the Commission draw a distinction between general solicitation activity engaged in by a private fund relying on Section 3(c)(1) of the Investment Company Act compared to a fund relying on Section 3(c)(7) of the Investment Company Act?[156] If so, how and why? General solicitation can be conducted through a broad array of media, including, but not limited to, print advertisements, billboards, television, the Internet and radio. Which ones will be most likely used in private fund offerings? Are there certain types of media that present heightened investor protection concerns?

IV. PROPOSED TEMPORARY RULE FOR MANDATORY SUBMISSION OF WRITTEN GENERAL SOLICITATION MATERIALS

We are proposing new Rule 510T of Regulation D to require that an issuer conducting an offering in reliance on Rule 506(c) submit to the Commission any written general solicitation materials prepared by or on behalf of the issuer and used in connection with the Rule 506(c) offering. Under the proposed rule, the written general solicitation materials must be submitted no later than the date of first use of such materials in the offering. We are proposing the rule as a temporary rule that would expire two years after its effective date.

In connection with the Rule 506(c) Proposing Release, a number of commenters recommended that the Commission require materials used in general solicitations under

[156] See notes 107 and 108.

Rule 506(c) to be filed with, or furnished to, either the Commission or FINRA. Some commenters recommended that we require the submission of all proposed general solicitation materials as an exhibit to Form D.[157] Other commenters, including the Investor Advisory Committee, suggested the creation of a publicly-available online electronic "drop box" on the Commission's website into which all general solicitation materials (whether in print, audio or video forms) could be deposited, together with a cover form identifying the issuer using the general solicitation materials and the circumstances under which the materials are to be used, with the Rule 506(c) exemption conditioned on such filings being made either before first use or promptly after first use.[158] Still other commenters recommended that we consider requiring the pre-filing of all general solicitation materials under Rule 506(c) with FINRA, regardless of whether any broker-dealer involved in the offering is exempt from registration under the Exchange Act.[159] These commenters generally asserted that such a requirement is needed as a safeguard for investor protection.

The Commission will need to understand developments in the Rule 506 market after the effectiveness of Rule 506(c). One of these developments would be the market practices through which issuers would solicit potential purchasers of securities offered in reliance on Rule 506(c). We believe that it is important that the Commission have the ability to assess these market practices. Proposed Rule 510T would facilitate this

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[157] See letters from Massachusetts Securities Division (July 2, 2012); Ohio Division of Securities (July 3, 2012).

[158] See letters from Investor Advisory Committee; Consumer Federation.

[159] See letters from AFL-CIO and AFR; BetterInvesting (recommending that "the SEC require all public solicitation materials under Rule 506 to be independently reviewed for compliance (perhaps by an independent authority such as FINRA, which already reviews broker-dealer advertising) before or after the public solicitation" (emphasis omitted)); ICI.

assessment by requiring issuers to submit any written general solicitation materials used in their Rule 506(c) offerings no later than the date of the first use of these materials. Such materials would be required to be submitted through an intake page on the Commission's website. To allow the Commission to assess market developments prior to the adoption of proposed Rule 510T, the Commission will establish and make available for use the intake page upon the effectiveness of Rule 506(c). Doing so will allow issuers, investors and other market participants to submit voluntarily any written general solicitation materials used in Rule 506(c) offerings. The submitted materials would be considered by the Commission staff as part of the Rule 506(c) Work Plan.

We are not proposing, at this time, that issuers file their written general solicitation materials through the Commission's EDGAR system. Written general solicitation materials submitted to the Commission pursuant to proposed Rule 510T would not be treated as being "filed" or "furnished" for purposes of the Securities Act or Exchange Act, including the liability provisions of those Acts. As the written general solicitation materials would be submitted to the Commission for the purpose of furthering the Commission's understanding of the market practices in the Rule 506 market, we are not proposing to make the written general solicitation materials publicly available on the Commission's website.[160] Oral communications used to solicit potential purchasers of securities offered through Rule 506(c) offerings would not be subject to proposed Rule 510T. We believe that limiting the requirements of proposed Rule 510T in this manner is reasonable as we expect that many issuers will prefer to use written general solicitation materials due to the potentially greater reach and lower costs of such solicitation

[160] We do not contemplate that the submitted written general solicitation materials would be subject to a staff review similar to that conducted on Securities Act registration statements.

methods. Thus, we expect that requiring the submission of only written general solicitation materials should provide us with an efficient way to assess developments in the Rule 506 market.

Compliance with proposed Rule 510T would not be a condition of Rule 506(c). As with the proposed Rule 509 requirement that issuers include legends and other disclosures in written general solicitation materials, we believe that conditioning the availability of Rule 506(c) on such compliance could lead to disproportionate consequences in the event of non-compliance. Instead, we are proposing to amend existing Rule 507(a) so that Rule 506 would be unavailable for an issuer if such issuer, or any of its predecessors or affiliates, has been subject to any order, judgment or court decree enjoining such person for failure to comply with Rule 510T. As with proposed Rule 509, we believe that the possibility of disqualification from reliance on Rule 506 would provide issuers with sufficient incentive to comply with the requirement of Rule 510T, without penalizing them unfairly for an inadvertent error or failure to submit written general solicitation materials. We also believe that Rule 507(a), with its provision that disqualification would occur only if a court issues an injunction, may be better suited for addressing the varied facts and circumstances that may cause an issuer not to submit written general solicitation materials and for determining whether disqualification for this failure is appropriate.

As noted above, we are proposing Rule 510T as a temporary rule that will expire two years after the effective date of proposed Rule 510T. We believe that a two-year period would provide sufficient time for the Commission and the Commission staff to assess many of the market practices used to solicit potential purchasers of securities offered through Rule 506(c) offerings and determine whether further action is warranted.

Request for Comment

87. Should we require the submission of written general solicitation materials used in Rule 506(c) offerings, as proposed? Should oral communications that constitute general solicitation be required to be submitted in some form? If so, how should a requirement to submit general solicitation materials be applied to telephone solicitations, solicitations through broadcast media or oral communications?

88. What are the appropriate ramifications for an issuer that fails to submit written general solicitation materials? Should failure to submit general solicitation materials disqualify an issuer from using Rule 506 for future offerings without court action? Should a cure period be provided? Should submission of written general solicitation materials be a condition to the Rule 506(c) exemption?

89. What are the benefits and costs of requiring the submission of written general solicitation materials in Rule 506(c) offerings? If the staff were able to conduct only limited review of a small portion of the materials submitted, how does that impact an assessment of costs and benefits?

90. Should the submitted written general solicitation materials be made publicly available on the Commission's website? Would the availability of such materials on the Commission's website give undue credibility to the materials and create the impression that submitted materials have been reviewed and/or approved by the Commission?

91. Should written general solicitation materials be required to be submitted as an exhibit to Form D? Why or why not? Could submission of these materials publicly, through EDGAR or another means, have the effect of encouraging broadened investor interest in these offerings, beyond what the offerors would achieve by engaging in their own general solicitation efforts? Would this be in the interests of investors?

92. Should the written general solicitation materials be submitted at a time other than the date of first use of such materials? For example, currently, free writing prospectuses in the form of media publications or broadcasts that include information about the issuer, its securities, or the offering provided, authorized, or approved by or on behalf of the issuer or an offering participant and that are published or disseminated by unaffiliated media must be filed within four business days after the issuer or offering participant becomes aware of its publication or first broadcast. Should a similar deadline be considered for the submission of written general solicitation materials that are in the form of media publications or broadcasts and that include information provided or authorized by the issuer or an offering participant?

93. Should a requirement to submit written general solicitation materials be applied to all Rule 506(c) offerings, or should certain issuers or certain Rule 506(c) offerings be excluded or exempted from such a requirement? If yes, what issuers or offerings should be excluded or exempted? Should smaller issuers or smaller offerings be excluded or exempted?

94. As proposed, only the issuer relying on Rule 506(c) would have an obligation under Rule 510T to submit written general solicitation materials to the Commission, even if the materials were prepared and disseminated by an offering participant on behalf of the issuer. Should this requirement extend to the submission of all written general solicitation materials used by other offering participants in the same offering? Would this requirement further the Commission's assessment of the market practices used by issuers in Rule 506(c) offerings?

95. How would a requirement that written general solicitation materials be submitted to the Commission affect the amount or quality of information in such materials? How would it affect the use of Rule 506(c)?

96. Should the proposed requirement for issuers to submit written general solicitation materials be in the form of a temporary rule? Should this requirement be made a permanent one? If it is in the form of a temporary rule, is the proposed two-year period sufficient for purpose of understanding the market practices used by issuers to solicit potential purchasers in Rule 506(c) offerings?

V. REQUEST FOR COMMENT ON THE DEFINITION OF "ACCREDITED INVESTOR"

Many commenters stated, and we agree, that the definition of accredited investor as it relates to natural persons should be reviewed and, if necessary or appropriate, amended. Several commenters recommended that the accredited investor definition be revised to include a financial knowledge or investment experience component[161] and/or a

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[161] See letters from AARP; BetterInvesting; CFA Institute; Consumer Federation; ICI; Massachusetts Securities Division (July 2, 2012). One commenter recommended adding "knowledgeable employees" to

threshold based on the amount of securities investments owned by the purchaser, which, in their view, may be a more appropriate proxy for financial sophistication.[162]

At the outset, we note that amending the definition of "accredited investor" raises a number of issues separate from the implementation of Section 201(a). The accredited investor definition is subject to a number of independent regulatory requirements that mandate review and consideration of the definition. For example, Section 415 of the Dodd-Frank Act mandates the completion of a study by the Government Accountability Office ("GAO") regarding the appropriate criteria for determining the financial thresholds or other criteria for qualifying as an accredited investor not later than three years after the date of enactment of the Dodd-Frank Act, which would be July 20, 2013. Under Section 413(b) of the Dodd-Frank Act, the Commission is required to undertake a review of the accredited investor definition as it relates to natural persons in its entirety four years after the enactment of the Dodd-Frank Act, and once every four years thereafter. Also, Section 413(a) of the Dodd-Frank Act stipulates that the net worth standard shall be $1 million, excluding the value of a person's primary residence, until July 2014.

Because any change we would propose to the definition of accredited investor would benefit from our consideration of these mandated reviews as well as from the

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the accredited investor definition. See letter from MFA (May 4, 2012). Another commenter suggested having the Commission offer investor education classes whereby investors who meet a lower financial threshold but pass a qualifying test could be granted accredited investor status. See letter from Cambridge Innovation Center (June 13, 2012).

All of the commenters that recommended that the Commission amend the definition of accredited investor focused on the definition as it relates to natural persons. See, e.g., letters from AARP; AFL-CIO and AFR; BetterInvesting; CFA Institute; Consumer Federation; ICI; Investor Advisory Committee; Massachusetts Securities Division (July 2, 2012).

[162] See letters from AARP; Consumer Federation; ICI.

ability to consider modifications to the net worth standard, we are not proposing any amendments to the accredited investor definition at this time. Nonetheless, in light of the considerations that commenters raised, the Commission staff has begun a review of the definition of accredited investor as it relates to natural persons, including the need for any changes to this definition following the effectiveness of Rule 506(c). This review, which we anticipate will be completed in a timely manner, will encompass, among other things, both the question of whether net worth and annual income should be used as the tests for determining whether a natural person is an accredited investor and the question of what the thresholds should be for those and other potential tests. We believe that it would be appropriate to coordinate the review and consideration of the accredited investor definition required by Section 413(b) of the Dodd-Frank Act with the completion of the Commission staff's ongoing review and the GAO study.

Request for Comment

97. Are the net worth test and the income test currently provided in Rule 501(a)(5) and Rule 501(a)(6), respectively, the appropriate tests for determining whether a natural person is an accredited investor? Do such tests indicate whether an investor has such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of a prospective investment? If not, what other criteria should be considered as an appropriate test for investment sophistication?

98. Are the current financial thresholds in the net worth test and the income test still the appropriate thresholds for determining whether a natural person is an accredited investor? Should any revised thresholds be indexed for inflation?

99. Currently, the financial thresholds in the income test and net worth test are based on fixed dollar amounts (such as having an individual income in excess of $200,000 for a natural person to qualify as an accredited investor). Should the net worth test and the income test be changed to use thresholds that are not tied to fixed dollar amounts (for example, thresholds based on a certain formula or percentage)?

VI. ADDITIONAL REQUESTS FOR COMMENT

We are also soliciting comment on the following additional matters:

100. Should it be a condition of Rule 506(c) that, prior to any sale of a security in reliance on the Rule, the purchaser shall have received an offering document containing specified information? If so, should such information requirements be the same as, or more or less inclusive than, the information requirements set forth in Rule 502(b) of Regulation D (which apply only when an issuer sells securities under Rule 505 or Rule 506 to a purchaser that is not an accredited investor)?

101. Should an issuer subject to the reporting requirements of Sections 13 or 15(d) of the Exchange Act be permitted to use Rule 506(c) if it is not current in its reporting obligations?

VII. GENERAL REQUEST FOR COMMENT

We request and encourage any interested person to submit comments regarding the proposed rule and form amendments, specific issues discussed in this release, and other matters that may have an effect on the proposed rules. We request comment from the point of view of issuers, investors and other market participants. With regard to any comments, we note that such comments are of particular assistance to us if accompanied by supporting data and analysis of the issues addressed in those comments. Commenters are urged to be as specific as possible.

VIII. PAPERWORK REDUCTION ACT

A. Background

The proposed rule and form amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[163] The titles of these requirements are:

- "Form D" (OMB Control No. 3235-0076);[164] and
- "Rule 506(c) General Solicitation Materials" (a proposed new collection of information).

We are submitting these requirements to the Office of Management and Budget ("OMB") for review and approval in accordance with the PRA and its implementing regulations.[165] We are applying for an OMB control number for the proposed new collection of information in accordance with 44 U.S.C. 3507(j) and 5 CFR 1320.13, and OMB has not yet assigned a control number to the new collection. If adopted, responses to the new collection of information would be mandatory. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information requirement unless it displays a currently valid OMB control number.

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163 44 U.S.C. 3501 et seq.

164 Form D was adopted pursuant to Sections 2(a)(15), 3(b), 4(a)(2), 19(a) and 19(c)(3) of the Securities Act (15 U.S.C. 77b(a)(15), 77c(b), 77d(a)(2), 77s(a) and 77s(c)(3)).

165 44 U.S.C. 3507(d); 5 CFR 1320.11.

B. Burden and Cost Estimates Related to the Proposed Amendments

1. Proposed Amendments Relating to Form D

We adopted Regulation D and Form D as part of the establishment of a series of exemptions for offerings and sales of securities under the Securities Act. Form D contains collection of information requirements, requiring an issuer to file a notice of sale of securities pursuant to Regulation D or Section 4(a)(5) of the Securities Act. The Form D is required to include basic information about the issuer, certain related persons and the offering. This information is needed for implementing the exemptions and evaluating their use. The information collection requirements related to the filing of Form D with the Commission are mandatory to the extent that an issuer elects to make an offering of securities in reliance on the relevant exemption. Responses are not confidential. The hours and costs associated with preparing and filing forms and retaining records constitute reporting and cost burdens imposed by the collection of information requirements.

We are proposing to require the advance filing of Form D for Rule 506(c) offerings and to require the filing of a closing amendment to Form D after the termination of all Rule 506 offerings. In addition, we are proposing to amend Item 2 of Form D to require the identification of the issuer's publicly accessible (Internet) website address, if any; Item 3 of Form D to require, in Rule 506(c) offerings, the name and address of controlling persons, in addition to the information currently required for "related persons;" Item 4 of Form D to require the issuer to briefly describe its industry group if the issuer checks the "Other" box; Item 5 of Form D to replace the "Decline to Disclose" option with a "Not Available to Public" option; Item 7 of Form D to add separate fields or check boxes for issuers to indicate whether they are filing a Form D in advance of a Rule 506(c) offering or a closing Form D amendment for a Rule 506 offering; Item 9 of Form D to require information on the ticker symbol and security identifier for the offered securities, if any; Item 14 of Form D to add a table requiring information, in regard to Rule 506 offerings, on the number of accredited investors and non-accredited investors, whether they are natural persons or entities, and the amount raised from each category of investor; and Item 16 of Form D to require information, if the issuer is not a pooled investment fund, on the percentage of the offering proceeds from a Rule 506 offering that was or will be used (1) to repurchase or retire the issuer's existing securities; (2) to pay offering expenses; (3) to acquire assets, otherwise than in the ordinary course of business; (4) to finance acquisitions of other businesses; (5) for working capital; and (6) to discharge indebtedness.

We are also proposing to add new items to Form D, which would require the following additional information in regard to offerings conducted under Rule 506: the number and types of accredited investors that purchased securities in the offering; for Rule 506(c) offerings, the methods used to verify accredited investor status and the types of general solicitation used; if a class of the issuer's securities is traded on a national securities exchange, ATS or any other organized trading venue, and/or is registered under the Exchange Act, the name of the exchange, ATS or trading venue and/or the Exchange Act file number and whether the securities being offered under Rule 506 are of the same class or are convertible into or exercisable or exchangeable for such class; if the issuer used a registered broker-dealer in connection with the offering, whether any general solicitation materials were filed with FINRA; and in the case of pooled investment funds, the name and SEC file number for each investment adviser who functions directly or indirectly as a promoter of the issuer.

We anticipate that if the proposed amendments to require the advance filing of Form D for Rule 506(c) offerings, the filing of a closing amendment to Form D after the termination of Rule 506 offerings, and additional information in Form D are adopted, the burden for responding to the collection of information in Form D would increase for most issuers. For purposes of the PRA, we estimate that the annual compliance burden of the collection of information requirements for issuers making Form D filings after these proposed amendments would be an aggregate 32,736 hours of issuer personnel time and $39,283,200 for the services of outside professionals per year. Our methodologies for deriving the above estimates are discussed below.

The table below shows the current total annual compliance burden, in hours and in costs, of the collection of information pursuant to Form D in connection with the rule and form amendments to implement Section 201(a) of the JOBS Act we are adopting today. For purposes of the PRA, prepared in connection with the amendments to Form D adopted today, we estimate that, over a three-year period, the average burden estimate will be four hours per Form D filing. Our burden estimate represents the average burden for all issuers. This burden is reflected as a one hour burden of preparation on the company and a cost of $1,200 per filing. In deriving these estimates, we assume that 25% of the burden of preparation is carried by the issuer internally and that 75% of the burden of preparation is carried by outside professionals retained by the issuer 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 issuer internally is reflected in hours.

Table 1. **Estimated paperwork burden under Form D, pre-amendments to Regulation D and Form D**

	Number of responses (A)[166]	Burden hours/form (B)	Total burden hours (C)=(A)*(B)	Internal issuer time (D)	External professional time (E)	Professional costs (F)=(E)*$400
Form D	21,824	4	87,296	21,824	65,472	$26,188,800

We believe that the proposed amendments to Form D, if adopted, would increase the existing paperwork burden of the form by requiring additional information in Form D, particularly with respect to Rule 506 offerings. In addition, while we do not anticipate that these proposed rule and form amendments will result in an increase in the number of Regulation D offerings, we believe that the paperwork burden of the form would increase as a result of the advance filing requirement for Rule 506(c) offerings and the requirement to file an additional amendment after the termination of Rule 506 offerings.[167] We estimate that the paperwork burden associated with filing the required information on Form D over the span of a particular offering would increase to approximately 6 hours per offering.[168]

The table below illustrates the total annual compliance burden of the collection of information in hours and in cost under the proposed amendments to Regulation D and

[166] The information in this column is based on the 18,187 new Form D filings that were actually made in 2012, plus the additional 3,637 filings we estimate would be filed in the first year after the effective date of Rule 506(c).

[167] As discussed in Section IX.B.4.a of this release, there is evidence that some issuers are not filing Form D for their offerings in compliance with Rule 503.

[168] The estimate of approximately 6 hours per offering is a blended average of the paperwork burden for all offerings for which a Form D is required to be filed, not only offerings under Rule 506.

Form D. The burden estimates were calculated by multiplying the estimated number of responses by the estimated average amount of time it would take an issuer to prepare and review a Form D filing consistent with the assumptions above. We continue to estimate that 25 percent of the burden of preparation is carried by the company internally and that 75 percent of the burden of preparation is carried by outside professionals retained by the issuer 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 issuer internally is reflected in hours.

Table 2. Estimated paperwork burden under Form D, post-amendments to Regulation D and Form D

	Number of responses (A)	Burden hours/form (B)	Total burden hours (C)=(A)*(B)	Internal issuer time (D)	External professional time (E)	Professional costs (F)=(E)*$400
Form D	21,824	6	130,944	32,736	98,208	$39,283,200

2. Rule 506(c) General Solicitation Materials

We are proposing new Rule 510T of Regulation D to require that an issuer conducting an offering in reliance on Rule 506(c) submit to the Commission any written general solicitation materials prepared by or on behalf of the issuer and used in connection with the Rule 506(c) offering. Under the proposed rule, the written general solicitation materials must be submitted to the Commission through an intake page on the Commission's website no later than the date of first use of such materials in the offering. Written general solicitation materials submitted to the Commission in this manner would not be publicly available on the Commission's website. We are proposing Rule 510T as a temporary rule that will expire two years after the effective date of proposed Rule 510T. In addition, we are proposing a number of legends and other disclosures that would need to be included in written general solicitation materials used in Rule 506(c) offerings. All such materials would need to disclose that only accredited investors can purchase in the Rule 506(c) offering. All such materials used by private funds would need to disclose that the securities offered are not subject to the protections of the Investment Company Act. And finally, any private fund that includes performance data in its written general solicitation materials would need to disclose certain information about the performance data. We propose to prescribe the basic elements of the disclosures but not the exact wording. We do not believe that any of the disclosures would be burdensome to prepare.

For purposes of the PRA, we estimate that the annual compliance burden of this collection of information requirement for issuers conducting Rule 506(c) offerings would be an aggregate 7,274 hours of issuer personnel time. We estimate that compliance with the proposed requirements related to written general solicitation materials would result in an estimated burden of two hours per offering under Rule 506(c). This estimated two hour burden includes the time it would take to prepare any applicable disclosures for the written general solicitation materials and to submit such materials through the Commission's website. Our burden estimate represents the average burden for all issuers per Rule 506(c) offering. In deriving this estimate, we assume that 100% of the burden of preparation will be carried by the issuer internally, which is reflected as an hourly burden.

Although it is not possible to predict the number of future offerings made in reliance on Rule 506(c) with any degree of accuracy, particularly because Rule 506(c) is not yet effective, for purposes of this analysis we estimate that there would be 3,637 Rule

506(c) offerings per year.[169] We assume for purposes of this analysis that all Rule 506(c) offerings will involve the use of written general solicitation materials.[170] Based on this estimated number of Rule 506(c) offerings and an estimated burden of two hours per Rule 506(c) offering, we estimate that the annual compliance burden of this collection of information requirement for the first year in which issuers would be required to submit written general solicitation materials to the Commission pursuant to Rule 510T would be an aggregate of 7,274 hours of issuer personnel time.

C. Request for Comment

We request comment in order to: (i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of our estimate of the burden of the proposed collections of information; (iii)

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[169] As a reference point for the potential increase in the total number of Rule 506 offerings after the adoption of Rule 506(c), we use the impact of another past rule change on the market for Regulation D offerings. In 1997, the Commission amended Rule 144(d) under the Securities Act [17 CFR 230.144(d)] to reduce the holding period for restricted securities from two years to one year, thereby increasing the attractiveness of Regulation D offerings to investors and to issuers. See Revision of Holding Period Requirements in Rules 144 and 145, Release No. 33-7390 (Feb. 20, 1997) [62 FR 9242 (Feb. 28, 1997)]. There were 10,341 Form D filings in 1996. This was followed by a 20% increase in the number of Form D filings in each of the subsequent three calendar years, reaching 17,830 by 1999. We assume that there could be a similarly significant increase in the overall number of Rule 506 offerings following the adoption of Rule 506(c). We also assume, for purposes of this analysis, that this 20% increase will be comprised entirely of Rule 506(c) offerings because of the benefits to issuers in using general solicitation, including wider access to accredited investors, and because non-accredited investors reportedly purchased securities in only 11% of the Rule 506 offerings conducted between 2009 and 2012. See Ivanov/Bauguess Study.

According to DERA, for the year ended December 31, 2012, there were 18,187 new Form D filings. A 20% increase in this number would result in a total of 21,824 new Regulation D offerings. Assuming the entire 20% increase is comprised of Rule 506(c) offerings, this would result in an estimated 3,637 Rule 506(c) offerings per year after adoption of the rule.

[170] Not all Rule 506(c) offerings will involve the use of written general solicitation materials and not all private funds will include performance data in their written general solicitation materials but we cannot predict with any degree of accuracy how issuers will conduct their Rule 506(c) offerings. Therefore, for purposes of this analysis, we are assigning two hours per Rule 506(c) offering, which we think represents a reasonable estimate of the average cost to issuers in Rule 506(c) offerings of complying with the proposed information requirements related to written general solicitation materials.

determine whether there are ways to enhance the quality, utility and clarity of the information to be collected; and (iv) evaluate whether there are ways to minimize the burden of the collections of information on those who respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and send a copy to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-06-13. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-06-13, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street, NE, Washington, DC 20549. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

IX. ECONOMIC ANALYSIS

As directed by Section 201(a)(1) of the JOBS Act, the Commission has amended Rule 506 of Regulation D to permit general solicitation for offers and sales of securities made pursuant to Rule 506, provided that all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify their accredited investor status. This rule amendment has raised a number of concerns with respect to the Commission's ability to evaluate and assess the changing nature of the Rule 506 market and investor awareness of the risks associated with offerings under Rule 506(c). We are proposing amendments to Regulation D, Form D and Rule 156 of the Securities Act to address these concerns.

The proposed amendments to Form D and Regulation D as it relates to Form D would:

- require the advance filing of Form D in Rule 506(c) offerings;
- require the filing of a closing amendment to Form D after the termination of a Rule 506 offering;
- require issuers to provide additional information in Form D primarily in regard to Rule 506 offerings; and
- disqualify an issuer from relying on Rule 506 for future offerings until one year after the required Form D filings are made if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the last five years, with Form D filing requirements in a Rule 506 offering.

These proposed amendments are intended to enhance the Commission's ability to evaluate the development of market practices in Rule 506 offerings. In addition, these proposed amendments are expected to support and facilitate examination and enforcement efforts by the Commission and other regulators.

We are also proposing a new rule in Regulation D and an amendment to Rule 156 designed to address investor protection concerns arising from the ability of issuers to engage in general solicitation in their Rule 506(c) offerings. The new rule and the amendment to Rule 156 would:

- require written general solicitation materials used in these offerings to include certain legends and other disclosures; and
- extend the interpretive guidance contained within Rule 156 to the sales literature of private funds.

Further, we are soliciting comment on whether manner or content restrictions should be imposed on general solicitation materials used by private funds.

We are proposing a new rule in Regulation D to require issuers, on a temporary basis, to submit any written general solicitation materials used in their Rule 506(c) offerings to the Commission. Such materials would be required to be submitted through an intake page on the Commission's website no later than the date of the first use of the materials in a Rule 506(c) offering. If adopted, this new rule would expire two years after the effective date of the rule.

We are mindful of the costs imposed by and the benefits obtained from our rules. The discussion below addresses the potential economic effects of these proposed amendments, including the likely benefits and costs of the amendments and their potential impact on efficiency, competition and capital formation.[171] These costs and benefits are not a result of the statutory mandate of Section 201(a) and are affected by the discretion we may exercise in implementing measures to supplement the implementation of the statutory mandate as contained in the amendments we are adopting today.

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171 Section 2(b) of the Securities Act and Section 3(f) of the Exchange Act require the Commission, when engaging in rulemaking that requires it to consider 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. 15 U.S.C. 77b(b); 15 U.S.C. 78c(f). Section 23(a)(2) of the Exchange Act requires the Commission, in adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition and prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. 15 U.S.C. 78w(a)(2).

A. Broad Economic Considerations

As we highlight in our baseline analysis below, we note that a large percentage of current Rule 506 offerings are conducted by small issuers, which is consistent with the original Commission initiative in the early 1980s to facilitate capital formation by small issuers.[172] We stated at that time that an important purpose of the Form D filing requirement was "to collect empirical data which will provide a basis for further action by the Commission either in terms of amending existing rules and regulations or proposing new ones. Further, the proposed Form would allow the Commission to elicit information necessary in assessing the effectiveness of Regulation D as a capital raising device for small businesses."[173]

As previously noted, we substantially revised Form D in 2008 to mandate its filing in electronic form.[174] At that time, we highlighted that a searchable electronic database of machine-readable filings would enable both federal and state securities regulators to analyze exempt securities transactions more effectively, thereby improving coordination among regulators and enhancing investor protections.[175] Since the adoption of the electronic Form D, we have been able to systematically extract information from the machine-readable filings, which are the best source of data about Rule 506 offerings and the basis of the baseline information provided below.

With the adoption of Rule 506(c), issuers are expected to have access to a greater number of capital sources because they will be able to generally solicit investors through

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[172] Form D and Regulation D were adopted in 1982. Release No. 33-6389 (adopting Form D as a replacement for Forms 4(6), 146, 240 and 242).

[173] Release No. 33-6339.

[174] See Release No. 33-8891.

[175] Id.

a variety of means, thereby lowering search costs. While participating investors must be accredited investors, and Rule 506(c) requires issuers to take reasonable steps to verify that such persons are accredited investors, it is possible that some verification methods could lead to participation by non-accredited investors. Non-accredited investors who are not detected by reasonable verification methods could then participate in Rule 506(c) offerings for which they may not be well suited. There is also an increased likelihood of non-accredited investor participation in Rule 506(c) offerings if verification methods are deficient. Both of these likelihoods increase with issuers' ability to generally solicit their offers to an audience of potential investors through broader communication and advertising channels.

The proposed enhancements to the Form D filing requirements are prompted, in part, by the additional investor protection concerns associated with the ability to generally solicit private offerings. The proposed additional information and filing requirements should also enable the Commission to better evaluate the effectiveness of general solicitation in raising capital for small businesses.

All of these proposed rules could also impose certain costs on issuers, including filing burdens, reduced flexibility in offering methods and disclosure of potentially sensitive information. We discuss these potential costs in relation to the anticipated benefits in the sections below.

B. Economic Baseline

To assess the economic impact of the proposed rules, we are using as our baseline the regulation of private offerings as it exists today, including the adoption of Rule 506(c), which removes the prohibition on general solicitation for offerings under Rule 506. We also include in our baseline the provisions enacted with the adoption of the bad actor rule, which disqualifies issuers and other market participants from relying on Rule 506 if "felons and other 'bad actors'" are participating in the offering. Because these provisions are being adopted today, the information provided below regarding the current state of the private offering market in the United States does not include data related to the use of general solicitation in Rule 506(c) offerings or the disqualification of bad actors, because no such data exist. Hence, some of our analysis of the potential impact of the proposed rules considers the anticipated effects of the adoption of Rules 506(c) and 506(d). As a result, many of the potential costs and benefits are difficult to quantify with any degree of certainty, especially as the practices of market participants are expected to evolve and adapt to the ability to generally solicit in Rule 506(c) offerings. To the extent applicable, we will consider developments in the private offering market subsequent to the adoption of today's rule amendments in any future assessment of the potential economic impact of the rules proposed today.

The baseline analysis that follows is in large part based on information collected from Form D filings submitted by issuers relying on Regulation D to raise capital, which is based on issuer reporting practices and requirements that could change because of the proposed amendments. As we describe in more detail below, we believe that we do not have a complete view of the Rule 506 market, particularly with respect to the amount of capital raised. Currently, issuers are required to file an initial Form D within 15 days of the first sale of securities, and are required to report additional sales through amended filings only under certain conditions. In addition, issuers do not report all required information, either due to error or because they do not wish to make the information public. Commenters have suggested and we also have evidence that some issuers are not filing a Form D for their offerings in compliance with Rule 503.[176] Consequently, the analysis that follows is necessarily subject to these limitations in the current Form D reporting process.

Some of the proposed rules, such as an Advance Form D filing for Rule 506(c) offerings, a closing Form D amendment for Rule 506 offerings, and expanded information requirements in Form D primarily in regard to Rule 506 offerings, seek to address these reporting limitations and are intended to result in more complete information on the Rule 506 market.

1. Size of the Exempt Offering Market

Exempt offerings play a significant role in capital formation in the United States. Offerings conducted in reliance on Rule 506 account for 99% of the capital reported as being raised under Regulation D from 2009 to 2012, and represent approximately 94% of the number of Regulation D offerings.[177] The significance of Rule 506 offerings is underscored by the comparison to registered offerings. In 2012, the estimated amount of capital reported as being raised in Rule 506 offerings (including both equity and debt) was $898 billion, compared to $1.2 trillion raised in registered offerings.[178] Of this $898 billion, operating companies (issuers that are not pooled investment funds) reported raising $173 billion, while pooled investment funds reported raising $725 billion.[179] The amount reported as being raised by pooled investment funds is comparable to the amount of capital raised by registered investment funds. In 2012, registered investment funds

[176] See note 85.

[177] See Ivanov/Bauguess Study.

[178] See id.

[179] See id.

(which include money market mutual funds, long-term mutual funds, exchange-traded funds, closed-end funds and unit investment trusts) raised approximately $727 billion.[180]

In 2011, the estimated amount of capital (including both equity and debt) reported as being raised in Rule 506 offerings was $849 billion compared to $985 billion raised in registered offerings.[181] Of the $849 billion, operating companies reported raising $71 billion, while pooled investment funds reported raising $778 billion.[182] More generally, when including offerings pursuant to other exemptions – Rule 144A, Regulation S and Section 4(a)(2) – significantly more capital appears to be raised through exempt offerings than registered offerings (Figure 1).[183]

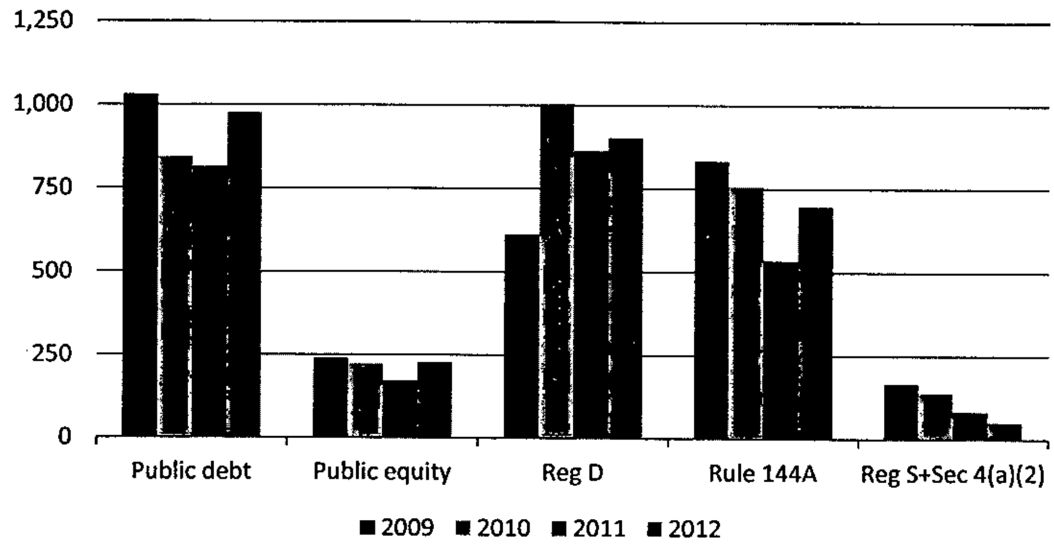
[180] In calculating the amount of capital raised by registered investment funds, we use the net amounts (plus reinvested dividends and reinvested capital gains), which reflect redemptions, and not gross amounts, by open-ended registered investment funds because they face frequent redemptions, and do not have redemption restrictions and lock-up periods common among private funds. In addition, we use the new issuances of registered closed-end funds and the new deposits of registered unit investment trusts. See 2013 Investment Company Institute Factbook, available at http://www.icifactbook.org.

[181] See Ivanov/Bauguess Study.

[182] See id.

[183] See id.

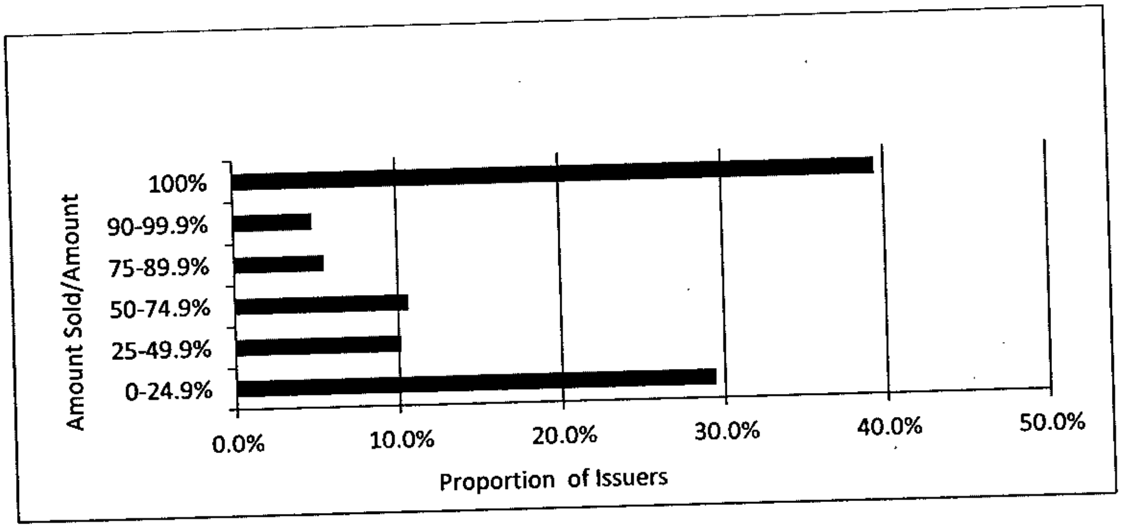
Figure 1: Capital Raised in U.S. Capital Markets during 2009-2012[184]



At present, issuers are required to file a Form D not later than 15 days after the first sale of securities in a Regulation D offering and an amendment to the Form D only under certain circumstances. Since issuers are not required to submit a filing when an offering is completed, and submit amendments only under certain circumstances, we have no definitive information on the final amounts raised. Figure 2, below, illustrates that at the time of the initial Form D filing, only 39% of offerings by non-pooled investment fund issuers were completed relative to the total amount sought. Separately, 70% of pooled investment funds state their total offering amount to be "Indefinite" in their Form D filings. As a result, the initial Form D filings of these pooled investment funds likely do not accurately reflect the total amount of securities offered or sold.

[184] The 2012 non-ABS Rule 144A offerings data is based on an extrapolation of currently available data through May 2012 from Sagient Research System's Placement Tracker database. For more detail, see the Ivanov/Bauguess Study.

Figure 2: Amount Sold as Percentage of Total Offering Amount by Non-Pooled Investment Fund Issuers in Regulation D Offerings at the Time of Form D Filing: 2009-2012



2. Affected Market Participants

The amendments to Rule 506 we are adopting today in a separate release will affect a number of different market participants. Issuers of securities in Rule 506 offerings include both reporting and non-reporting operating companies and pooled investment funds. Investment advisers organize and sponsor pooled investment funds that conduct Rule 506 offerings. Intermediaries that facilitate Rule 506 offerings include registered broker-dealers, finders and placement agents. Investors in Rule 506 offerings include accredited investors (both natural persons and legal entities) and non-accredited investors who meet certain "sophistication" requirements. Affected market participants might also include investors that are not eligible to participate in Rule 506(c) offerings, but do because of poor investor verification standards or fraudulent activities. Each of these market participants is discussed in further detail below.

a. Issuers

Based on the information submitted in 112,467 new and amended Form D filings between 2009 and 2012, there were 67,706 new Regulation D offerings by 49,740 unique issuers during this four-year period.[185] The size of the average Regulation D offering during this period was approximately \$30 million, whereas the size of the median offering was approximately \$1.5 million.[186] The difference between the average and median offering sizes indicates that the Regulation D market is comprised of many small offerings, which is consistent with the view that many smaller businesses are relying on Regulation D to raise capital, and a smaller number of much larger offerings.

Some information about issuer size is available from Item 5 in Form D, which requires issuers in Regulation D offerings to report their size in terms of revenue ranges or, in the case of pooled investment funds, net asset value ranges. All issuers can currently choose not to disclose this size information, however, and a significant majority of issuers that are not pooled investment funds declined to disclose their revenue ranges in the Forms D that they filed between 2009 and 2012. For those that did, most reported a revenue range of less than \$1 million (Figure 3).[187] During the 2009-2011 period, approximately 10% of all public companies raised capital in Regulation D offerings; in

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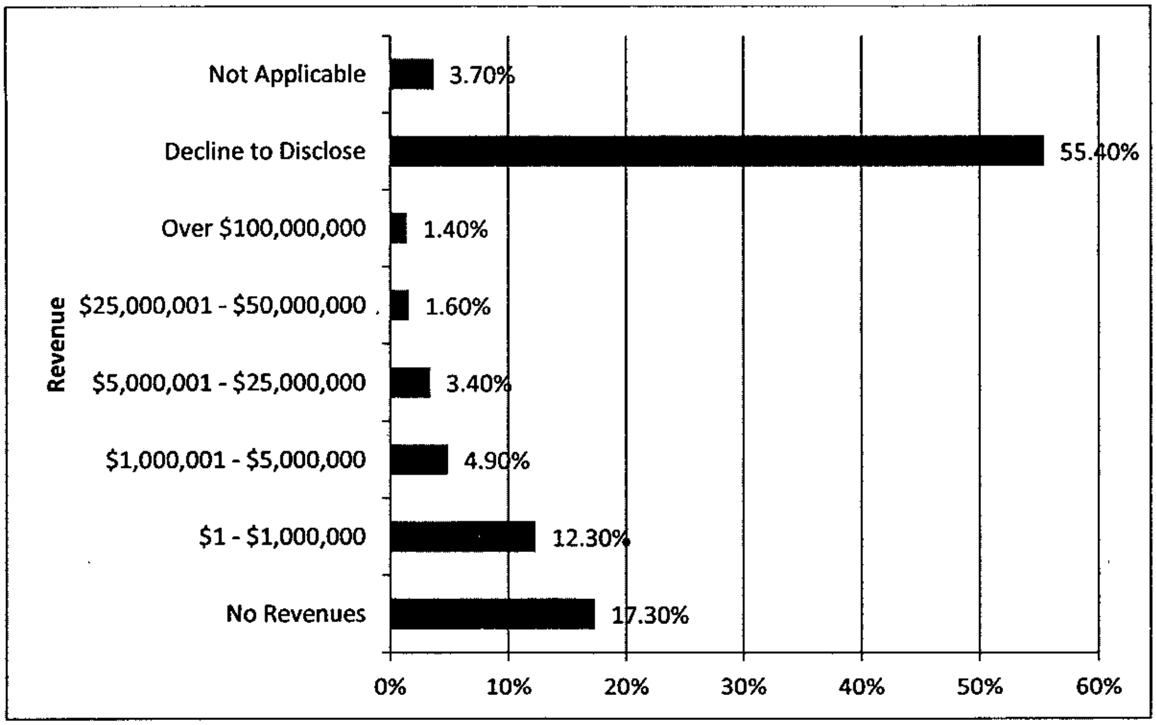
185 See Ivanov/Bauguess Study.

186 See id. The average and median amounts are calculated based on the amounts sold by Regulation D issuers as reported in their Form D filings. A study of unregistered equity offerings by publicly-traded companies over the period 1980-1996 finds that the mean offering amount was \$12.7 million, whereas the median offering amount was \$4.5 million. See Michael Hertzel, Michael Lemmon, James Linck and Lynn Rees, Long-Run Performance Following Private Placements of Equity, 57 Journal of Finance 2595 (2002).

187 See Ivanov/Bauguess Study.

2012, approximately 6% of such companies did so.[188] These public companies tended to be smaller and less profitable than their industry peers, which illustrates the importance of the private capital markets to smaller companies, whether public or private.[189]

Figure 3: Distribution of Non-Pooled Investment Fund Issuers in Regulation D Market by Revenue: 2009-2012



During this period, pooled investment funds conducted approximately 24% of the total number of Regulation D offerings and raised approximately 81% of the total amount of capital raised in Regulation D offerings.[190] More than 75% of pooled investment funds declined to disclose their net asset value range. The proposed amendments to Form

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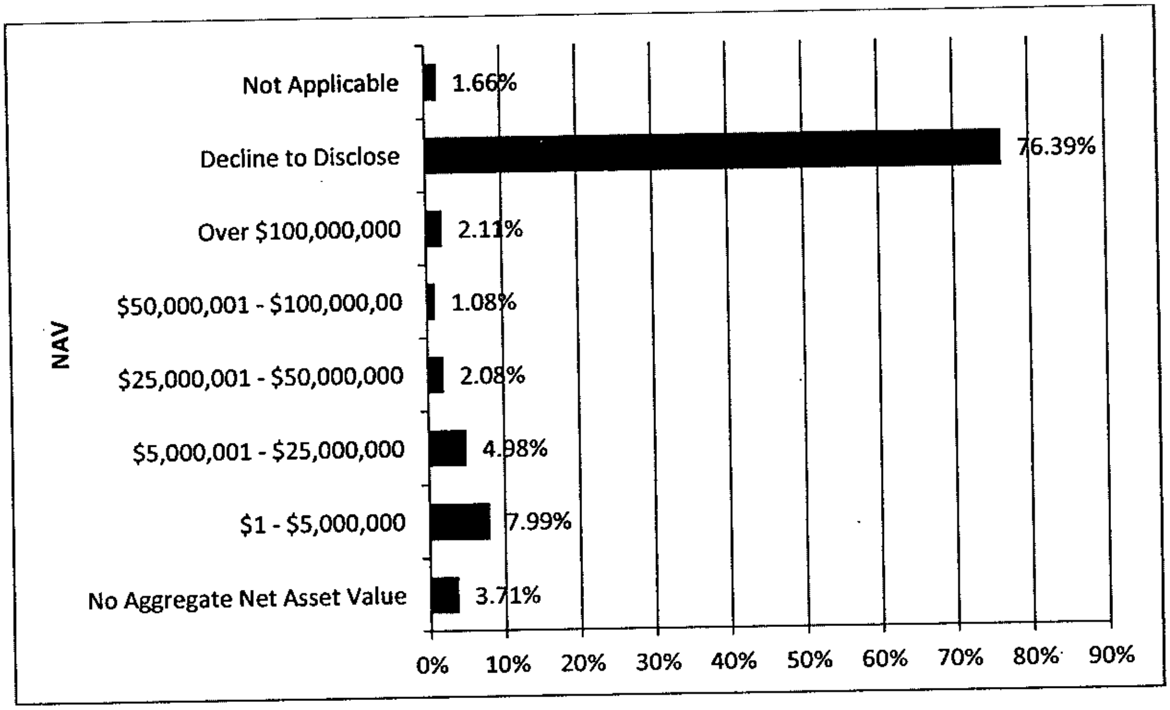
[188] Id. (explaining methodology of using listings in the Standard & Poor's Compustat database and the University of Chicago's Center for Research in Securities Prices database to determine which companies were public companies).

[189] Id.

[190] Id.

D would eliminate this voluntary choice to decline to report fund size (or issuer size for those that are not pooled investment funds), except for issuers who do not include such information in general solicitation materials under Rule 506(c) or otherwise make this information publicly available.

Figure 4: Distribution of Pooled Investment Fund Issuers in Regulation D Market by Net Asset Value: 2009-2012



Between 2009 and 2012, approximately 66% of Regulation D offerings were of equity securities, and almost two-thirds of these were by issuers other than pooled investment funds.[191] Non-U.S. issuers accounted for approximately 19% of the amount of capital raised in Regulation D offerings, indicating that the U.S. market is a significant source of capital for these issuers.[192]

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[191] Id.

[192] Id.

b. Investors

We have relatively little information on the types and number of investors in Rule 506 offerings. Form D currently requires issuers in Rule 506 offerings to provide information about the total number of investors who have already invested in the offering and the number of persons who do not qualify as accredited investors.[193] In 2012, approximately 153,000 investors participated in offerings by operating companies, while approximately 81,000 investors invested in offerings by pooled investment funds.[194] Because some investors participate in multiple offerings, these numbers likely overestimate the actual number of unique investors in these reported offerings. We do not know what fraction of these investors are natural persons or entities because Form D does not require any other information on the types of investors.[195] In offerings under Rule 506(b), both accredited investors and up to 35 non-accredited investors who meet certain "sophistication" requirements are eligible to purchase securities. In offerings under new Rule 506(c), only accredited investors will be eligible to purchase securities.

Information collected from Form D filings indicates that most Rule 506 offerings do not involve broad investor participation. More than two-thirds of these offerings have ten or fewer investors, while less than 5% of these offerings have more than 30 investors. Although Rule 506 currently allows for the participation of non-accredited investors who meet certain sophistication requirements, such non-accredited investors purchased

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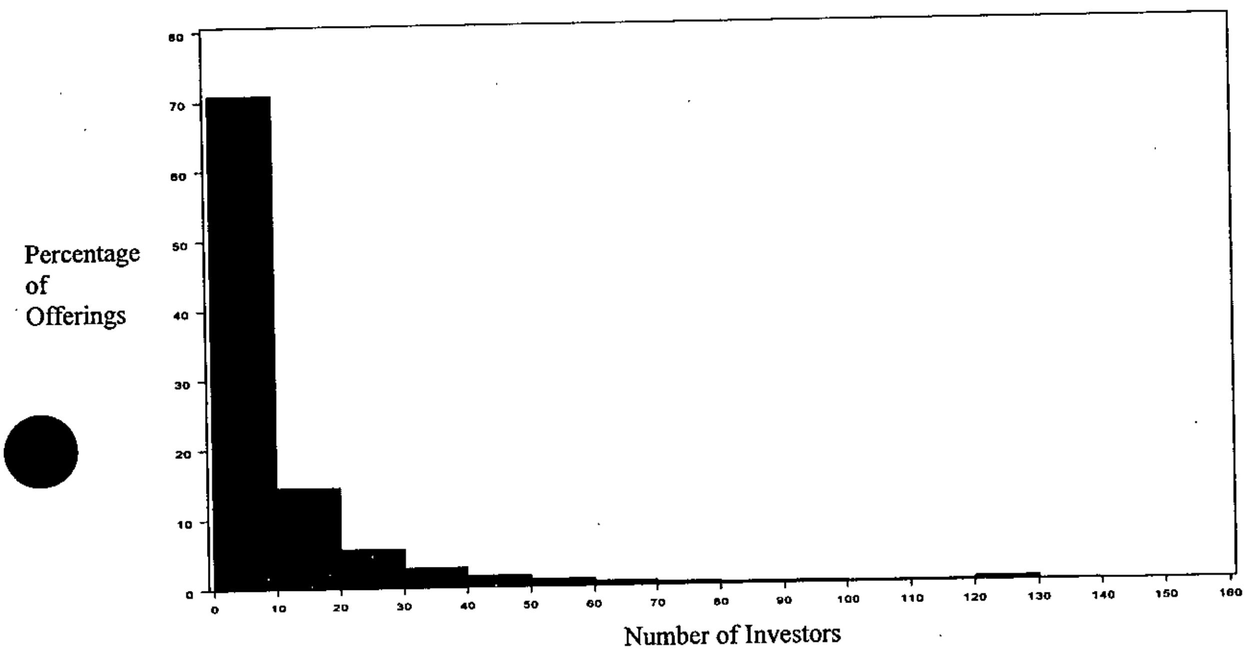
193 See Item 14 of Form D. Form D does not require any other information on the types of investors, such as whether they are natural persons or legal entities.

194 These numbers are based on initial Form D filings submitted in 2012.

195 See Item 14 of Form D.

securities in only 11% of the Rule 506 offerings conducted between 2009 and 2012.[196] Only 8% of the offerings by pooled investment funds included non-accredited investors, compared to 12% of the offerings by other issuers.[197]

Figure 5: Distribution of Regulation D Offerings by Number of Investors: 2009-2012



As stated above, between 2009 and 2012, the size of the median Regulation D offering, based on the information in Form D filings, was approximately $1.5 million. The presence of so many relatively small offerings suggests that a sizable number of current investors in Rule 506 offerings are natural persons or legal entities in which all equity owners are natural persons. This is because smaller offerings may not provide sufficient scale for institutional investors to earn a sizable return. Institutional investors

[196] See Ivanov/Bauguess Study.

[197] Id.

typically have a larger investible capital base and more formal screening procedures compared to investors who are natural persons, and the associated costs of identifying potential investments and monitoring their investment portfolio lead them to make larger investments than natural persons.[198] As for whether natural persons investing in these offerings are accredited investors or non-accredited investors, almost 90% of the Regulation D offerings conducted between 2009 and 2012 did not involve any non-accredited investors.[199]

While we do not know what percentage of investors in Rule 506 offerings are natural persons, the vast majority of Regulation D offerings are conducted without the use of an intermediary,[200] suggesting that many of the investors in Regulation D offerings likely have a pre-existing relationship with the issuer or its management because these offerings would not have been conducted using general solicitation. This category of investors is likely to be much smaller than the total number of eligible investors for Rule 506(c) offerings, which is potentially very large. We estimate that at least 8.7 million U.S. households, or 7.4% of all U.S. households, qualified as accredited investors in 2010, based on the net worth standard in the definition of "accredited investor" (Figure 6).[201]

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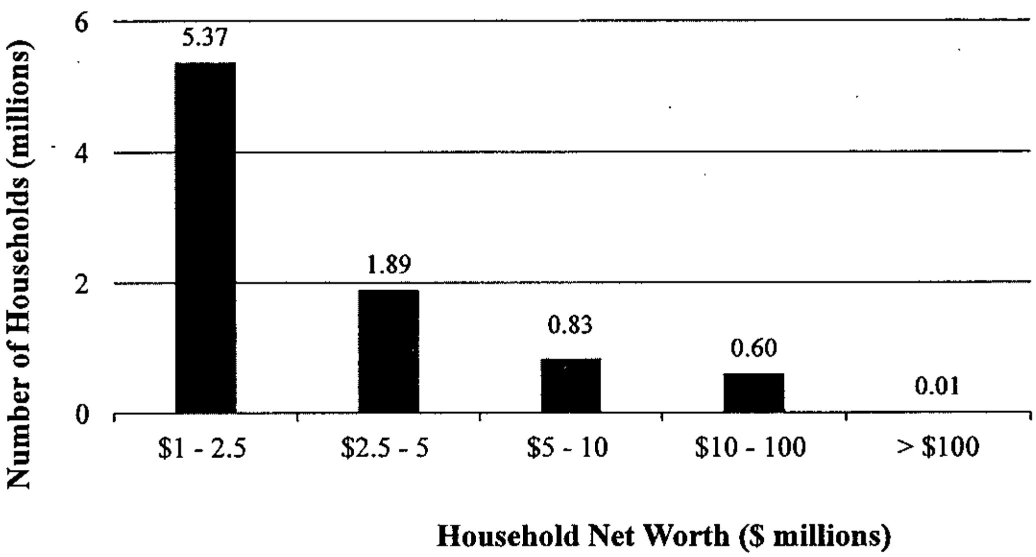
198 See, e.g., George Fenn, Nellie Liang and Stephen Prowes, The Economics of Private Equity Markets (1998); Steven Kaplan and Per Strömberg, Leveraged Buyouts and Private Equity, 23 Journal of Economic Perspectives 121 (2009).

199 See Ivanov/Bauguess Study.

200 An analysis of all Form D filings submitted between 2009 to 2012 shows that approximately 11% of all new offerings reported sales commissions of greater than zero because the issuers used intermediaries. See Ivanov/Bauguess Study. We assume that the lack of a commission indicates the absence of an intermediary.

201 This estimate is based on net worth and household data from the Federal Reserve Board's Triennial Survey of Consumer Finances 2010. Our calculations are based on all 32,410 observations in the 2010 survey.

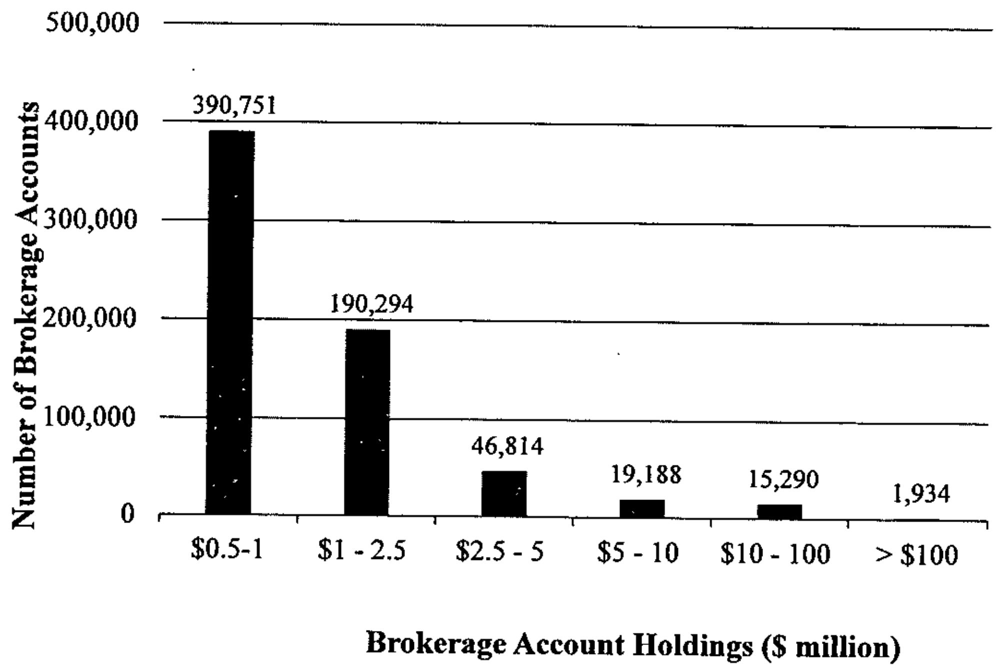
Figure 6: Number of U.S. Households that Qualify as Accredited Investors Based on 2010 Net Worth



Our analysis, however, leads us to believe that only a small percentage of these households are likely to participate in securities offerings, especially exempt offerings. First, as mentioned above, data from Form D filings in 2012 suggests that fewer than 234,000 investors (of which an unknown subset are natural persons) participated in Regulation D offerings, which is small compared to the 8.7 million households that qualify as accredited investors. Second, evidence suggests that only a small fraction of the total accredited investor population has significant levels of direct stockholdings. Based on an analysis of retail stock holding data for 33 million brokerage accounts in 2010, only 3.7 million accounts had at least $100,000 of direct investments in equity securities issued by public companies listed on domestic national securities exchanges, while only 664,000 accounts had at least $500,000 of direct investments in such equity

securities (Figure 7).[202] Assuming that investments in publicly-traded equity securities are a gateway to investments in securities issued in exempt offerings, and accredited investors with investment experience in publicly-traded equity securities are more likely to participate in an exempt offering than accredited investors who do not, the set of accredited investors likely to be interested in investing in Rule 506(c) offerings could be significantly smaller than the total accredited investor population.

Figure 7: Direct Stock Holdings of Retail Investors, 2010



c. Investment Advisers

As of December 2012, there were 10,870 Commission-registered investment advisers that filed Form ADV with the Commission, representing approximately $50

[202] This analysis by DERA is based on the stock holdings of retail investors from more than 100 brokerage firms covering more than 33 million accounts during the period June 2010-May 2011.

trillion total assets under management.[203] The average investment adviser registered with the Commission has assets under management of approximately $4.6 billion; the median size of assets under management for these registered investment advisers is $258 million.

Approximately one-fourth of registered investment advisers (2,842) currently advise (or advised) private funds that filed Form D between 2002 and 2012, while another 1,250 registered investment advisers currently advise (or advised) private funds that did not file Form D during the same period. The registered investment advisers advising private funds that submitted Form D filings during this period had average assets under management of $8.7 billion, while the ones advising private funds that did not submit Form D filings had average assets under management of $8.6 billion. Registered investment advisers that did not advise private funds (6,623) are considerably smaller, with average assets under management of $2.1 billion.

d. Broker-Dealers

As of December 2012, there were 4,450 broker-dealers registered with the Commission who file on Form X-17A-5, with average total assets of approximately $1.1 billion per broker-dealer. The aggregate total assets of these registered broker-dealers are approximately $4.9 trillion. Of these registered broker-dealers, 410 are dually registered as investment advisers. The dually registered broker-dealers are larger (average total assets of $6.4 billion) than those that are not dually registered. Among the dually registered broker-dealers, we identified 24 that currently have or have had private funds that submitted Form D filings between 2002 and 2012.

[203] For the same time period, 2,303 exempt reporting advisers filed a Form ADV with the Commission. Certain investment advisers that are ineligible to register with the Commission may also be exempt from registration with any state.

3. Incidence of Fraud in Securities Offerings

As discussed above, commenters expressed concern that the use of general solicitation in Rule 506(c) offerings could lead to greater incidence of fraud in this market as those seeking to conduct fraudulent offerings would be able to directly solicit unsophisticated investors. Our principal source of data about the Rule 506 market is Form D filings and the incidence of fraud detected by us and other regulators. Because data on the incidence of fraud in private securities offerings is extremely limited, we are unable to estimate the extent of fraud in the existing market for privately offered securities or the degree, if any, to which such fraud may increase upon the adoption of Rule 506(c).

Some commenters suggested that we look to our experience with offerings conducted pursuant to Rule 504, as amended in 1992, as a means of evaluating the potential for fraud in the Rule 506(c) market. We do not believe that our experience with the 1992 amendments to Rule 504 is particularly instructive with respect to the potential incidence of fraud resulting from our implementation of Section 201(a) of the JOBS Act.[204]

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[204] In 1992, when we amended Rule 504 to eliminate the prohibition against general solicitation, we also provided that the securities issued in these Rule 504 offerings would not be "restricted securities" for purposes of resale pursuant to Rule 144 under the Securities Act. As a result, a non-reporting company could sell up to $1 million of immediately freely-tradable securities in a 12-month period and be subject only to the antifraud and civil liability provisions of the federal securities laws.

By 1998, we concluded that securities issued in these Rule 504 offerings facilitated a number of fraudulent secondary transactions in the over-the-counter markets, and that these securities were issued by "microcap" companies, characterized by thin capitalization, low share prices and little or no analyst coverage. Moreover, we stated that, while "we believe that the scope of abuse is small in relation to the actual usage of the exemption, we also believe that a regulatory response may be necessary." As the freely-tradable nature of the securities facilitated the fraudulent secondary transactions, we proposed to "implement the same resale restrictions on securities issued in a Rule 504 transaction as apply to transactions under the other Regulation D exemptions," in addition to reinstating the prohibition against general solicitation. Although we recognized that resale restrictions would have "some impact upon small businesses trying to raise 'seed capital' in bona fide transactions," we believed that such restrictions were necessary so that

Several commenters echoed concerns regarding the potential of fraud related to private funds in the Rule 506(c) market.[205] Empirical evidence on the extent of fraud involving private funds is not readily available. While a few economic studies suggest that certain hedge funds engage in various types of misreporting, such as misrepresenting past performance,[206] delaying disclosure of returns[207] and inflating returns at the end of the fiscal year in order to earn higher fees,[208] these studies do not provide information about the extent or magnitude of any such misreporting activities. In a 2003 report, the Commission staff noted that there was no evidence that hedge funds were disproportionately involved in fraudulent activity and that the charges brought by the Commission in 38 enforcement actions against hedge fund advisers and hedge funds between 1999 and 2003 were similar to the charges against other types of investment advisers.[209] Evidence on the extent of fraud involving other types of pooled investment funds also is sparse. A more recent study has identified 245 lawsuits (both federal and

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"unscrupulous stock promoters will be less likely to use Rule 504 as the source of the freely tradable securities they need to facilitate their fraudulent activities in the secondary markets." Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Release No. 33-7541 (May 21, 1998) [63 FR 29168, 29169].

In contrast, issuers using Rule 506(c) can sell only to accredited investors, and the securities issued in these offerings are deemed to be "restricted securities" for purposes of resale under Rule 144. As a result, schemes involving price manipulation to defraud unknowing investors in the immediate resale of securities purchased directly from issuers (colloquially referred to as "pump and dump" schemes) are not the types of fraud we believe are likely to occur in Rule 506(c) offerings, given the holding period requirement in Rule 144(d) and other structural impediments, such as restricted transfer legends on stock certificates.

205 See letters from Consumer Federation; Fund Democracy; IDC.

206 See Andrew Patton, Tarun Ramadorai and Michael Streatfield, Change You Can Believe In? Hedge Fund Data Revisions (Duke University, Working Paper, 2013). But see letter from MFA (June 20, 2013) (questioning the reliability of the underlying data used in the study).

207 See George Aragon and Vikram Nanda, Strategic Delays and Clustering in Hedge Fund Reported Returns (Arizona State University, Working Paper, 2013).

208 See Vikas Agarwal, Naveen Daniel and Naranyan Naik, Do Hedge Funds Manage Their Reported Returns?, 24 Review of Financial Studies 3282 (2011).

209 See Implications of the Growth of Hedge Funds, Staff Report to the U.S. Securities and Exchange Commission (Sept. 2003), available at http://www.sec.gov/news/studies/hedgefunds0903.pdf.

state) involving 200 venture capitalists as defendants between 1975 and 2007, and has shown that venture capital funds that are older and have a larger presence in terms of size and network are less likely to be sued.[210]

For comparison purposes, a recent study using enforcement actions brought by the Commission and private securities class action lawsuits to measure the incidence of fraud in the registered offering market found that approximately 3% of registered initial public offerings during the period from 1995 to 2007 were associated with allegations of fraud.[211] This study used the filing of a securities lawsuit against an issuer for financial misreporting during the initial public offering process as the proxy for detected fraud. The analysis covered 3,297 initial public offerings that resulted in 110 cases. The study determined that the incidence of fraud increased to 12% when securities law violations committed in years subsequent to the initial public offering were included. These are cases where fraud was detected and the Commission filed or instituted enforcement action; at best, they represent a lower bound on incidence of fraud in those markets.

While we cannot estimate the extent of fraud in the market for privately offered securities, we do know, based upon our own experience enforcing the federal securities laws and the enforcement efforts of criminal authorities and state securities regulators, that fraud exists in this market. One of the primary objectives of the amendments to Regulation D and Form D being proposed today is to increase the information available to the Commission about the Rule 506 market so that we can better assess, and, if necessary, take steps to respond to, fraudulent practices in the market for privately

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[210] See Vladimir Atanasov, Vladimir Ivanov and Kate Litvak, Does Reputation Limit Opportunistic Behavior in the VC Industry? Evidence From Litigation Against VCs, 67 Journal of Finance 2215 (2012).

[211] See Tracy Wang, Andrew Winton and Xiaoyun Yu, Corporate Fraud and Business Conditions: Evidence from IPOs, 65 Journal of Finance 2255 (2010).

offered securities.

4. Current Practices

The potential economic impact of the proposed amendments will depend on the current practices of issuers and market participants in Rule 506 offerings – specifically, on the extent to which issuers currently file Form D and their incentives for doing so in the future. The analysis below provides an assessment of current compliance rates with respect to Form D filing requirements.

a. Missing Form D Filings

Issuers that use an exemption under Regulation D to raise capital are required to file a Form D not later than 15 days after the first sale of securities in the offering; however, the filing of Form D is not a condition to the use of Regulation D. Commenters have indicated that a number of issuers in Regulation D offerings do not file the form, even though the filing of Form D is a requirement of Regulation D. Assessing the prevalence of current non-compliance is difficult because a Form D filing is often the only public record of a Regulation D offering. We can provide an estimate of filing compliance for issuers under Rule 506 that use a registered broker-dealer in these offerings and for private funds that are managed by a Commission-registered investment adviser.[212] Because information related to private offerings for these sets of issuers is available in other filings, we can determine, in certain cases, when a Form D should have been but was not filed. In the analyses below, we present evidence on the corresponding

[212] Broker-dealers registered with FINRA are required to file private placement memoranda under FINRA Rules 5122 and 5123 for their or their client's private offering. Sections 203 and 204 of the Advisers Act [15 U.S.C. §§ 80b-3 and 80b-4] authorize the Commission to collect the information required by Form ADV. Investment advisers that are required to register with the Commission and exempt reporting advisers are required to file Form ADV with the Commission. The form includes disclosure of Regulation D offerings that they conduct for their client issuers.

rate at which we observe Form D filings. It should be noted that our estimates are subject to some degree of error because in some instances it is possible that that a Form D was filed even though we could not match it to a specific offering. In other instances, a Form D may not have been filed because the issuer may be relying on another exemption from Securities Act registration that does not require a Form D filing, such as the statutory exemption under Section 4(a)(2). Our estimates of compliance for issuers that use a registered investment adviser or broker-dealer also may not reflect the rate of compliance among issuers that do not. To the extent that Forms D are more likely to be filed when a registered entity is involved, there could be a greater rate of non-compliance among the remaining Rule 506 offerings that do not involve a registered investment adviser or broker-dealer.[213]

Form D and Form ADV reconciliation. Our estimate of Form D filing compliance among Commission-registered investment advisers that manage private funds is based on their requirement to report to the Commission on Form ADV the Regulation D offerings that they conduct. We matched the Form D file numbers reported on Form ADV filings from 2012 to the actual Form D and Form D amendments filed on EDGAR. This created a universe of 18,276 private funds identified on Form ADV filings for the period between 2002 and 2012.[214] The matching was done in two steps. First, we matched the file number of each Regulation D offering as reported by the investment adviser on Form ADV to the file numbers in EDGAR.[215] Second, if there was no file

213 Approximately 20% of Rule 506 offerings use either a broker-dealer or investment adviser.

214 We chose this period because Form D file numbers are not available for Form D filings submitted prior to January 1, 2002.

215 Some advisers identify a private fund's Form D file number as a series of 9s because they may not be able to locate the fund's Form D file number (particularly with respect to Form D filings made prior to

number for the Regulation D offering, we matched by private fund name. We compared the name of the private fund reported by the investment adviser in its Form ADV to the issuer names in the Form D and Form D amendment filings. Conducting both steps resulted in an 89% match – i.e., during the period from 2002 to 2012, as many as 11% of the private funds advised by registered investment advisers did not file a Form D when relying on the Regulation D exemption. This number, however, could overstate the actual number of private funds that did not file a Form D due to typographical errors in the name of the private fund or filing number. Also, registered investment advisers are required to identify Form D filing numbers only for private funds that are currently offering their securities. As a result, the Form ADV filings of advisers to private funds that are closed to new investments or are no longer engaged in a Regulation D offering of their securities are not required to disclose a Form D filing number.

Form D and FINRA filing reconciliation. Our estimate of Form D filing compliance among registered broker-dealers that facilitate private offerings is based on their compliance with FINRA Rules 5122 and 5123 (the latter rule took effect on December 3, 2012), which requires member firms that sell securities in certain private offerings to file with FINRA copies of any private placement memorandum, term sheet or other offering document used in these offerings (or amendments thereof) or, alternatively, to file a notice stating that no such offering document was used.[216] As of December 31,

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January 1, 2002 because such file numbers are not available through an EDGAR search). Advisers may also mask the Form D file number to maintain the anonymity of a private fund's name. These factors will understate the number of funds that file Form D and Form D amendments. Thus, in such cases we attempted to match by fund name.

216 Not all broker-dealers that sell securities in private offerings have to file private placement memoranda with FINRA under FINRA Rules 5122 and 5123. FINRA filings represent a small proportion of Regulation D offerings. For example, if a broker-dealer is not registered as a member of FINRA, they will

2012, FINRA oversaw nearly 4,300 brokerage firms.[217] During the period from December 3, 2012 to February 5, 2013, FINRA received 366 filings under this rule. Each private offering could have multiple broker-dealers and consequently the 366 filings could represent fewer than 366 unique offerings. Further, FINRA rules require filing by broker-dealers associated with a Regulation D or other private offerings, not all of which require the filing of Form D. A Form D filing is only required by issuers that undertake Regulation D offerings. We cannot identify how many of the 366 filings are related to non-Regulation D offerings.

We matched these FINRA filings to the Form D and Form D amendment filings received on EDGAR. The matching was done in multiple steps. First, we matched using the issuer CIK number and the Form D filing number[218] contained in each of the separate filings. Then, for each unmatched FINRA filing, we searched the issuer name, and variants of the name, in EDGAR to determine if a Form D was filed for that issuer's offering. Applying both procedures resulted in a 91% match – i.e., during this three-month period, subject to the limitations described above, as many as 9% of the offerings represented in the FINRA filings for Regulation D or other private offerings that used a registered broker did not have a corresponding Form D.

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not file with FINRA. Further only those private offerings that have retail investors, i.e., natural persons, trigger the requirement for the broker-dealer to file the private placement memorandum with FINRA.

[217] See http://www.finra.org/Newsroom/Statistics/.

[218] The Form D filing number is the 021- Commission filing number reported in the header of the Form D filing.

b. Legends and Other Disclosures in Regulation D Offering Materials

Prior to the effectiveness of Rule 506(c), general solicitation has not been permitted for private offerings under Rule 506. Although advertising by issuers is prohibited, issuers may provide some material or information to intermediaries and interested investors regarding themselves and their offering. Because this information is not filed with the Commission, we do not know if legends and relevant disclosures are included in any such material.

C. Analysis of the Amendments Relating to Form D

We are proposing amendments to Form D and Regulation D as they relate to Form D in order to enhance our understanding of the Rule 506 market, particularly the impact of the adoption of Rule 506(c). These proposed amendments would:

- require the filing of Form D 15 calendar days in advance of the first use of general solicitation in a Rule 506(c) offering;
- require the filing of a closing amendment to Form D within 30 calendar days after the termination of a Rule 506 offering;
- require issuers to provide additional information in Form D primarily with respect to Rule 506 offerings; and
- disqualify an issuer from relying on Rule 506 for future offerings until one year after the required Form D filings are made if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the last five years, with Form D filing requirements in a Rule 506 offering.

The proposals relating to the Form D filing requirements are intended to improve the availability of Form D information to the Commission that would enable it to evaluate market developments in the Rule 506 market. The amendments to the information requirements of Form D would enable the Commission to obtain more complete information about the Rule 506 market than it has now, especially with respect to the composition of investors and the general solicitation practices and verification methods employed in Rule 506(c) offerings.

1. Advance Filing of Form D for Rule 506(c) Offerings

We are proposing to amend Rule 503 of Regulation D to require issuers that intend to engage in general solicitation for Rule 506(c) offerings to file an initial Form D with certain information 15 calendar days in advance of any general solicitation for the offering. We believe that requiring issuers to file an Advance Form D would assist the Commission's efforts to evaluate the use of Rule 506(c). The Advance Form D would be useful to the Commission and the Commission staff, as it would enhance the information available to the Commission to analyze issuers that attempted to conduct Rule 506(c) offerings but were unsuccessful in selling any securities through these offerings or chose alternative forms of raising capital. Currently, Form D is required to be filed only after the first sale of securities, which means that issuers that attempted to, but did not, complete a sale are not required to file a Form D, thereby limiting the Commission's ability to determine which issuers are facing challenges raising capital under Rule 506(c) and whether further steps are needed to facilitate issuers' ability to raise capital under Rule 506(c). We also understand that the Advance Form D would be useful to state securities regulators and to investors in gathering timely information about the use of Rule 506(c).

On the other hand, to the extent that an Advance Form D filing signals planned capital-raising activity and related details to potential competitors, some issuers may be reluctant to use Rule 506(c) when they might otherwise. The proposed Advance Form D filing requirement could thus deter some issuers from using Rule 506(c) as they would be forced to indicate their capital raising plans to a limited extent prior to commencing their general solicitation activities. In addition, the proposed Advance Form D filing requirement could impose market timing costs to the extent that an issuer would like to move quickly but has not yet filed an Advance Form D. We have proposed an advance filing deadline that we think appropriately balances the benefits of advance notice with these market timing costs. Nevertheless, many issuers may choose to file an Advance Form D just in case they decide to conduct a Rule 506(c) offering. As a result, many Advance Form D filings may not reflect the true intent of issuers to conduct these offerings. If there are large numbers of issuers that frequently engage in this practice, there could be a sizable number of premature, and possibly even meaningless, notices of Rule 506(c) offerings; however, requiring specific information about the anticipated offering could decrease the likelihood that issuers file an Advance Form D when they do not intend to conduct an offering in the near term.

To complete an Advance Form D would cause issuers to incur costs; however, because the information in Advance Form D mirrors the information required to be filed within 15 days of the first sale of securities, the additional expense to collect the information for the Advance Form D would be offset by the lack of any need to do so for the subsequent filings.

2. Form D Closing Amendment for Rule 506 Offerings

We are also proposing to amend Rule 503 to require the filing of a final amendment to Form D within 30 calendar days after the termination of a Rule 506 offering. Requiring a closing filing through a Form D amendment upon the termination of a Rule 506 offering, in combination with the changes to Form D to require additional information on Rule 506 offerings, would provide more complete information of the total amounts of capital raised in these offerings by the types of investor and the methods used to verify accredited investor status in Rule 506(c) offerings.

At present, issuers are required to file a Form D within 15 days of the first sale of securities in a Regulation D offering and amendments to the Form D under certain circumstances. As a result, if the total offering amount remains the same or is increased by less than 10%, any capital raised or any change in the composition of subscribing investors, subsequent to the last filing for the offering, is not required to be reported in a Form D. For example, in 2010, issuers sought to raise $1.2 trillion in reported Regulation D offerings, but only $905 billion was reported as sold at the time of the initial Form D filing.[219] Thus, based on the available information, we are not able to determine the actual amount raised. A requirement to file a closing amendment to Form D for a Rule 506 offering that confirms the actual amount raised in the offering could provide more complete information.

Without a closing Form D amendment requirement, it may be difficult to clearly ascertain, for example, all of the methods of general solicitation that issuers used in Rule 506(c) offerings or the types of investors solicited in these offerings, particularly if any changes in solicitation methods or targeted investors after the initial Form D filing are not otherwise required to be reported. In such case, any analysis of the information in

[219] See Ivanov/Bauguess Study. For issuers that reported their offering amount as 'Indefinite', we assumed that amount offered is equal to amount raised.

Form D filings would be based on incomplete data, which may limit the intended benefits of collecting the Form D information. Updated and more conclusive data on Rule 506 offerings from closing Form D amendments would provide the Commission with a more complete account of the flow of capital in the Rule 506 market, how the flow relates to offering characteristics and the potential associated risks and would assist the Commission in evaluating whether further regulatory action is necessary.

Requiring a closing Form D amendment for Rule 506 offerings would likely come at a nominal cost to issuers in terms of filing another notice, particularly because the filing would be substantially similar to the initial Form D filing or prior Form D amendments for the offering.

3. Amendments to the Content Requirements of Form D

The information about Regulation D offerings collected to date and described in this release illustrates and underscores the importance of the non-registered offering market to the U.S. economy. Form D is the primary source of information for the Commission to assess the Regulation D market. Much of what we know about the size and characteristics of the private offering market comes from Form D filings. The continued collection of this information following the elimination of the prohibition against general solicitation in Rule 506(c) offerings will be an important tool for determining the ongoing impact of Rule 506(c).

A number of the proposed amendments to Form D would require additional information specific to Rule 506(c) offerings, which would enable the Commission to develop a greater understanding of the new Rule 506(c) market, particularly with respect to those matters where limited to no information would otherwise be available. Other proposed revisions to Form D would require additional information in regard to both Rule 506(b) offerings and Rule 506(c) offerings, which would permit a more complete analysis and comparison of the use of current Rule 506(b) and new Rule 506(c).[220] Without a substantially similar set of information collected for both Rule 506(b) and 506(c) offerings, the effects of the use of general solicitation on the Rule 506 market may be difficult to measure or identify. Increased consistency in the reporting of information in Form D filings for offerings under Rules 506(b) and 506(c) would promote the availability of comparable data for the two types of offerings and, consequently, may result in a more complete assessment of the effects of the elimination of the prohibition against general solicitation on raising capital under Regulation D. In addition, because the overwhelming majority of Regulation D offerings are conducted in reliance on Rule 506, this should provide the Commission with substantially more complete information about the Regulation D market generally, which, when considered along with the information collected as part of the Commission's Rule 506 review program, would help the Commission evaluate the need for additional action to enhance investor protection.

On the other hand, the proposed amendments to Form D may result in higher compliance costs for issuers conducting offerings in reliance on Rule 506(b) and new Rule 506(c). Issuers relying on Rule 506(b) would have to provide more information than is currently the case in regard to Form D, which would be coupled with the risk of disqualification from using Rule 506 in future offerings, under proposed Rule 507(b), if they or their affiliates or predecessors fail to comply with the additional Form D filing

[220] A number of the proposed revisions to Form D would also require additional information in regard to offerings under Rule 504, Rule 505, and Section 4(a)(5).

requirements. Nevertheless, we believe that the additional burden to provide the additional required information to be minimal. The proposed amendments would also require, depending on the circumstances, additional information under Items 5 and 9 of Form D with respect to offerings under Rule 504, Rule 505 or Section 4(a)(5), which, as discussed below, we do not believe would result in materially higher compliance costs for issuers conducting these offerings.

Issuers may view the increased reporting requirements as a greater regulatory burden and a loss of commercial privacy,[221] which could put certain issuers at a competitive disadvantage if the costs are sufficient to deter them from raising capital in the private offering market. Requiring issuers to report more information in Form D could also result in some issuers choosing to consider other capital-raising options.

A discussion of a number of the proposed amendments to Form D is set forth below.

a. Investor Types

The proposed amendment to Item 14 (Investors) of Form D would require information, with respect to Rule 506 offerings, on the number of investors under the following categories: natural persons who are accredited investors, legal entities that are accredited investors, and if applicable, non-accredited natural persons and non-accredited legal entities. The additional required information would include the amount raised from each of the four categories of investors. At present, Form D requires information on the total amount of capital expected to be raised and the number of accredited and non-

[221] Issuers may not wish to reveal certain information such as the timing of amounts offered and raised, including whether an offering was successfully completed, which could inform other market participants, including competitors, about the issuers' ability to finance investments.

accredited investo have purchased securities in a particular offering. We do not have informa e number of investors who are natural persons or legal entities, or the amo om each of these investor categories. The proposed amendment wo more detailed information on the composition of investors in the than is currently available. Because all purchasers in Rule 506(c) be accredited investors, and offerings under Rule 506(b) can have no more accredited investors who meet certain sophistication requirements, ed data regarding the number of each type of investor and the amount by accredited and non-accredited investors would provide a more complete view participation in the Rule 506 market.

Understanding the composition of investors in Rule 506 offerings as between natural persons and legal entities would also be important for risk assessment purposes. Institutional investors usually have a greater amount of resources at their disposal and therefore are more likely to have better information and greater sophistication when considering the potential risks and benefits of a particular investment, as compared to natural persons.[222] To the extent that natural persons are less sophisticated and more prone to be targets of fraud than institutional investors, understanding how many natural persons are participating in Rule 506(c) offering could help identify those Rule 506(c) offerings that raise greater investor protection concerns. This information could also help the Commission better understand how general solicitation is used with respect to the types of investors. Additionally, concerns about verification methods to assess accredite investor status are greatest as it relates to natural persons. Having a better understan

[222] See note 198.

of the involvement of natural persons in Rule 506(c) offerings would assist the Commission in its assessment of the efficacy of the verification provisions.

Issuers relying on Rule 506(c) will be collecting such information as part of their verification of accredited investor status for Rule 506(c) offerings. We do not expect the requirement that issuers report this information on Form D to impose significant additional costs.

b. Issuer Size

The proposed amendment to Item 5 (Issuer Size) of Form D would replace the "Decline to Disclose" option with "Not Available to Public" option. This change to Form D would assist the Commission in obtaining a greater amount of information on the size of issuers that conduct Rule 506 offerings. This proposed amendment would also apply to offerings under Rule 504, Rule 505 and Section 4(a)(5). At present, a majority of Form D filings do not provide information on the size of the issuer's revenue (if the issuer is an operating company) or net asset value (if the issuer is a hedge fund or other investment fund). It is likely that some issuers keep this information private for competitive purposes and therefore do not make this information widely available. For those issuers that already make this information publicly available, or that do not currently make a reasonable effort to keep such information confidential, reporting their size range in a Form D filing would not impose a material cost. Having this information would provide a more complete picture of the Rule 506 market and allow the Commission to more accurately assess the impact of allowing general solicitation on capital formation across issuer sizes. This information would be particularly useful in better understanding the effects of general solicitation on capital formation by small businesses, a set of issuers that otherwise face significantly greater challenges than larger issuers in finding investors.

c. Issuer Industry Group

Industry information is an important issuer characteristic that helps in assessing the effectiveness of private markets in promoting capital formation across industry groups. An analysis of Form D filings over the period 2009-2012 indicates that the "Other" category was checked in over 15% of offerings.[223] The proposed amendment to Item 4 (Industry Group) would require an explanation to be provided when an issuer checks "Other" as its industry. This would allow a better assessment of the representation of a particular industry or sub-industry in Regulation D offerings and help the Commission evaluate whether industry classifications are appropriately defined in Form D.

d. Control Persons

The proposed amendment to Item 3 (Related Persons) to include controlling persons when the issuer seeks to use general solicitation in a Rule 506(c) offering will expand the set of persons covered under the existing list of related persons that includes promoters, directors and executive officers. Thus, a beneficial owner who has a significant equity stake in an issuer but may not be a managing executive would now need to be identified. This information may be helpful to the Commission in developing a more comprehensive understanding of the issuers and other market participants that are involved in Rule 506(c) offerings.

Including information regarding control persons would enable investors to better

[223] See Ivanov/Bauguess Study.

identify persons who may be in positions to influence the Rule 506(c) offering. The identity information could also be useful if questions arise about the offering. Issuers would incur additional reporting costs when there are control persons that are not also related persons. In many instances this information is readily available and easy to collect, particularly to the extent that issuers identify controlling shareholders under the bad actor provisions we are adopting today. Issuers could, however, find this amendment burdensome as they may want to keep information on controlling persons private.

There could be instances where some shareholders who own a significant stake in the issuers' equity but are passive owners are incorrectly identified as control persons in a publicly filed form. Because this information would be required only for Rule 506(c) offerings, issuers would not face these privacy concerns if they do not rely on Rule 506(c) for their offering.

e. Trading Venue and Security Identifiers

Proposed Item 18 would require issuers to identify if any of its securities are traded on a national securities exchange, ATS or any other organized trading venue. If the issuer answers in the affirmative, it is required to identify the names of such trading venues where its securities are being traded and the SEC file number for such class of securities. The issuer, under proposed Item 18, would also need to identify if the securities to be sold in the offering are of the same class as the class of securities listed or quoted on the trading venue. Further, the proposed amendment to Item 9 (Types of Securities Offered) of Form D would require information on the trading symbol and security identifier, such as a CUSIP number[224] or ISIN (International Securities Identification Number), for the offered securities, if any.

These proposed amendments would apply to offerings under Rule 506 as well as to offerings under Rule 504, Rule 505 and Section 4(a)(5). In many cases, the class of an issuer's security offered through a Rule 506 offering may not be eligible for trading on a national securities exchange, ATS or any other organized trading venue, and may not have an assigned security identifier.

For classes of securities where this information is available, regulators could link the offered securities to financial information about the issuer and the class of security – such as accounting data and security-price data – that is not available on Form D but is available through common third-party data aggregation platforms and through the associated trading venues. The inclusion of a security identifier in Form D would be relevant information for a number of private offerings. For example, analysis of Form D filings shows that approximately 10% of Exchange Act reporting companies conducted Regulation D offerings during the period between 2009 to 2011.[225]

The inclusion of this information could be useful to the Commission in evaluating developments in the Rule 506 market in several ways. First, with respect to a security identifier, linking Rule 506 offerings and financial information about the issuer from other financial data providers would allow for a more effective evaluation of one part of

[224] CUSIP (Committee on Uniform Securities Identification Procedures) is a universally recognized identification for more than 9 million unique financial instruments. The CUSIP system, owned by the American Bankers Association and operated by Standard & Poor's, facilitates the clearing and settlement process of securities. The number consists of nine characters (including letters and numbers) that uniquely identify a company or issuer and the type of security. See https://www.cusip.com/cusip/index.htm. CUSIP is one of the most widely available securities identifiers and is available for the securities issued by Exchange Act reporting companies.

[225] Ivanov/Bauguess Study.

the Rule 506 market. In particular, the availability of a security identifier would enable us to automatically match and process financial and other information about the issuer in a manner that would be significantly less burdensome than if we had to rely solely on a firm name and other identifying information. Security identifiers also could facilitate tracking multiple issuances by the same issuer, which might not otherwise be clear if a security identifier exists but is not made available. In addition, identifying the trading venue for an offered security could help us assess whether particular trading venues – or the lack of trading venue – is associated with higher prevalence of fraud and other illegal activities.

Identifying whether the securities being offered in reliance on Rule 506 are of the same class of securities, or are convertible into, or exercisable, or exchangeable for such class of securities will provide additional informational linkages between publicly available data and private offerings. The marginal cost to issuers of providing this information is likely to be low because this information should be readily available to the issuers of the offered securities.

f. Use of Proceeds

The proposed amendment to Item 16 (Use of Proceeds) of Form D would require issuers that are not pooled investment funds to report information on the portion of proceeds (if any) from Rule 506 offerings that will be used to repurchase or retire the issuer's existing securities. This information would allow the Commission to distinguish between offerings that raise capital to allow insiders and/or incumbent shareholders a partial or full exit and offerings that use the proceeds for investments or capital expenditures. This information could help us better distinguish the impact of the ability to use general solicitation in Rule 506(c) offerings on capital formation versus investment exit strategies, particularly for small businesses. It may also help inform investors and the market generally about the issuer's incentives or related risks. For example, proceeds used towards redemption of securities could indicate that existing shareholders are lowering their investment exposure in the issuer.

The proposed amendment also requires issuers, other than pooled investment funds, that are relying on Rule 506 to provide more information on the use of offering proceeds. Issuers will be required to indicate what part of the proceeds is being used to pay for offering expenses, asset acquisition, working capital, business acquisition or repayment of existing debts. For non-fund issuers, this information would help us evaluate whether and how Rule 506 enhances capital formation that would be used for new investments, consistent with the intent of the JOBS Act, as compared to refinancing and capital restructuring. However, the additional information may reveal previously non-public information about issuer plans that could put the issuer at a competitive disadvantage. Moreover, an issuer may not be certain as to the ultimate use of proceeds or may alter its intended use as time passes and market conditions change. In these cases, the Form D information may not accurately reflect issuer plans or the issuer may be required to file an amended Form D.

g. Issuer Website

The proposed amendment to Item 2 (Principal Place of Business and Contact Information) would require all Regulation D issuers to provide their publicly accessible business website, if they have one. Websites for operating businesses have become ubiquitous and are part of their contact information, and in some instances, businesses could be operating only via the Internet and may not have a physical location. When available, this information would be a useful component of issuer identification and would not be burdensome to provide.

h. Types of General Solicitation Used

The proposed amendments to Form D would include adding a requirement for issuers to provide information on the types of general solicitation used in Rule 506(c) offerings. The options would include oral communications, written communications, such as mass mailings and emails, websites or television and the web link to the advertising if the advertising is presented on a website. Having this information would help the Commission perform reviews of the Rule 506 market to better understand how the different methods of solicitation correspond to issuer behavior, including potentially fraudulent activity, identified through the Commission's Rule 506 review program.

i. Verification Methods

The proposed amendments to Form D would include adding requirements for issuers to provide information about how the investors in the offerings qualified as accredited investors, such as a natural person on the basis of income or net worth, as well as information on the types of methods used for verifying the accredited investor status of purchasers. This information would help us assess the nature of the verification methods used and how issuers are complying with the requirement to take reasonable steps to verify the accredited investor status of purchasers in Rule 506(c) offerings. The Commission may be able to use this information to analyze whether there are correlations between certain verification methods and the incidence of fraud in the private offering market. Similarly, information about verification practices learned through the

Commission's Rule 506 review program could be applied to subsequent Commission reviews of any practices, or combinations of practices and other offering characteristics, associated with the increased likelihood of fraudulent activity.

4. Proposed Amendment to Rule 507

The proposed amendment to Rule 507 would disqualify an issuer from using Rule 506 for future offerings if the issuer, or its predecessors or affiliates, had conducted an offering under Rule 506 in which, within the last five years, it or they did not comply with the Form D filing requirements of Rule 503 in Rule 506 offerings. Disqualification would extend for a period of one year after the filing of all required Forms D and Form D amendments have been made. This provision should increase the incentive for issuers to submit timely filings of Form D.

As described above, we could not locate Form D filings for approximately 10% of Regulation D offerings where broker-dealers or registered investment advisers were involved.[226] Although we cannot estimate the rate of compliance among the issuers of the remaining 89% of Rule 506 offerings that do not use a registered investment adviser or broker-dealer, it may be reasonable to assume that they are no more likely to file a Form D, particularly to the extent that they undertake an offering without the assistance of a regulated entity. This evidence suggests that many private issuers are failing to file a Form D even though this is a requirement under Regulation D. By disqualifying an issuer from relying on the Rule 506 exemption for one year for future offerings when the issuer, or any predecessor or affiliate of the issuer, did not comply, within the last five

[226] This evidence was based on 11 years of Form ADV filings by registered investment advisers, and three months of data at the beginning of 2012 for broker-dealers filing offering documents with FINRA.

years, with Form D filing requirements in a Rule 506 offering, the Commission intends to increase the incentive for issuers to comply with the Form D filing requirements.

Greater compliance with Form D filing requirements would provide a more complete picture of the Regulation D market. It would enhance the Commission's ability to assess the effectiveness and efficiency of the private offering market and the impact of the elimination of the prohibition against general solicitation. As the Commission obtains more comprehensive data on Regulation D offerings, it would be able to better evaluate activity in Rule 506(b) and Rule 506(c) markets and undertake regulatory action in a more informed manner. In particular, to the extent that certain issuer and offering characteristics collected through Form D are associated with illegal market practices, regulators would be in a better position to focus monitoring efforts on offerings that present heightened investor protection concerns.

A better-informed view of capital-raising in the Rule 506 market could help the Commission engage in targeted regulatory responses to the potential for fraudulent activity in the Rule 506 market. To the extent that these regulatory responses decrease fraudulent activity, they could promote investor protection and investor interests potentially leading to higher participation by eligible investors, especially natural persons who are accredited investors, and to greater capital-raising opportunities.

While the proposed disqualification provision is designed to encourage a higher rate of compliance with the Form D filing requirements, it would make failure to file costly to Rule 506 issuers if they or their successors and affiliates cannot rely on Rule 506 in a timely manner for future offerings and they would otherwise do so. The loss of access to Rule 506 offerings could impair their competitiveness if they are unable to secure alternative sources of capital at the same cost.

For those issuers that submit their Form D filings in a timely manner, the potential for disqualification under proposed Rule 507 would pose little additional risk, such as from an accidental failure to file a Form D or the late filing of a Form D that was not identified and corrected during the cure period. Those issuers that, in the past, have chosen not to file a Form D or filed it late may have a stronger incentive to file (i.e., the risk of losing the ability to conduct a Rule 506 offerings in the future may outweigh the cost of giving their competitors better access to certain capital-raising information). To the extent that these issuers otherwise engage in legitimate capital raising activities, the cost of conditioning the future use of Rule 506 on Form D filings could be disproportionate to the benefit of having a public notice of their offering.

We are not proposing to disqualify an issuer from reliance on Rule 506 in its current offering for failure to file a Form D for such offering; an issuer that does not comply with the filing requirements will therefore not be subject to immediate costs, such as the loss of an offering exemption and potential rescission rights of investors. Disqualification for future offerings only would provide a less severe consequence for inadvertent missed filings and late filings, and would limit the potential costs to more active issuers of securities in private markets. In this regard, repeat issuers in Rule 506 offerings would be more affected by the disqualification provision but would be more likely to understand the Rule 503 filing requirements.

The inclusion of a cure period and providing the disqualification to be lifted for one-year after the required Form D filings have been made or by virtue of a waiver by the

Commission, would help moderate issuers' costs of non-compliance in Form D filings. At the same time, making issuers that repeatedly fail to file Form D ineligible for a cure period will provide a strong incentive for timely compliance with the filing requirements. This would increase the cost associated with non-compliance, although issuers that have been disqualified from future use of Rule 506 would retain the option of applying for a waiver. We believe that disqualifying an issuer from relying on Rule 506 for one year may be a sufficient incentive for achieving higher filing compliance, and is not so severe that it would deter issuers from using Rule 506 for their capital-raising activity.

D. Analysis of the Proposed Rule and Rule Amendments Relating to General Solicitation Materials

We are proposing a new rule under Regulation D and an amendment to a Securities Act rule in connection with an issuer's ability to engage in general solicitation in Rule 506(c) offerings.

1. Mandated Legends and Other Disclosures for Written Solicitation Materials

We are proposing new Rule 509 of Regulation D to require issuers to include legends in all written general solicitation materials used in a Rule 506(c) offering and to require private funds to include an additional legend and other disclosures where the written general solicitation materials include performance data. Specifically, issuers would be required to include:

- Eligibility legends that advise investors that securities offered under Rule 506(c) may be purchased only by accredited investors.
- Risk legends that advise investors of the following: the securities are being offered in reliance on an exemption from the registration requirements of the

Securities Act and are not required to comply with specific disclosure requirements under the Securities Act; the Commission has not passed upon the merits of or given its approval to the securities, the terms of the offering, or the accuracy or completeness of any offering materials; the securities are subject to legal restrictions on transfer and resale and investors should not assume they will be able to resell their securities; and investing in securities involves risk and purchasers should be able to bear the loss of the entire investment. Private funds would be required to include a legend informing investors that the funds are not subject to the protections of the Investment Company Act.

- Performance disclosures in the case of private funds informing investors that the performance data represents past performance, that past performance is not indicative of future results, that the current performance may be lower or higher than the performance presented, that performance data is not calculated on a standardized basis as is required for registered funds, and that the performance of the private fund may not be directly comparable to the performance of other funds. Private funds also would be required to include only performance data as of the most recent practicable date and to include a telephone number or website where an investor may obtain current performance data. Private funds also would be required to disclose the period for which performance is presented and if performance data does not reflect the deduction of fees and expenses, private funds would be required to disclose that fees and expenses have not been deducted and that if such fees and expenses had been deducted, performance may be lower than presented.

The inclusion of mandated legends would better inform potential investors as to whether they are qualified to purchase in Rule 506(c) offerings. Including risk and performance legends could make investors more aware of the potential risks associated with such offerings and, with respect to offerings by private funds, could help investors avoid confusing private funds with registered funds, which have a different risk and regulatory profile. Performance disclosures for private funds would also assist potential investors in assessing performance claims that may be included in the general solicitation materials. These legends would alert potential investors to certain investment risks.

Even though only accredited investors are allowed to purchase in Rule 506(c) offerings, advertising and other activities by issuers and intermediaries could induce non-accredited investors to believe that they are eligible to participate in these investment opportunities. Legends notifying them that only accredited investors are eligible to invest in these offerings could help alert non-accredited investors as to their ineligibility to participate.

We anticipate that the cost of including such legends in sales materials would be minimal for issuers. In some instances, the legends may be of limited benefit to investors because legends do not address whether the offering is fraudulent. It is possible that some unsuspecting accredited investors might erroneously believe that the inclusion of legends validates all of the information and risks regarding the offering. Further, it is possible that because these legends may contain standardized language, investors might discount the relevance of these legends.

Requiring additional disclosures for private funds, similar to those required by Rule 482 under the Securities Act for registered investment companies, would increase the likelihood that the performance data that is reported in the written general solicitation material is timely and would provide additional information and context about the performance presented. Because there are no standardized performance reporting requirements for private funds, such disclosure would address some concerns about investors being misled or confused in interpreting the performance information and may decrease the likelihood of misleading or exaggerated performance information being presented in private fund written general solicitation materials. While flexibility in reporting performance data may be appropriate for private funds that have a varied scope of investment strategies, performance calculation methodologies that are non-standardized or complicated limit how much investors can appropriately glean from the data advertised in the written material. The purpose for requiring these additional disclosures is to provide context so investors can better understand fund performance information.

The proposed requirement for private funds to include a telephone number or website where an investor may obtain current performance data could impose costs, including the cost of establishing a telephone line or establishing a website for this information. We have attempted to address these costs by providing flexibility to distribute the information either through a telephone number or a website. We have also determined to not require that the telephone number be toll-free or collect. We believe that most private funds (or their advisers) currently maintain either a telephone number or website, though we recognize that some private funds or their advisers may incur and technology. The current information that a private fund

additional costs ovide would only need to be as of the most recent practicable

would be uirement would not require a private fund to calculate performance

e fund would not otherwise be calculating performance, we believe

date osts incurred by private funds. In addition, updated current

d be provided as of the last date on which the private fund determined

ts portfolio securities. We do not expect a private fund to value its

for the purpose of providing updated current performance under proposed

ch would not increase costs.

2. Proposed Amendments to Rule 156

Rule 156 under the Securities Act is an interpretive rule that provides guidance on the types of information in investment company sales literature that could be misleading for purposes of the federal securities laws, including Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. We are proposing amendments to Rule 156 to apply the guidance contained in the rule to sales literature used by private funds. The sales literature and other offering materials used by private funds are already subject to the antifraud provisions of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5. The proposed amendments to Rule 156 are intended to provide helpful guidance to private fund issuers in developing sales literature that is neither fraudulent nor misleading. The proposal may also encourage private funds to include additional disclosure regarding performance and other statements or representations about the characteristics of the fund. Funds may incur some costs in reviewing their sales literature for consistency with the interpretive guidance set forth in Rule 156. We note, however, that private funds should already be reviewing their sales literature for misleading statements to avoid violating the antifraud provisions of the federal securities laws. Accordingly, we believe that the amendments to Rule 156 would not impose significant compliance costs on private funds.

3. Request for Comment on Manner and Content Restrictions for Private Funds

Commenters have suggested that there be standards or requirements that would govern the content and/or manner of general solicitations by private funds in Rule 506(c) offerings. As discussed above, there may be investor protection concerns with respect to the offering materials used by private funds as these funds are not subject to specific disclosure requirements in reporting their performance, unlike registered funds. Some commenters have advocated that, in order to engage in general solicitation, the materials used by private funds should be held to standards that are analogous to those that are applicable to the materials used by mutual funds. They have also advocated for restricting the use of performance data in general solicitation materials by private funds until the Commission can develop standardized performance calculation and reporting requirements. We recognize, however, that prescribing performance standards in general solicitation materials could reduce the flexibility of issuers when methodologies for calculating performance may vary for legitimate reasons, including investor preferences, and could be burdensome for issuers, especially if their general solicitation materials are otherwise not misleading.

E. Analysis of Temporary Rule Relating to Mandatory Submission of Written General Solicitation Materials

Proposed new Rule 510T in Regulation D would require an issuer conducting a Rule 506(c) offering to submit to the Commission any written general solicitation materials prepared by or on behalf of the issuer and used in connection with the Rule 506(c) offering. This requirement would enable the Commission to evaluate the use of written general solicitation materials. It could also serve as a deterrent against potential forms of misleading advertising or other fraud because the written general solicitation materials would be submitted to the Commission and accessible to other securities regulators. Having access to the written general solicitation material could help regulators evaluate market practices.

The written general solicitation material would not be treated as filed or furnished with the Commission and is therefore not subject to the particular liability provisions under the Securities Act or the Exchange Act for filings. Conditioning the future availability of Rule 506 on not being subject to any order, judgment or court decree for failure to comply with proposed Rule 510T would provide incentives for submitting written general solicitation material. Inclusion of a two-year sunset period for this rule would provide a finite period of time (and information) for issuers to submit written general solicitation materials for the Commission's consideration in assessing general solicitation in Rule 506(c) offerings and would therefore also limit issuers' costs of compliance.

Under the proposed rule, written general solicitation materials would be required to be submitted no later than the date of first use of such materials. Issuers are required to submit only written general solicitation materials, so to the extent issuers' written general solicitation materials do not change, they should not be costly to submit. If the written general solicitation materials change or are updated during the course of an offering, however, submission of these materials at multiple times could create an increased burden for issuers.

F. Analysis of Potential Impacts on Efficiency, Competition and Capital Formation

The proposed amendments to the Form D filing requirements would enable the Commission to evaluate the effectiveness of Regulation D market more systematically and to more accurately determine the economic impact of eliminating the prohibition against general solicitation in Rule 506 offerings. A more complete understanding of how and where capital is being raised in offerings relying on Rule 506(b) or Rule 506(c) would help the Commission better assess the risk in these markets and evaluate the effectiveness of the use of general solicitation materials in capital-raising activity. Appropriate and timely regulatory responses to Rule 506 market developments would enhance investor protection, and could encourage greater investor participation in the Rule 506 markets, which would lead to higher aggregate of capital formation.[227]

The proposed amendments to the Form D filing requirements would also provide the Commission, other regulators and investors with more information about market participants and practices in the private offering market. The increased quantity and quality of information about private offerings is designed to make it easier for regulators to identify poor or inappropriate market practices, which may help deter fraudulent

[227] See, e.g., Andrei Shleifer and Daniel Wolfenzon, Investor Protection and Equity Markets, 66 Journal of Financial Economics 3 (2002).

activity. A better understood and regulated market would promote investor protection and contribute to broader participation by accredited investors.

The inclusion of legends and additional disclosures would inform investors about the differences between Rule 506(c) offerings and registered offerings, allowing for greater transparency and better understanding of the differences in the underlying risks of the two types of offerings. This would improve investor decision-making and thereby, the allocative efficiency of capital in the Rule 506 market. The proposed amendments to Securities Act Rule 156 may also make private funds and their investment advisers more aware of potentially misleading statements in their sales literature and written general solicitation material.

The elimination of the prohibition against general solicitation may enhance the ability of accredited investors to identify and evaluate investment opportunities in private funds that would not have previously been available. This could increase the level of competition between private funds and registered funds and result in a shift in the flow of invested capital from registered to private funds. The proposed amendments to require legends and disclosures in written general solicitation materials are intended to limit such a shift to only those investors that are qualified to participate in Rule 506(c) offerings. We are not, however, able to quantify the magnitude of such a potential substitution of investment in private funds and registered funds or the extent to which the proposed legends will affect that shift.

We recognize the proposed rule and form amendments in this release could increase the regulatory burden for issuers in the Rule 506(b) and Rule 506(c) markets, which could drive potential issuers, especially small issuers, to the Rule 504 and Rule

505 markets. Some issuers may even find accessing public markets more attractive. However, with the availability of general solicitation in Rule 506(c) offerings, the benefits of using Rule 506(c) are still likely to justify the higher costs of complying with the proposed rule and form amendments.

X. SMALL BUSINESS REGULATORY ENFORCEMENT FAIRNESS ACT

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA"),[228] the Commission must advise the OMB as to whether a proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- an annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- a major increase in costs or prices for consumers or individual industries; or
- significant adverse effects on competition, investment or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review.

We request comment on whether our proposed amendments would be a "major rule" for purposes of SBREFA. We solicit comment and empirical data on:

- the potential effect on the U.S. economy on an annual basis;
- any potential increase in costs or prices for consumers or individual industries; and
- any potential effect on competition, investment or innovation.

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[228] Pub. L. No. 104-121, Tit. II, 110 Stat. 857 (1996).

We request those submitting comments to provide empirical data and other factual support for their views to the extent possible.

XI. INITIAL REGULATORY FLEXIBILITY ANALYSIS

The Commission has prepared this Initial Regulatory Flexibility Analysis in accordance with Section 603 of the Regulatory Flexibility Act.[229] This Initial Regulatory Flexibility Analysis relates to the amendments to Regulation D and Form D and Rule 156 that we are proposing in this release.

A. Reasons for, and Objectives of, the Proposed Action

The primary reason for, and objective of, the proposed amendments to Form D and the proposed amendments to Regulation D relating to Form D is to improve the Form D data collection process with respect to offerings under Rule 506 of Regulation D and, in particular, to assist our efforts to assess the use of general solicitation in Rule 506(c) offerings. We believe these amendments, in general, would improve our Form D data collection efforts by providing a greater incentive for issuers to file Form D and by amending the information requirements of Form D to require additional information on Rule 506 offerings. Proposed Rule 509, which would require issuers to include certain legends and other disclosures in written general solicitation materials used in Rule 506(c) offerings, is intended to address investor protection concerns arising from the ability of issuers to engage in general solicitation in these offerings. Proposed Rule 510T, which would require issuers to submit to the Commission any written general solicitation materials used in Rule 506(c) offerings, is intended to facilitate the Commission's understanding of the market practices relating to how issuers solicit

[229] See 5 U.S.C. 603.

potential purchasers through written general solicitation materials for their Rule 506(c) offerings. The proposed amendments to Rule 156 are intended to provide helpful antifraud guidance to those preparing sales literature for private funds.

We are proposing the amendments to Regulation D and Form D under the authority in Sections 4(a)(2), 19(a) and 28 of the Securities Act,[230] as amended, and Section 201(a) of the JOBS Act.[231] We are proposing the amendments to Rule 156 under the authority in Section 19(a) of the Securities Act[232] and Sections 10(b) and 23(a) of the Exchange Act.[233]

B. Small Entities Subject to the Proposed Rule and Form Amendments

For purposes of the Regulatory Flexibility Act, under our rules, an issuer, other than an investment company, is a "small business" or "small organization" if it has total assets of $5 million or less as of the end of its most recent fiscal year and is engaged or proposing to engage in an offering of securities which does not exceed $5 million.[234] For purposes of the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[235]

The proposed amendments would apply to all issuers that conduct offerings under Rule 506 and would affect small issuers (including both operating businesses and pooled

[230] 15 U.S.C. 77d(a)(2), 77s(a), and 77z-3.

[231] Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313 (Apr. 5, 2012).

[232] 15 U.S.C. 77s(a).

[233] 15 U.S.C. 78j(b) and 78w(a).

[234] 17 CFR 230.157.

[235] 17 CFR 270.0-10(a).

investment funds that raise capital under Rule 506) relying on this exemption from Securities Act registration. All issuers that sell securities in reliance on Rule 506 are required to file a Form D with the Commission reporting the transaction. For the year ended December 31, 2012, 16,067 issuers made 18,187 new Form D filings, of which 15,208 issuers relied on the Rule 506 exemption. Based on information reported by issuers on Form D, there were 3,958 small issuers[236] relying on the Rule 506 exemption in 2012. This number likely underestimates the actual number of small issuers relying on the Rule 506 exemption, however, because over 50% of issuers declined to report their size. The proposed amendments to Rule 156 would apply to all private funds.

C. Projected Reporting, Recordkeeping and Other Compliance Requirements

The proposed amendments to Regulation D and Form D would impose certain reporting and compliance requirements on issuers that conduct Rule 506 offerings. The proposed amendment to disqualify an issuer from relying on the Rule 506 exemption if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the last five years, with Form D filing requirements in a Rule 506 offering would not add a new reporting, recordkeeping or other compliance requirement because the filing of Form D is currently a requirement of Regulation D. The proposed amendments to Regulation D to require an Advance Form D filing for Rule 506(c) offerings, a closing Form D amendment for Rule 506 offerings, temporary submission of written general solicitation materials used in Rule 506(c) offerings, prescribed legends and disclosure in written general solicitation materials used in Rule 506(c) offerings, as well as the proposed

[236] Of this number, 3,627 of these issuers are not investment companies, and 331 are investment companies. We also note that issuers that are not investment companies disclose only revenues on Form D, and not total assets. Hence, we use the amount of revenues as a measure of issuer size.

amendments to Form D to require additional information, would, however, impose additional reporting and compliance requirements on issuers that conduct offerings under Rule 506 and, to a much lesser extent, offerings under Rule 504, Rule 505 and Section 4(a)(5). We expect that small entities would incur additional initial and ongoing costs related to complying with these requirements. Initial costs include those associated with preparing the first Form D filing that includes the required additional information in Form D, preparing legends and disclosures to be included in written general solicitation materials for Rule 506(c) offerings and submitting such materials to the Commission prior to the date of first use. Ongoing costs include the additional costs arising from providing this additional information in each subsequent filing of a Form D or Form D amendment when required, including the prescribed legends in written general solicitation materials, submitting updated or new written general solicitation materials to the Commission and submitting Advance Form D filings for Rule 506(c) offerings and closing amendments to Form D for Rule 506 offerings. The proposed amendments to Rule 156 may cause small entities to incur some costs in reviewing their sales literature for consistency with the interpretative guidance set forth in Rule 156, but we do not expect these costs to be significant.

D. Duplicative, Overlapping or Conflicting Federal Rules

The Commission believes that the proposed amendments would not duplicate, overlap or conflict with other federal rules.

E. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objectives of our amendments, while minimizing any significant adverse impact on small entities. In connection with the proposed amendments, we considered several alternatives, including the following:

- establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- further clarifying, consolidating or simplifying the proposed requirements;
- using performance rather than design standards; and
- providing an exemption from the proposed requirements, or any part of them, for small entities.

The Commission is not proposing the establishment of different compliance or reporting requirements or timetables for the rules, as proposed, for small entities. The Commission believes that, as to small entities, differing compliance, reporting or timetable requirements, a partial or complete exemption from the proposed requirements or the use of performance rather than design standards would be inappropriate because these approaches would detract from the completeness and uniformity of the Form D dataset and, as a result, reduce the expected benefits of more consistent submission of Rule 506 information and improved collection of data for Commission enforcement and rulemaking efforts. We believe that the proposed amendments to Rule 156 should apply to all private funds, regardless of size. The Commission solicits comment, however, on whether differing compliance, reporting or timetable requirements, a partial or complete exemption, or the use of performance rather than design standards would be consistent with the main goal of improving the Form D data collection process with respect to Rule 506 offerings.

F. General Request for Comment

The Commission is soliciting comments regarding this analysis. In particular, the Commission requests comment regarding:

- the number of small entities that may be affected by the proposed amendments;
- the existence or nature of the potential impact of the proposed amendments on small entities as discussed in this analysis, as well as any effects that have not been discussed; and
- how to quantify the impact of the proposed amendments.

The Commission asks those submitting comments to describe the nature of any impact and to provide empirical data to support the nature and extent of the impact. These comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed amendments are adopted, and will be placed in the same public file as comments on the proposed amendments themselves.

XII. STATUTORY AUTHORITY AND TEXT OF PROPOSED RULE AND FORM AMENDMENTS

The Form D and Regulation D amendments contained in this release are being proposed under the authority set forth in Sections 4(a)(2), 19(a) and 28 of the Securities Act, as amended, and Section 201(a) of the JOBS Act. The amendments to Rule 156 contained in this release are being proposed under the authority set forth in Section 19(a) of the Securities Act and Sections 10(b) and 23(a) of the Exchange Act.

List of Subjects in 17 CFR Parts 230 and 239

Reporting and recordkeeping requirements, Securities.

Advertising, Investment companies, Securities.

For the reasons set out above, the Commission proposes to amend Title 17, chapter II of the Code of Federal Regulations, as follows:

PART 230—GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The general authority citation for Part 230 is revised to read as follows:

Authority: 15 U.S.C. 77b, 77b note, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78o-7 note, 78t, 78w, 78ll (d), 78mm, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, and 80a-37, and Pub. L. No. 112-106, § 201(a), 126 Stat. 313 (2012), unless otherwise noted.

2. Amend § 230.156 by:

a. Revising the heading;

b. In paragraph (a), adding the phrase "or a private fund" at the end of the first sentence.

c. Revising paragraphs (b)(3) and (c); and

d. Adding paragraph (d).

The revisions and addition read as follows:

§ 230.156 Investment company and private fund sales literature.

(a) * * *

(b) * * *

(3) A statement involving a material fact about the characteristics or attributes of an investment company or a private fund could be misleading because of:

(i) * * *

(ii) Exaggerated or unsubstantiated claims about management skill or techniques, characteristics of the investment company or the private fund or an investment in securities issued by such entity, services, security of investment or funds, effects of government supervision, or other attributes; and

* * * * *

(c) For purposes of this section, the term sales literature shall be deemed to include any communication (whether in writing, by radio, or by television) used by any person to offer to sell or induce the sale of securities of any investment company or private fund. Communications between issuers, underwriters and dealers are included in this definition of sales literature if such communications, or the information contained therein, can be reasonably expected to be communicated to prospective investors in the offer or sale of securities or are designed to be employed in either written or oral form in the offer or sale of securities.

(d) For purposes of this section, the term private fund means an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), but for section 3(c)(1) or 3(c)(7) of that Act (15. U.S.C. 80a-3(c)(1) or 80a-3(c)(7)).

3. Amend § 230.503 by:

a. Redesignating paragraphs (a)(1), (a)(2), (a)(3) and (a)(4) as paragraphs (a)(2), (a)(3), (a)(4) and (a)(6), respectively;

b. Adding new paragraphs (a)(1) and (a)(5);

c. Revising newly redesignated paragraph (a)(2);

d. Removing "and" in newly redesignated paragraph (a)(4)(ii)(I);

e. Removing the reference to "." and adding in its place ";" in newly redesignated paragraph (a)(4)(iii); and

f. Adding new paragraphs (a)(4)(iv) and (a)(4)(v).

The revisions and additions read as follows:

§ 230.503 Filing of notice of sales

(a) When notice of sales on Form D is required and permitted to be filed.

(1) An issuer that intends to offer or sell securities in reliance on § 230.506(c), and has not previously filed a notice under paragraph (a)(2) of this section of such intended offering in reliance on § 230.506(c), must file with the Commission, no later than 15 calendar days prior to the first use of general solicitation or general advertising for such offering, a notice of sales containing the following information required by Form D (17 CFR 239.500) for such offering:

(i) The issuer's identity (Item 1);

(ii) Principal place of business and contact information (Item 2);

(iii) Related persons (Item 3);

(iv) Industry group (Item 4);

(v) Federal exemptions and exclusions claimed (Item 6);

(vi) Type of filing (Item 7);

(vii) Type(s) of Securities Offered (Item 9);

(viii) Business combination transaction (Item 10)

(ix) Sales compensation (Item 12)

(x) Use of proceeds (Item 16)

(2) An issuer offering or selling securities in reliance on § 230.504, § 230.505, or § 230.506 (other than an issuer that has previously filed a notice for such offering under paragraph (a)(1) of this section) must file with the Commission a notice of

sales containing the information required by Form D (17 CFR 239.500) for each new offering of securities no later than 15 calendar days after the first sale of securities in the offering.

(3) * * *

(4) * * *

(iv) To contain the information required by Form D for such offering of securities in reliance on § 230.506(c), if the issuer is offering or selling securities in reliance on § 230.506(c) and has previously filed the notice under paragraph (a)(1) of this section, no later than 15 calendar days after the first sale of securities in the offering; and

(v) Not later than 30 calendar days after the termination of an offering conducted in reliance on § 230.506, unless all the information that would be included in such amendment is included in a notice previously filed under this paragraph (a) and such notice indicated that it was the closing amendment to the Form D.

(5) Where the end of a period specified for filing under paragraph (a)(1), (a)(2), (a)(4)(iv) or (a)(4)(v) of this section falls on a Saturday, Sunday or holiday, the due date for such filing would be the first business day following.

4. Amend § 230.507 by:

a. Redesignating paragraph (b) as paragraph (c);

b. Revising paragraph (a);

c. Adding new paragraph (b); and

d. In newly redesignated paragraph (c), removing the words "paragraph (a)" and adding in their place "paragraphs (a) and (b)".

The revision and addition read as follows:

§ 230.507 Disqualifying provision relating to exemptions under §§ 230.504, 230.505 and 230.506.

(a) No exemption under § 230.504, § 230.505 or § 230.506 shall be available for an issuer if such issuer, or any of its predecessors or affiliates, has been subject to any order, judgment, or decree of any court of competent jurisdiction temporarily, preliminary or permanently enjoining such person for failure to comply with § 230.503. No exemption under § 230.506 shall be available for an issuer if such issuer, any of its predecessors or affiliates have been subject to any order, judgment, or decree of any court of competent jurisdiction temporarily, preliminary or permanently enjoining such person for failure to comply with § 230.509 or § 230.510T.

(b) (1) No exemption under § 230.506 shall be available for an issuer if such issuer, or any of its predecessors or affiliates, has, within the five preceding years, failed to comply with the requirements of § 230.503 in connection with an offering conducted in reliance on § 230.506, except that such exemption shall be available for offers and sales in connection with offerings that commenced before the failure to comply occurred. In determining compliance with § 230.503 for purposes of this paragraph (b)(i), a notice on Form D (§ 239.500) or amendment thereto will be deemed timely if it is filed not later than 30 calendar days after the date specified for such filing in § 230.503, unless the issuer previously failed to comply with such a filing deadline in connection with the same offering.

(2) One year after the filing by the issuer and such predecessor(s) and affiliate(s), as the case may be, of all notices on Form D (§ 239.500) and amendments thereto

required under § 230.503 in connection with each offering conducted in reliance on § 230.506 that has not been terminated, and of the closing amendment required under § 230.503(a)(4)(v) with respect to each previous offering conducted in reliance on § 230.506 within the five preceding years that has been terminated, the issuer shall be permitted to rely on the exemption under § 230.506.

(3) For purposes of paragraph (b)(1) of this section, failures to comply with § 230.503 that occurred before [INSERT – effective date of rule] shall be disregarded.

5. Adding § 230.509 to read as follows:

§ 230.509 Required Legends and Other Disclosures.

(a) Required legends. An issuer shall include, in a prominent manner, the following legends in any written communication that constitutes a general solicitation or general advertising in any offering conducted in reliance on § 230.506(c):

(1) The securities may be sold only to "accredited investors," which for natural persons are investors who meet certain minimum annual income or net worth thresholds;

(2) The securities are being offered in reliance on an exemption from the registration requirements of the Securities Act and are not required to comply with specific disclosure requirements that apply to registration under the Securities Act;

(3) The Commission has not passed upon the merits of or given its approval to the securities, the terms of the offering, or the accuracy or completeness of any offering materials;

(4) The securities are subject to legal restrictions on transfer and resale and investors should not assume they will be able to resell their securities; and

(5) Investing in securities involves risk, and investors should be able to bear the loss of their investment.

(b) Additional Legend for Private Funds. If the issuer is a private fund, the issuer shall include, in a prominent manner, in any written communication that constitutes a general solicitation or general advertising in any offering conducted in reliance on this § 230.506(c), a legend disclosing that the securities offered are not subject to the protections of the Investment Company Act.

(c) Required Disclosure for Performance Data of Private Funds. If the issuer is a private fund and includes performance data in any written communication that constitutes a general solicitation or general advertising in any offering conducted in reliance on this § 230.506(c):

(i) The private fund shall include in such written communication a legend disclosing that the performance data represents past performance; that past performance does not guarantee future results; that current performance may be lower or higher than the performance data presented; that the private fund is not required by law to follow any standard methodology when calculating and representing performance data; and that the performance of the private fund may not be directly comparable to the performance of other funds. The legend should also identify either a telephone number or a website where an investor may obtain current performance data.

(ii) All performance data must be as of the most recent practicable date considering the type of private fund and the media through which the data will be conveyed, and the private fund must disclose the period for which performance is presented.

(iii) If the performance presentation does not include the deduction of fees and expenses, the private fund must disclose that the presentation does not reflect the deduction of fees and expenses and that if such fees and expenses had been deducted, performance may be lower than presented.

Note to § 230.509: A private fund is an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), but for section 3(c)(1) or 3(c)(7) (15 U.S.C. 80a-3(c)(1) or 80a-3(c)(7)) of that Act. If applicable, a private fund may modify the required legend to reflect any higher minimum requirements to purchase in the offering, such as for qualified clients, as defined in § 275.205-3(d)(1) of this chapter, and qualified purchasers, as defined in section 2(a)(51) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(51)) and the rules thereunder.

6. Adding § 230.510T to read as follows:

§ 230.510T Submission of Written General Solicitation Materials

(a) An issuer shall submit to the Commission any written communication that constitutes a general solicitation or general advertising in any offering conducted in reliance on § 230.506(c) no later than the date of first use. The communication shall be submitted using the intake page designated on the Commission's website for the submission of such materials.

(b) This temporary rule shall expire and no longer be effective on [ ].

* * * * *

PART 239 – FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

7. The authority citation for Part 239 continues to read, in part, as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77sss, 78c, 78l, 78m, 78n, 78 o(d), 78o-7 note, 78u-5, 78w(a), 78ll, 78mm, 80a-2(a), 80a-3, 80a-8, 80a-9, 80a-10, 80a-13, 80a-24, 80a-26, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

* * * * *

8. Amend Form D (referenced in § 239.500) by:

a. Revising Item 2;

b. Revising Item 3;

c. Revising Item 4;

d. In Item 5, in the first column, removing the phrase "Decline to Disclose" after "Over $100,000,000" and adding in its place "Not Available to Public," and in the second column removing the phrase "Decline to Disclose" after "Over $100,000,000" and adding in its place "Not Available to Public";

e. In Item 7, adding a check box that reads "Advance Notice – Rule 506(c) Offering" and the word "OR" before "New Notice" and adding the word "OR" after "Amendment" and adding a check box that reads "Closing Amendment – Rule 506 Offering" after the word "OR"; and

f. Revising Item 9;

g. Revising Item 14;

h. Revising Item 16;

i. Adding Items 17 through 22 to Form D; and

j. Revising the instruction "When to file:" and the instructions to Items 2, 3, 4, 5, 7, 9, 14 and 16, and adding instructions to Items 17 through 22 to the General Instructions to Form D.

The revisions and additions read as follows:

(Note: The text of Form D does not, and the amendments will not, appear in the Code of Federal Regulations.)

§ 239.500 Form D, notice of sales of securities under Regulation D and section 4(5) of the Securities Act of 1933.

* * * * *

Form D Notice of Exempt Offerings of Securities

* * * * *

Item 2. * * *

Issuer's publicly accessible website address, if any: ___________

* * * * *

Item 3. * * *

Relationship(s): * * * [ ] Controlling Person (for Rule 506(c) offerings only)

* * * * *

Item 4. * * *

Clarification of Response (if Other): ___________

* * * * *

Item 9. * * *

Trading Symbol for the Offered Securities, if any: __________

Generally Available Security Identifier Number for the Offered Securities, if any: __________

* * * * *

Item 14. * * *

For offerings under Rule 506 only:		Natural Persons	Legal Entities
Accredited Investors	Number		
	Amount Raised ($)		
Non-accredited Investors	Number		
	Amount Raised ($)		

* * * * *

Item 16. * * *

<u>Issuers that are not Pooled Investment Funds – Offerings under Rule 506</u>
What fraction of offering proceeds was or will be used to repurchase/retire existing securities:
[ ] None
[ ] Less than 10%
[ ] 10-25%
[ ] 25-50%
[ ] More than 50%

What fraction of offering proceeds was or will be used to pay offering expenses:
[ ] None
[ ] Less than 10%
[ ] 10-25%
[ ] 25-50%
[ ] More than 50%

What fraction of offering proceeds was or will be used to acquire assets, otherwise than in the ordinary course of business:
[ ] None
[ ] Less than 10%
[ ] 10-25%
[ ] 25-50%
[ ] More than 50%

What fraction of offering proceeds was or will be used to finance acquisitions of other businesses:
[ ] None
[ ] Less than 10%
[ ] 10-25%
[ ] 25-50%
[ ] More than 50%

What fraction of offering proceeds was or will be used for working capital:
[ ] None
[ ] Less than 10%
[ ] 10-25%
[ ] 25-50%
[ ] More than 50%

What fraction of offering proceeds was or will be used to discharge indebtedness:
[ ] None
[ ] Less than 10%
[ ] 10-25%
[ ] 25-50%
[ ] More than 50%

Item 17. <u>Offerings Under Rule 506: Specify the Number of Purchasers Who Qualified as Accredited Investors on the Basis of</u>

[ ] Income
[ ] Net worth
[ ] Director, executive officer or general partner of issuer or its general partner
[ ] Other basis

Item 18. <u>Offerings Under Rule 506: National Securities Exchange or Alternative Trading System</u>

If the issuer's securities are traded on a national securities exchange, alternative trading system or any other organized trading venue, the name of such trading venue

____

If a class of the issuer's securities is registered under the Securities Exchange Act of 1934, the SEC file number for such class of securities ____________________

Check this box [ ] if the securities being offered in reliance on Rule 506 are of the same class of securities or are convertible into or exercisable or exchangeable for such class of securities.

Item 19. Offerings Under Rule 506: Filing of General Solicitation Materials with FINRA

If the issuer used a registered broker-dealer in connection with the offering, were general solicitation materials filed with the Financial Industry Regulatory Authority (FINRA)?
[ ] Yes [ ] No [ ] Not applicable

Item 20. Offerings Under Rule 506: Name and SEC File Number of Investment Advisers

If the issuer is a pooled investment fund, the name and SEC file number for each registered investment adviser or exempt reporting adviser that functions directly or indirectly as a promoter of the issuer ____________________

Item 21. Offerings Under Rule 506(c): Types of General Solicitation and General Advertising Used or To Be Used (check all that apply)

[ ] Email
[ ] Mass mailing
[ ] Telephone solicitations
[ ] Public website(s) or webcast(s). [Specify web address(es):______]
[ ] Broadcast media
[ ] Print media
[ ] Social media
[ ] Other written communications [Specify:____________________]
[ ] Seminar(s)/meetings(s)
[ ] Other oral communications
[ ] Not applicable

Item 22. Offerings Under Rule 506(c): Methods Used or To Be Used to Verify that Purchasers Are Accredited Investors (check all that apply):

Non-exclusive List of Verification Methods in Rule 506(c)(2)(ii):

[ ] Verification of natural person's **income** under Rule 506(c)(2)(ii)(A)
[ ] Verification of natural person's **net worth** under Rule 506(c)(2)(ii)(B)
[ ] Confirmation under Rule 506(c)(2)(ii)(C) by
    [ ] Registered broker-dealer
    [ ] SEC-registered investment adviser

[ ] Certified public accountant
[ ] Licensed attorney

Verification Using Other Methods (check all that apply):

[ ] Publicly available information [Specify: ____________]
[ ] Documentation provided by purchaser [Specify: ____________]
[ ] Documentation provided by third parties [Specify: ____________]
[ ] Reliance on verification by a third party other than a registered broker-dealer, registered investment adviser, certified public accountant, or licensed attorney
[ ] Questionnaire
[ ] Other (Specify:____________________)

* * * * *

General Instruction

* * *

- **When to file:**

  - For offerings under Rule 504, Rule 505 and Rule 506(b) of Regulation D and Section 4(a)(5) of the Securities Act, an issuer must file a new notice with the SEC for each new offering of securities no later than 15 calendar days after the "date of first sale" of securities in the offering as explained in the Instruction to Item 7. For this purpose, the date of first sale is the date on which the first investor is irrevocably contractually committed to invest, which, depending on the terms and conditions of the contract, could be the date on which the issuer receives the investor's subscription agreement or check. An issuer may file the notice at any time before that if it has determined to make the offering. An issuer must file a new notice with each state that requires it at the time set by the state. For state filing information, go to www.NASAA.org. A mandatory capital commitment call does not constitute a new offering, but is made under the original offering, so no new Form D filing is required.

- When an issuer intends to offer or sell securities under Rule 506(c) of Regulation D and has not previously filed a Form D for the offering, the issuer must file a new notice with the SEC for each new offering of securities no later than 15 calendar days prior to the first use of general solicitation or general advertising for the offering. The advance Form D is required to include the following information for such offering: the issuer's identity (Item 1), principal place of business and contact information (Item 2), related persons (Item 3), industry group (Item 4), federal exemptions and exclusions claimed (Item 6), type of filing (Item 7), type(s) of securities offered (Item 9), business combination transaction (Item 10), sales compensation (Item 12), and use of proceeds (Item 16). The information under Item 9 and Item 12 is required only to the extent that the information is known at the time of the filing of the advance Form D.

* * * * *

- An issuer must file an amendment to a previously filed notice for an offering:

- to provide the information required by Form D for each new offering of securities in reliance on Rule 506(c) no later than 15 calendar days after the first sale of securities in the offering;

- to correct a material mistake of fact or error in the previously filed notice, as soon as practicable after discovery of the mistake or error;

- to reflect a change in the information provided in the previously filed notice, except as provided below, as soon as practicable after the change;

- annually, on or before the first anniversary of the most recent previously filed notice, if the offering is continuing at that time; and

- not later than 30 calendar days after termination of an offering conducted in reliance on Rule 506, unless a previously filed Form D amendment for such issuer with respect to the same offering includes the information that would have been disclosed in the amendment following termination of such offering and such previously filed amendment indicates that it is the closing amendment to the Form D for the offering.

* * * * *

Item-by-Item Instructions

* * *

Item 2. Principal Place of Business and Contact Information. * * *

Enter the issuer's publicly accessible website address, if any.

Item 3. Related Persons. Enter the full name and address of each person having the specified relationships with any issuer and identify each relationship:

- Each executive officer and director of the issuer and person performing similar functions (title alone is not determinative) for the issuer, such as the general and managing partners of partnerships and managing members of limited liability companies; and

- Each person who has functioned directly or indirectly as a promoter of the issuer within the past five years of first sale of securities or the date upon which the Form D filing was required to be made, whichever date is later.

- For offerings conducted in reliance on Rule 506(c) only, each person who directly or indirectly controls the issuer.

If necessary to prevent the information supplied from being misleading, also provide a clarification in the space provided.

Identify additional persons having the specified relationships by checking the box provided and attaching Item 3 continuation page(s).

Item 4. Industry Group. * * *

If Other, provide a brief description of the issuer's industry group in the space provided.

Item 5. Issuer Size.

- **Revenue Range** (for issuers that do not specify "Hedge Fund" or "Other Investment Fund" in response to Item 4): Enter the revenue range of the issuer or of all the issuers together for the most recently completed fiscal year available, or, if not in existence for a fiscal year, revenue range to date. Domestic SEC reporting companies should state revenues in accordance with Regulation S-X under the Securities Exchange Act of 1934. Domestic non-reporting companies should state revenues in accordance with U.S. Generally Accepted Accounting Principles (GAAP). Foreign issuers should calculate revenues in U.S. dollars and state them in accordance with U.S. GAAP, home country GAAP or International Financial Reporting Standards. If the issuer(s) has not otherwise made information about its revenues publicly available (for example, in general solicitation materials for an offering conducted in reliance on Rule 506(c)) and otherwise uses reasonable efforts to maintain the confidentiality of such information, enter "Not Available to Public." If the issuer's(s') business is intended to produce revenue but did not, enter "No Revenues." If the business is not intended to produce revenue (for example, the business seeks asset appreciation only), enter "Not Applicable."

- **Aggregate Net Asset Value** (for issuers that specify "Hedge Fund" or "Other Investment Fund" in response to Item 4): Enter the aggregate net asset value range of the issuer or of all the issuers together as of the most recent practicable date. If the issuer(s) has not otherwise made information about its net asset value publicly available (for example, in general solicitation materials for an offering conducted in reliance on Rule 506(c)) and otherwise uses reasonable efforts to maintain the confidentiality of such information, enter "Not Available to Public."

* * * * *

Item 7. Type of Filing. Indicate whether the issuer is filing a new notice, an advance notice for an offering in reliance on Rule 506(c), an amendment to a notice that was filed previously, or a closing amendment for an offering in reliance on Rule 506. If this is a new notice, enter the date of the first sale of securities in the offering or indicate that the first sale has "Yet to Occur." For this purpose, the date of first sale is the date on which the first investor is irrevocably contractually committed to invest, which, depending on the terms and conditions of the contract, could be the date on which the issuer receives the investor's subscription agreement or check.

* * * * *

Item 9. Type(s) of Securities Offered. Select the appropriate type or types of securities offered as to which this notice is filed. State the trading symbol and general available security identifier, such as a CUSIP number or an International Securities Identification Number (ISIN), for the offered securities, if any. If the securities are debt convertible into other securities, however, select "Debt" and any other appropriate types of securities except for "Equity." For purposes of this filing, use the ordinary dictionary and commonly understood meanings of these categories. For instance, equity securities would be securities that represent proportional ownership in an issuer, such as ordinary common and preferred stock of corporations and partnership and limited liability company interests; debt securities would be securities representing money loaned to an issuer that must be repaid to the investor at a later date; pooled investment fund interests would be securities that represent ownership interests in a pooled or collective investment vehicle; tenant-in-common securities would be securities that include an undivided fractional interest in real property other than a mineral property; and mineral property securities would be securities that include an undivided interest in an oil, gas or other mineral property.

* * * * *

Item 14. Investors. Indicate whether securities in the offering have been or may be sold to persons who do not qualify as accredited investors as defined in Rule 501(a), 17 CFR 230.501(a), and provide the number of such investors who have already invested in the offering. In addition, regardless of whether securities in the offering have been or may be sold to persons who do not qualify as accredited investors, specify the total number of investors who already have invested. For an offering conducted in reliance on Rule 506, state the number of natural persons who are accredited investors and non-accredited investors and purchased securities in the offering, the number of legal entities that are accredited investors and non-accredited investors and purchased securities in the offering, and the dollar amount raised from each category of investor.

* * * * *

Item 16. Use of Proceeds. For an offering conducted in reliance on Rule 506 by an issuer that is not a pooled investment fund, enter the percentage range of the offering proceeds that was or will be used to repurchase or retire the issuer's existing securities; to pay offering expenses; to acquire assets, otherwise than in the ordinary course of business; to finance acquisitions of other businesses; for working capital; and to discharge indebtedness.

Item 17. Purchasers Who Qualified as Accredited Investors. For an offering conducted in reliance on Rule 506, enter the number of purchasers who qualified as accredited investors on the basis of (1) income, (2) net worth, (3) being a director, executive officer or general partner of the issuer or its general partner, or (4) other basis.

Item 18. National Securities Exchange or Alternative Trading System. For an offering conducted in reliance on Rule 506, if the issuer's securities are traded on a national securities exchange, alternative trading system or any other organized trading venue, state the name of such trading venue. If a class of the issuer's securities is registered under the Securities Exchange Act of 1934, state the SEC file number for such class of securities. Check the box if the securities being offered in reliance on Rule 506 are of the same class of securities or are convertible into or exercisable or exchangeable for such class of securities.

Item 19. Filing of General Solicitation Materials with FINRA. For an offering conducted in reliance on Rule 506, if the issuer used a registered broker-dealer in connection with the offering, indicate whether any general solicitation materials were filed with the Financial Industry Regulatory Authority (FINRA).

Item 20. Name and SEC File Number of Investment Advisers. For an offering conducted in reliance on Rule 506 by an issuer that is a pooled investment fund, if an investment adviser functions, directly or indirectly, as a promoter of the issuer, provide the name and Commission file number for each such investment adviser that is registered with, or reporting as an exempt reporting adviser to, the Commission.

Item 21. Types of General Solicitation and General Advertising. For an offering conducted in reliance on Rule 506(c), indicate each type of general solicitation and general advertising used or to be used in the offering. If public website(s) or webcast(s) are used, specify the web addresses for the public website(s) or webcast(s). If written communications are used other than those listed in this item, briefly describe the form of such written communications.

Item 22. Methods Used to Verify Accredited Investor Status. For an offering conducted in reliance on Rule 506(c), indicate each method used or to be used to verify that the purchasers of securities are accredited investors. If the issuer verifies the accredited investor status of purchasers other than through the non-exclusive list of verification methods in Rule 506(c)(2)(ii), specify the publicly available information, documentation provided by the purchaser or third parties, or other methods used to verify accredited investor status.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

July 10, 2013

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-69955; File No. SR-OCC-2013-804)

July 10, 2013

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of an Advance Notice in Connection With a Proposed Change to its Operations in the Form of a Private Offering by OCC of Senior Unsecured Debt Securities

Pursuant to Section 806(e)(1) of the Payment, Clearing, and Settlement Supervision Act of 2010 ("Clearing Supervision Act")[1] and Rule 19b-4(n)(1)(i)[2] of the Securities Exchange Act of 1934 ("Exchange Act") notice is hereby given that on June 10, 2013, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the advance notice as described in Items I and II below, which Items have been substantially prepared by OCC.[3] The Commission is publishing this notice to solicit comments on the advance notice from interested persons.

I. Clearing Agency's Statement of the Terms of Substance of the Advance Notice

OCC is proposing to change its operations in the form of a private offering of senior unsecured debt securities ("Offering").

II. Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Advance Notice

In its filing with the Commission, OCC included statements concerning the purpose of and basis for the advance notice and discussed any comments it received on the advance notice. The text of these statements may be examined at the places specified

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

2 17 CFR 240.19b-4(n)(1)(i).

3 OCC is a designated financial market utility and is required to file advance notices with the Commission. See 12 U.S.C. 5465(e).

in Item IV below. The clearing agency has prepared summaries, set forth in section A below, of the most significant aspects of such statements.[4]

(A) Advance Notices Filed Pursuant to Section 806(e) of the Clearing Supervision Act

Description of Change

OCC states that the proposed Offering would provide OCC with access to additional liquidity for working capital needs and general corporate purposes. The aggregate principal amount of the senior unsecured debt securities placed in the Offering is expected to be up to $100 million. The proceeds of the Offering would be among the financial resources used to satisfy the requirements applicable to OCC under CFTC regulations.

Among other things, OCC states that CFTC regulation Section 39.11(a)(2)[5] requires a derivatives clearing organization ("DCO") to hold an amount of financial resources that, at a minimum, exceeds the total amount that would enable the DCO to cover its operating costs for a period of at least one year, calculated on a rolling basis. In turn, CFTC regulation Section 39.11(e)(2)[6] provides that these financial resources must include unencumbered, liquid financial assets (i.e., cash and/or highly liquid securities), equal to at least six months' operating costs. OCC states that the Offering is intended to contribute to OCC's compliance with the financial resources requirement under CFTC

4 The Commission has modified the text of the summaries prepared by the clearing agency.

5 17 CFR 39.11(a)(2).

6 17 CFR 39.11(e)(2).

regulation Section 39.11(a)(2)[7] and the liquidity requirements prescribed by CFTC regulation Section 39.11(e)(2).[8] OCC states that the proceeds of the offering would be invested in instruments such as reverse repurchase agreements in which working capital may be invested under OCC's By-Laws.

Under the proposal, OCC would issue senior unsecured debt securities through the Offering, which would be structured as a private placement for which a broker-dealer registered with the Securities and Exchange Commission under the Exchange Act would act as the exclusive placement agent. Under the terms of the Offering, OCC would be required to use any capital raised to finance its working capital needs or for general corporate purposes.

According to OCC, one of the conditions of OCC's proposed Offering is the execution of definitive agreements. These agreements are expected to include a number of conditions related to OCC's performance under such agreements including, without limitation, certain covenants and default provisions.

OCC states that the Offering would involve a variety of customary fees and expenses payable by OCC to the placement agent and the noteholders, including but not limited to: (1) a placement agent fee calculated as a percentage of the aggregate principal amount of debt securities sold in the Offering; and (2) other costs and expenses incurred by the placement agent in relation to its activities in connection with the Offering including, but not limited to, travel expenses and reasonable fees of counsel. These fees and expenses may be paid out of the proceeds of the Offering.

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[7] 17 CFR 39.11(a)(2).

[8] 17 CFR 39.11(e)(2).

Anticipated Effect on and Management of Risk

OCC states that any impact of the Offering on the risks presented by OCC would be to reduce such risks by providing an additional source of liquidity for the protection of OCC, its clearing members, and the options market in general. OCC states that the Offering would provide OCC with additional liquidity for working capital needs and general corporate purposes and thereby assist OCC in satisfying the CFTC's requirements with respect to liquidity under CFTC regulation Section 39.11.[9]

OCC states that, like any debt offering, the Offering would involve risks. According to OCC, one risk associated with the Offering relates to the need for OCC to maintain sufficient cash flow to support ongoing interest payments to the noteholders. OCC states this risk is mitigated by its conservative fiscal practices under which clearing and other fees are assessed at a level designed to ensure that OCC has more than sufficient funds to operate and satisfy liabilities, and refunds are paid to clearing members only when it is clear that excess funds are available. Clearing member refunds would be effectively subordinated to interest payments on the notes sold in the Offering.

OCC states that the Offering involves a risk of OCC's defaulting by failing to make timely payment of principal or interest or to comply with financial covenants, which would allow the noteholders to take legal action against OCC to recover any losses resulting from a default. However, OCC states that the risk of default from a payment failure is mitigated because, as discussed above, OCC does not expect to have difficulty making interest payments. Similarly, OCC states that the tests included in the financial covenants will be established at reasonable levels, making it unlikely that OCC would default by violating these covenants. In addition, because the Offering would involve the

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[9] 17 CFR 39.11.

issuance of unsecured notes, OCC states that it would not be at risk of the noteholders' liquidating OCC assets in the event of OCC's default.

The agreement with noteholders also requires OCC to make the noteholders "whole" in the event OCC elects to prepay any outstanding principal. According to OCC, this "make-whole" covenant poses risk to the extent OCC is unable to immediately pay the outstanding interest payments. OCC would mitigate the risk of having to make a large make-whole payment by either electing not to call the notes prior to termination or by waiting to call the notes until the make-whole premium has been reduced by the passage of time to a smaller amount. OCC expects to need the additional liquidity for the term of the notes and to issue the notes at a time of favorable market conditions, and accordingly OCC does not expect to call the notes prior to termination.

According to OCC, one risk of obtaining capital through the Offering as opposed to an unsecured line of credit is that OCC will incur more expense in connection with the Offering given that it must pay interest expense on the entire outstanding note balance as opposed to a comparatively smaller commitment fee on a line of credit. However, OCC states that this risk is justified by the difficulty in obtaining an unsecured line of credit of a size comparable to that of the Offering. Moreover, OCC states the risk is mitigated by OCC's investment of the proceeds, which generates income to offset the interest expense. In addition, by obtaining capital through the Offering OCC avoids the funding risk associated with a line of credit.

III. Date of Effectiveness of the Advance Notice and Timing for Commission Action

OCC may implement the proposed change pursuant to Section 806(e)(1)(G) of the Clearing Supervision Act[10] if it has not received an objection to the proposed change within 60 days of the later of (i) the date that the Commission received the advance notice or (ii) the date the Commission receives any further information it requested for consideration of the notice. The clearing agency shall not implement the proposed change if the Commission has any objection to the proposed change.

The Commission may extend the period for review by an additional 60 days if the proposed change raises novel or complex issues, subject to the Commission providing the clearing agency with prompt written notice of the extension. A proposed change may be implemented in less than 60 days from the date of receipt of the advance notice, or the date the Commission receives any further information it requested, if the Commission notifies the clearing agency in writing that it does not object to the proposed change and authorizes the clearing agency to implement the proposed change on an earlier date, subject to any conditions imposed by the Commission.

The clearing agency shall post notice on its website of proposed changes that are implemented.

The proposal shall not take effect until all regulatory actions required with respect to the proposal are completed.[11]

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10 12 U.S.C. 5465(e)(1)(G).

11 OCC also filed the proposals contained in this advance notice as a proposed rule change under Section 19(b)(1) of the Exchange Act and Rule 19b-4 thereunder. See supra note 3.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-OCC-2013-804 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-OCC-2013-804 This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the advance notice that are filed with the Commission, and all written communications relating to the advance notice between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 am and 3:00 pm. Copies of the filing also will be available for inspection and copying at the principal office of OCC and on OCC's website (http://theocc.com/about/publications/bylaws.jsp). All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-OCC-2013-804 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

By the Commission.

Kevin M. O'Neill

Kevin M. O'Neill
Deputy Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

Release No. 34-69964; File No. S7-30-11

RIN 3235-AL19

Retail Foreign Exchange Transactions

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Commission is adopting a rule to permit a registered broker-dealer to engage in a retail forex business, provided that the broker-dealer complies with the Securities Exchange Act of 1934, the rules and regulations thereunder, and the rules of the self-regulatory organization(s) of which the broker-dealer is a member insofar as they are applicable to retail forex transactions. The Commission is adopting Rule 15b12-1 substantially in the form previously adopted as an interim final temporary rule and is providing that the rule will expire on July 31, 2016.

DATES: Effective Date: July 16, 2013. The expiration date of Rule 15b12-1 (17 CFR 240.15b12-1) is July 31, 2016.

FOR FURTHER INFORMATION CONTACT: Catherine Moore, Senior Special Counsel; Shaheen Haji Zuver, Special Counsel; or Stephen J. Benham, Attorney-Adviser, at (202) 551-5550 or Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

SUPPLEMENTARY INFORMATION: The Commission is adopting Rule 15b12-1 under the Exchange Act, to permit a registered broker or dealer ("broker-dealer") to engage in retail forex transactions, as such transactions are defined below. Unless the Commission acts further, the rule will expire and no longer be effective on July 31, 2016.

I. BACKGROUND

A. Retail Foreign Exchange

The foreign currency exchange ("forex") market is a large and liquid market used by banks, insurance companies, large corporations, and other large financial institutions to trade in risks associated with fluctuations in foreign currency rates. In recent years, a secondary off-exchange market for forex has developed for retail customers.[1] Many customers may view forex as a possible investment opportunity or portfolio risk management strategy. However, the Commission, its staff,[2] and other regulatory authorities[3] have cautioned investors that the forex market poses risks for retail customers.

The regulatory oversight of the retail forex market has developed primarily through a series of amendments to the Commodity Exchange Act ("CEA").[4] Transactions commonly referred to as "retail forex transactions" are foreign exchange transactions with persons who are

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1 See, e.g., FINRA Regulatory Notice 08-66 (Retail Foreign Currency Exchange) (November 2008) available at: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117362.pdf ("FINRA Forex Notice").

2 See Investor Bulletin: Foreign Currency Exchange (Forex) Trading for Individual Investors (July 2011), available at http://www.sec.gov/investor/alerts/forextrading.pdf ("Forex Bulletin"). See also Retail Foreign Exchange Transactions, Exchange Act Release No. 64874 (July 13, 2011), 76 FR 41676 (July 15, 2011) ("2011 Interim Rule Release") at 41677 (noting that media reports have highlighted potential abuses).

3 See, e.g., Press Release, Commodities Futures Trading Commission ("CFTC"), CFTC Releases Final Rules Regarding Retail Forex Transactions (Aug. 30, 2010) (available at http://www.cftc.gov/PressRoom/PressReleases/pr5883-10.html?dbk) (noting that retail forex is the largest area of retail fraud that the CFTC oversees).

4 See Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 FR 3282 (Jan. 20, 2010) ("CFTC Proposing Release") for a detailed discussion by the CFTC of the amendments to the CEA regarding retail forex.

retail customers (persons who are not eligible contract participants ("ECPs") as defined in the CEA) and that settle on a T+3 or greater timeline.[5] Significantly, certain types of transactions are not "retail forex transactions" under the CEA, even where one of the counterparties is a person that is not an ECP. These transactions include: (i) "spot forex transactions" where one currency is bought for another and the two currencies are exchanged within two days; (ii) forward contracts that create an enforceable obligation to make or take delivery, provided that each counterparty has the ability to deliver and accept delivery in connection with its line of business; and (iii) options that are executed or traded on a national securities exchange registered pursuant to section 6(a) of the Exchange Act.[6] In addition, and as discussed in more detail below, conversion trades – trades in which a foreign exchange transaction facilitates the settlement of a foreign security transaction – are spot forex transactions and, therefore, are outside the scope of the CEA prohibition and this rulemaking.[7]

Only certain regulated entities may act as counterparty to foreign exchange transactions.[8] These approved entities include Futures Commission Merchants ("FCMs"), Retail Foreign Exchange Dealers ("RFEDs") registered with the CFTC, banks, and insurance companies, as well as broker-dealers registered with the Commission.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") further amended the CEA to limit potential abuses in the retail forex market by prohibiting retail forex transactions as of July 16, 2011, in the absence of a rulemaking permitting retail forex

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5 See 7 U.S.C. 2(c)(2)(B)(i).

6 See 7 U.S.C. 2(c)(2)(B)(i)(I).

7 See Further Definition of "Swap," "Security-Based Swap," and "Security/Based Swap Agreement"; Mixed Swaps; Security/Based Swap Agreement Recordkeeping; Final Rule, Exchange Act Release No. 67453 (July 18, 2012), 77 FR 48207 (Aug. 13, 2012) ("Products Definitions Release").

8 7 U.S.C. 2(c)(2)(B)(i).

transactions by the relevant Federal regulatory agency. The prohibition in the CEA applies to retail forex transactions with registered broker-dealers, and the Commission adopted an Interim Final Temporary Rule on July 13, 2011 ("Interim Rule"), to allow retail forex transactions with broker-dealers under terms and conditions prescribed by the Commission.[9]

B. Amendments to the Commodity Exchange Act

As amended by the Dodd-Frank Act,[10] the CEA provides that a person for which there is a Federal regulatory agency,[11] including a broker-dealer registered under section 15(b) (except pursuant to paragraph (11) thereof) or 15C of the Exchange Act,[12] shall not enter into, or offer to enter into, a transaction described in section 2(c)(2)(B)(i)(I) of the CEA with a person who is not an ECP,[13] except pursuant to a rule or regulation of a Federal regulatory agency allowing the

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9 See 2011 Interim Rule Release. See also Extension of Interim Final Temporary Rule on Retail Foreign Exchange Transactions, Exchange Act Release No. 67405 (July 11, 2012), 77 FR 41671 (July 16, 2012) ("2012 Extension Release").

10 7 U.S.C. 2(c)(2)(E).

11 7 U.S.C. 2(c)(2)(E)(i), as amended by § 742(c) of the Dodd-Frank Act, defines a "Federal regulatory agency" to mean the CFTC, the Securities and Exchange Commission, an appropriate Federal banking agency (as defined in section 3(q) of the Federal Deposit Insurance Act (12 U.S.C. 1813(q))), the National Credit Union Association, and the Farm Credit Administration.

12 7 U.S.C. 2(c)(2)(B)(i)(II).

13 "Eligible contract participant" is defined in CEA section 1a(18), as re-designated and amended by section 721 of the Dodd-Frank Act. See Public Law 111-203, § 721 (amending CEA section 1a). The CEA's definition of ECP generally comprises regulated persons; entities that meet a specified total asset test (e.g., a corporation, partnership, proprietorship, organization, trust, or other entity with total assets exceeding $10 million subject to certain restrictions) or an alternative monetary test coupled with a non-monetary component (e.g., a corporation, partnership, proprietorship, organization, trust, or other entity with a net worth in excess of $1 million and enters into an agreement, contract, or transaction in connection with the conduct of the entity's business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity's business); certain employee benefit plans, the investment decisions of which are made by one of four enumerated types of regulated entities; and certain governmental entities and individuals that meet defined thresholds. The Commission and the CFTC adopted rules

transaction under such terms and conditions as the Federal regulatory agency shall prescribe ("retail forex rule").[14] An individual can qualify as an ECP if the individual has aggregate amounts invested on a discretionary basis of more than $10 million or more than $5 million if such individual enters into the transaction in order to manage the risk associated with an asset owned or liability incurred, or reasonably likely to be owned or incurred by such individual.[15] Transactions described in CEA section 2(c)(2)(B)(i)(I) include "an agreement, contract, or transaction in foreign currency that ... is a contract of sale of a commodity for future delivery (or an option on such a contract) or an option (other than an option executed or traded on a national securities exchange registered pursuant to section 6(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78f(a))."[16] A Federal regulatory agency's retail forex rule must treat all agreements, contracts, and transactions in foreign currency described in CEA section 2(c)(2)(B)(i)(I) and all agreements, contracts, and transactions in foreign currency that are functionally or economically similar to agreements, contracts, or transactions described in CEA section 2(c)(2)(B)(i)(I),

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under the CEA that further define "eligible contract participant" with respect to transactions with major swap participants, swap dealers, major security-based swap participants, security-based swap dealers, and commodity pools. See Exchange Act Release No. 66868 (Apr. 27, 2012), 77 FR 30596 (May 23, 2012).

14 7 U.S.C. 2(c)(2)(E)(ii)(I). As used in this release, "retail forex rule" refers to any rule proposed or adopted by a Federal regulatory agency pursuant to section 742(c)(2) of the Dodd-Frank Act. On September 10, 2010, the CFTC adopted a retail forex rule for persons subject to its jurisdiction. See Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 FR 55410 (September 10, 2010) ("CFTC Final Rule"). The CFTC had proposed its rules regarding retail forex transactions prior to the enactment of the Dodd-Frank Act. See CFTC Proposing Release. The Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC"), and the Board of Governors of the Federal Reserve System ("Board") have adopted similar rules. See Retail Foreign Exchange Transactions, 76 FR 40779 (July 12, 2011) ("FDIC Final Rule"); Retail Foreign Exchange Transactions, 76 FR 41375 (July 14, 2011) ("OCC Final Rule"); and Retail Foreign Exchange Transactions, 78 FR 21019 (April 9, 2013) ("Board Final Rule").

15 7 U.S.C. 1a(18)(A)(xi).

16 7 U.S.C. 2(c)(2)(B)(i)(I).

similarly.[17] Any retail forex rule also must prescribe appropriate requirements with respect to disclosure, recordkeeping, capital and margin, reporting, business conduct, and documentation, and may include such other standards or requirements as the Federal regulatory agency determines to be necessary.[18]

This amendment to the CEA took effect on July 16, 2011.[19] As of that date, broker-dealers, including broker-dealers also registered with the CFTC as FCMs ("BD-FCMs"),[20] for which the Commission is the Federal regulatory agency could no longer engage in retail forex transactions except pursuant to a rule adopted by the Commission.[21]

C. The Interim Rule

On July 13, 2011, the Commission adopted the Interim Rule (Rule 15b12-1T), which allows a registered broker-dealer to continue to engage in, or enter into, a retail forex business until July 16, 2012, provided that the broker-dealer complies with the Exchange Act, the rules and regulations thereunder, and the rules of the self-regulatory organization(s) ("SRO") of which the broker-dealer is a member, insofar as they are applicable to retail forex transactions.[22] The Interim Rule was designed to provide an opportunity for the public to submit comments

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17 7 U.S.C. 2(c)(2)(E)(iii)(II).

18 7 U.S.C. 2(c)(2)(E)(iii)(I).

19 See Public Law 111-203, § 754.

20 See 7 U.S.C. 2(c)(2)(B)(i)(II)(cc), 2(c)(2)(C)(i)(I)(aa) and 2(c)(2)(E). Congress expressly provided that the CFTC has jurisdiction over an FCM's retail foreign exchange activities only if the FCM is not also a registered broker-dealer.

21 See 7 U.S.C. 2(c)(2)(B)(i)(II) and 7 U.S.C. 2(c)(2)(E)(ii)(I). This prohibition does not apply to (1) forex transactions with a customer who qualifies as an ECP, or (2) transactions that are spot forex contracts or forward forex contracts irrespective of whether the customer is an ECP. However, consistent with other Federal regulatory agencies' retail forex rules, Rule 15b12-1 applies to "rolling spot" transactions in foreign currency by broker-dealers. See section II.A. below for a description of rolling spot transactions.

22 See 2011 Interim Rule Release.

regarding broker-dealer practices in this area, which would inform the Commission's consideration of what additional rules may be necessary to address investor protection concerns, including abusive sales practices, volatility, and riskiness of the forex market as they affected the regulatory treatment of retail forex transactions by broker-dealers. We explained at the time that our action was also intended to preserve potentially beneficial market activity that, for example, may serve to minimize a retail customer's exposure to the risk of changes in foreign currency rates in connection with the customer's purchase or sale of a security. We also described potentially abusive practices, such as lack of disclosure about fees and forex pricing and insufficient capital or margin requirements, and requested comment on these practices and whether there are any steps we should take to seek to prevent them in the 2011 Interim Rule Release.[23] In July 2012, the Commission extended the Interim Rule to July 16, 2013.[24]

D. Interpretation regarding "Conversion Trades"

The Interim Rule was intended, in part, to address concerns that broker-dealers would be precluded from entering into foreign exchange transactions on behalf of retail customers in order to facilitate the customer's purchase or sale of a security listed on a foreign exchange and denominated in a foreign currency ("conversion trades").[25] Subsequent to the initial adoption

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23 See 2011 Interim Rule Release at 41684. The Commission's Office of Investor Education and Advocacy published an Investor Bulletin providing information about retail forex investing, including information about the risks involved in that type of trading. See Forex Bulletin. The CFTC and the North American Securities Administrators Association also have published an alert regarding risks of fraud in foreign exchange markets. See Foreign Exchange Currency Fraud: CFTC/NASAA Investor Alert, available at http://www.cftc.gov/ConsumerProtection/FraudAwarenessPrevention/ForeignCurrencyTrading/cftcnasaaforexalert.

24 See 2012 Extension Release.

25 See Memorandum from P. Georgia Bullitt, Morgan Lewis, on Pershing LLC – Proposed Relief regarding transactions in Retail Foreign Exchange to James Brigagliano et al.

and most recent extension of the Interim Rule, in August 2012, the CFTC issued an interpretation in a joint rulemaking with the Commission that conversion trades are not a form of retail forex transaction subject to the prohibition under the CEA.[26] Under this interpretation, broker-dealers are permitted to engage in conversion trades without a rulemaking by the Commission and the level of broker-dealer foreign exchange activity subject to the prohibition in section 2(c)(2)(E)(ii)(I) of the CEA (and this rulemaking) is significantly reduced.

Although the CFTC interpretation excludes conversion trades from the definition of retail forex, hedging and speculative trading in foreign currency (other than bona fide spot transactions[27]) are still within the scope of the definition. Broker-dealers, including BD-FCMs, are therefore prohibited from engaging in such trades absent a Commission rule.

(June 17, 2011) (available at http://www.sec.gov/comments/other/other-initiatives/otherinitiatives-56.pdf).

26 See Products Definitions Release. For purposes of the interpretation, a conversion trade is a transaction for the purchase or sale of an amount of foreign currency equal to the price of a foreign security with respect to which (i) the security and related foreign currency transactions are executed contemporaneously in order to effect delivery by the relevant securities settlement deadline and (ii) the actual delivery of both the foreign currency and securities occurs by the deadline.

27 See Products Definitions Release at 48257. The Commission and the CFTC consider a foreign exchange transaction that is entered into solely to effect the purchase or sale of a foreign security to be a bona fide spot transaction where certain conditions are met.

E. Comments

The Commission received 20 comments on the Interim Rule.[28] Sixteen comment letters were received on the Interim Rule after it was adopted in 2011. Four comment letters (from only two commenters) were received following the extension of the Interim Rule in 2012. To provide a broad overview of both investor and industry reaction to the Interim Rule, all of the comments received are addressed below.

Nine commenters asked the Commission to preserve their ability to engage in retail forex transactions.[29] Another group of commenters urged the Commission to adopt a final rule based on the approach followed in the Interim Rule.[30] These commenters maintained that it is in the

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28 The comments are available at http://www.sec.gov/comments/s7-30-11/s73011.shtml.

29 See email comments from Raul Gonzalez, dated July 17, 2011, James Peck, dated July 17, 2011, Bob Flowers, dated July 17, 2011, James M. Beatty, dated July 17, 2011, Angela Li, dated July 17, 2011, Mark A. McDonnell, dated July 21, 2011, Mark Smith, dated July 23, 2011, John Baur, dated July 27, 2011, and Ronald Covington, dated October 23, 2011.

30 See Letter from Kenneth E. Bentsen, Jr., Executive Vice President Public Policy and Advocacy, SIFMA and Robert Pickel, Executive Vice Chairman, ISDA, to Elizabeth Murphy, Secretary, Commission, dated October 17, 2011 ("SIFMA/ISDA Letter"). See also Memorandum from SIFMA and ISDA to Marc Menchel, Gary Goldsholle, Matthew Vitek, Rudy Verra, Glen Garofalo, FINRA, dated February 23, 2012. These commenters requested that the Commission clarify that the Commission's rule, together with FINRA regulation, would exclusively govern the retail foreign exchange activity of all broker-dealers, including BD-FCMs. The Commission notes that the rule being adopted, Rule 15b12-1, by its terms applies in the context of retail forex transactions but does not alter the requirement to comply with applicable Commission rules or other rules in other contexts. These commenters also requested that the Commission, in consultation with the CFTC, provide a safe-harbor to broker-dealers that would apply in the event that the status of a customer that is a natural person (including their investment vehicles and family offices) changes from that of a retail customer when a foreign exchange transaction is first entered into with the broker-dealer, including a BD-FCM, to that of an ECP, because of fluctuations in net assets, a change in market prices or other factors. However, given that interpretations regarding what constitutes a retail forex transaction are under the CEA and therefore subject to the jurisdiction of the CFTC and not the Commission, these commenters may wish to consider addressing this request to the CFTC.

best interest of retail customers to have the opportunity to conduct forex activity as part of their broader investing activity, through their broker-dealers, with the assistance of personnel with forex expertise.

One group of commenters limited their comments to conversion trades and, as discussed above, asked the CFTC and other Federal regulatory agencies (including the Commission), to take the view that conversion trades are not prohibited for purposes of section 2(c) of the CEA.[31] As noted above, the CFTC has issued an interpretation that conversion trades are not retail forex transactions subject to the prohibition under the CEA.

One commenter stated that the Commission should rescind the rule and allow the statutory ban to take effect or, in the alternative, limit the scope of the rule to a narrowly defined class of forex transactions, specifically hedging and the facilitation of settlement of foreign securities.[32] The commenter further stated that in initially adopting the Interim Rule, the Commission did not provide notice of and opportunity for comment on the rule, and did not include a concrete assessment or quantification of the need for the relief granted by the rule. As discussed throughout this release, the Commission does not believe it would be appropriate at

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31 See Letter from Phoebe A. Papageorgiou, Senior Counsel, American Bankers Association and James Kemp, Managing Director, Global Foreign Exchange Division, to Thomas J. Curry, Comptroller, OCC, Robert E. Feldman, Executive Secretary, FDIC, Jennifer J. Johnson, Secretary, the Board, David Stanwick, Secretary, CFTC, and Elizabeth Murphy, Secretary, Commission, dated April 18, 2012 ("ABA/GFMA Letter"). See also SIFMA/ISDA Letter. SIFMA and ISDA requested that the Commission amend the definition of "retail forex business" in section (a) of Rule 15b12-1T in order to make clear that conversion trade transactions would be permitted under the Interim Rule, which is no longer necessary as a result of the CFTC's interpretation.

32 See Letter from Dennis M. Kelleher, President and CEO, and Stephen W. Hall, Securities Specialist, Better Markets, Inc. to Elizabeth Murphy, Secretary, Commission, dated September 12, 2011 ("Better Markets Letter"). We understand the commenter's reference to transactions entered into to facilitate the settlement of foreign securities to mean the conversion trades discussed above that are no longer subject to the statutory prohibition.

this time to ban retail forex transactions or otherwise limit the scope of permissible transactions by broker-dealers. Such a ban or limitation may prohibit legitimate activities such as hedging or other transactions and, among other factors discussed below, the Commission has not obtained sufficient information to indicate that such restrictions are warranted. In addition, the final rule we are adopting today is being adopted after notice and comment in response to the 2011 Interim Rule Release and the 2012 Extension Release.

Three comment letters provided the Commission with data on retail forex activity. One of the commenters provided data, based on a sampling of five broker-dealers for an unknown year, showing that those members engaged in $550 million per month (principal) of over-the-counter currency forwards, currency options and rolling spot transactions with non-ECPs and $1.2 billion per month of conversion trades.[33]

The second comment letter provided data on the returns of retail forex accounts at certain FCMs and RFEDs, and offered suggestions for additional disclosure and business conduct requirements (such as suitability standards), and identified areas concerning regulation and market activities in the context of retail forex transactions that the commenter believed warrants further monitoring.[34] We agree with the commenter's suggestion that further monitoring of retail forex transactions is warranted. While the Commission has determined to adopt Rule 15b12-1 for the reasons discussed throughout this release, we believe it is appropriate to give additional consideration to the suggestions provided by the commenter. We are including in Rule 15b12-1

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33 See Letter from Kenneth E. Bentsen, Jr., Executive Vice President Public Policy and Advocacy, SIFMA, dated July 10, 2012 ("SIFMA Letter").

34 See Letter from Justin Hughes, CFA and Managing Member, Philadelphia Financial Management of San Francisco to Elizabeth Murphy, Secretary, Commission, dated August 2, 2011 ("Philadelphia Financial Letter"). The commenter's suggestions for additional regulation included limiting the product to only accredited investors, establishing order handling rules as well as limiting leverage and account churning.

a provision providing that the rule will expire on July 31, 2016 to permit additional time for the Commission to assess the market for retail forex (including recent regulatory developments discussed below) and potentially develop more targeted rules for retail forex or to consider any rules that an SRO may propose regarding its members' retail forex activities. The commenter also suggested that currency exchange-traded funds ("currency ETFs") would provide an alternative means for effectively hedging against currency risk.[35]

A third comment letter from a representative of another commenter provided 2010 data from a small sampling of large broker-dealers with an estimated notional value of foreign exchange conversion trades of $13.55 billion and an estimated notional value of foreign exchange non-conversion trades of $1.43 billion, although these values included transactions with both ECPs and non-ECPs.[36]

Following the extension of the Interim Rule in July 2012, the Commission received four additional comment letters from two commenters.[37] One commenter requested that broker-dealers be allowed to continue to engage in, or enter into, a retail forex business. This commenter argued that broker-dealers should be permitted to conduct retail forex to offer their retail clients a full suite of investment options and to facilitate hedging of transactions in foreign

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35 See Philadelphia Financial Letter. See also Better Markets Letter. See also supra section III.E. for a discussion of potential alternatives to retail forex transactions, including currency exchange traded products ("ETPs").

36 See letter from P. Georgia Bullitt, Michael A. Piracci and F. Mindy Lo, Morgan Lewis to Joseph Furey, Bonnie L. Gauch and Adam Yonce, Commission, dated July 28, 2011 ("Morgan Lewis Letter"). This commenter provided data from five large-broker dealers, but, only some of the broker-dealers provided information for every type of transaction cited in the letter.

37 See email comments from Ernest J. Guevara III, dated November 16, 2012 (this comment does not appear to be related to the Interim Rule), and Brad Georges of Greeneye Management, dated December 19, 2012 ("Greeneye Comment Email") February 28, 2013 ("Second Greeneye Comment Email"), and April 17, 2013.

stocks.[38] This commenter also noted that broker-dealers have risk management and customer suitability practices in place to monitor their activities not only in stocks but also in options and stated that retail forex activities should be able to be conducted within broker-dealers and subject to regulatory oversight by the Commission. In a separate communication, this commenter reiterated that the Commission should allow active trading and hedging of spot forex under the same guidelines as active trading of stocks and options.[39] The commenter asserted that brokers should be able to set their own margins, taking into account the currency, the client, and the market conditions.[40]

As noted above, and as discussed in more detail below, the Commission believes it is appropriate at this time to allow broker-dealers to continue engaging in retail forex transactions subject to existing restrictions under Commission and FINRA rules while any additional requirements for retail forex are considered in order to retain existing options for retail investors to access the foreign exchange markets. This approach is consistent with the approach contained in the Interim Rule and with the recommendations of most commenters; however, the Commission is adopting Rule 15b12-1 with a provision providing that the rule will expire on July 31, 2016. This provides an additional opportunity for the Commission to assess the market for retail forex and determine whether to issue more targeted rules for retail forex, to consider any rules that an SRO may develop regarding its members' retail forex activities, to consider whether to take action to extend the rule, or have the rule expire.

To that end, Commission staff will consult with FINRA periodically to discuss and obtain additional information about the retail forex marketplace, such as information regarding new

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38 See Greeneye Comment Email.

39 See Second Greeneye Comment Email.

40 See id.

FINRA member applications identifying retail forex business and any rules that FINRA may consider regarding its members' retail forex activities. Commission staff will also periodically consult with other regulatory agencies, including the CFTC and banking regulators, to discuss the retail forex marketplace and identify potential areas and instances of abuse, as well as the ways that retail investors have benefited or been harmed. In addition, the Commission will consider any relevant information obtained during standard broker-dealer examinations.

II. DISCUSSION

Taking into consideration all of the comments received, the Commission believes it is appropriate at this time to allow broker-dealers to continue to engage in retail forex transactions subject to existing requirements under Commission and FINRA rules while any additional requirements for retail forex are considered in order to retain existing options for retail investors to access the foreign exchange markets.

The Commission is adopting Rule 15b12-1 with the same terms and conditions as the Interim Rule in order to permit broker-dealers to continue to engage in a retail forex business under the framework of the Exchange Act for the time period specified in the rule. The final rule requires that broker-dealers comply with existing obligations under the Exchange Act, the rules and regulations thereunder, and the rules of the SRO of which the broker-dealer is a member.[41] As discussed in more detail below, the final rule meets the requirements in Section 2(c)(2)(E)(iii) of the CEA that the rule treat all agreements, contracts, and transactions in foreign currency described in CEA section 2(c)(2)(B)(i)(I) and all agreements, contracts, and transactions in foreign currency that are functionally or economically similar to agreements, contracts, or

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41 Broker-dealers engaging in conversion trades are not subject to the rule as a result of the CFTC's interpretation to exclude conversion trades from retail forex, but they remain subject to the Commission's antifraud authority, including Section 10(b) and Rule 10b-5, under the Exchange Act when engaging in these trades.

transactions described in CEA section 2(c)(2)(B)(i)(I), similarly, and that the rule prescribes appropriate requirements with respect to disclosure, recordkeeping, capital and margin, reporting, business conduct, and documentation by requiring that broker-dealers engaged in a retail forex business comply with the Exchange Act, the rules and regulations thereunder, and the rules of the SRO of which the broker-dealer is a member.[42]

The CFTC's interpretation regarding conversion trades that was issued following the extension of the Interim Rule has significantly narrowed the scope of retail forex transactions subject to a Commission rule. While we have only limited information on the level of retail forex activity conducted by broker-dealers, we received information from one commenter asserting that, based on a sampling of a small number of large broker-dealers, a substantial majority of foreign exchange transactions engaged in by these broker-dealers are conversion trades.[43] Given the clarification regarding the exclusion of conversion trades from the scope of retail forex transactions, we believe that the scope of transactions that are currently considered to be retail forex transactions, and thus subject to the Commission's rule, is much more limited than what the Commission anticipated in the Interim Rule.

Conversion trades were the focus of many of the comments received on the Interim Rule and the CFTC's interpretation was not issued until after the Commission had extended the interim temporary final rule. Given the recent modified scope of retail forex transactions to exclude conversion trades and the limited comments received on issues related to non-conversion trades, we believe it is appropriate to provide additional time for the Commission to focus its review on the current scope of activities that are included in retail forex transactions prior to considering any tailored rules for broker-dealers engaging in a retail forex business.

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42 7 U.S.C. 2(c)(2)(E)(iii).

43 See Morgan Lewis letter.

The CFTC has also adopted rules that contain requirements specific to retail forex transactions including disclosure requirements, net capital requirements and haircut deductions depending on the currency pair, security deposit requirements and profitability reporting.[44] Moreover, other regulatory agencies[45] have also adopted rules that are similar to the CFTC's rule, including the Board which very recently adopted final rules related to retail forex transactions.[46] These new requirements may have an impact on the how the retail forex market functions. The rule the Commission is adopting today differs from the rules adopted by the CFTC and other regulatory agencies as it does not contain the specific requirements tailored to the retail forex transactions referenced above. While the Commission has determined to adopt Rule 15b12-1 for the reasons discussed throughout this release including the relatively limited level of retail forex activity engaged in by broker-dealers and the existing framework of legal obligations, including SRO rules applicable to broker-dealers, the Commission anticipates the three-year sunset provision will provide it with additional time to assess further the market for retail forex (including any changes based on recent regulatory actions) and consider whether to develop more targeted rules for retail forex, to consider any rules that an SRO may develop regarding its members' retail forex activities, to consider whether to take action to extend the rule, or have the rule expire.

With respect to SRO rules, the Commission notes that FINRA has previously proposed a rule to establish leverage limitations with respect to retail forex[47] and that the National Futures

44 See CFTC Final Rule.

45 See FDIC Final Rule, OCC Final Rule, and Board Final Rule.

46 See Board Final Rule.

47 FINRA proposed a rule in 2009 to establish a leverage limitation for retail forex. See Notice of Filing of Proposed Rule Change as Modified by Amendment No. 2 to Adopt FINRA Rule 2380 to Limit the Leverage Ratio Offered by Broker-Dealers for Certain

Association (NFA) has in place rules governing retail forex activities.[48] The Commission understands that FINRA plans to continue to consider rules related to retail forex transactions taking into account the regulatory framework developed by other regulators. The Commission expects to evaluate possible future actions during the sunset period in light of developments in the retail forex market, as well as the Commission's and SROs' experiences with retail forex activity pursuant to this rule.

The Commission has previously cautioned investors about risks in the foreign exchange market generally, and highlighted certain key risks for investors, including the lack of a central marketplace for retail forex, uncertainty about transaction costs, and the possibility for investors to lose more than their original investment.[49] Commission staff also has cautioned investors that many forex traders employ leverage as a means of amplifying their returns and higher leverage, in the form of a small margin requirement, can result in large losses if prices move in an unfavorable direction.[50] The Commission stated in the 2011 Interim Rule Release that insufficient capital or margin requirements could result in costs to the market associated with the

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Forex Transactions, Exchange Act Release No. 61090 (Dec. 1, 2009), 74 FR 64776 (Dec. 8, 2009).

48 See e.g. NFA Compliance Rule 2-36. Requirements for Forex Transactions, NFA Compliance Rule 2-39. Soliciting, Introducing, or Managing Off-Exchange Retail Forex Transactions or Account, and NFA Financial Requirement Section 11. Forex Dealer Member Financial Requirements. The NFA rules that are relevant to retail forex transactions can be found at http://www.nfa.futures.org/NFA-compliance/NFA-futures-commission-merchants/forex.HTML.

49 See 2011 Interim Rule Release at 41677, noting media reports of potentially abusive practices and concerns expressed by other regulators with respect to the retail forex practices of the entities they regulate. See also Forex Bulletin. Commission staff also cautioned investors that there had been allegations of fraud by the Commission and the CFTC in cases involving foreign exchange investment schemes. Id.

50 See Forex Bulletin.

inefficient provision of retail forex services.[51] Although no instances of abuse with respect to retail forex involving broker-dealers were raised in the comment letters,[52] the Commission remains concerned about risks in the retail forex market and the potential harm to investors if abusive practices, including misleading advertising or sales practices, are employed.[53] We are, however, mindful that retail forex transactions may be used for hedging and gaining direct exposures to the foreign currency markets, which may be appropriate for retail investors through broker-dealers with the protections available to investors under existing Commission and SRO oversight. We are also sensitive to the fact that the statutory prohibition applies to BD-FCMs in the absence of Commission rules but does not apply to FCMs that are not dually registered and are permitted to engage in retail forex transactions pursuant to the CFTC's rules. Accordingly, the failure to adopt a rule permitting BD-FCMs to continue to conduct retail forex could affect investors who have an account at a BD-FCM and would need to open a new account with a different intermediary in order to continue to conduct retail forex transactions.

The sunset provision for the expiration of the rule is designed to provide the Commission with a reasonable period of time to consider further whether additional requirements for broker-dealers engaging in a retail forex business may be appropriate while avoiding any disruption or unintended consequences to broker-dealers and their customers if the statutory prohibition were to go into effect. The Commission believes that a three-year sunset, as opposed to a shorter period, is appropriate because a shorter time frame may fail to provide adequate time to reflect

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51 See 2011 Interim Rule Release at 41684.

52 The Better Markets Letter and Philadelphia Financial Letter refer generally to widespread abuses in the retail forex market, but do not cite specific instances of abuse involving intermediaries that are broker-dealers. See Better Markets Letter and Philadelphia Financial Letter.

53 The Commission encourages any person who is aware of abusive practices or other misconduct in the retail forex market to report those activities to the Commission.

on any developments in the retail forex market and then engage in any subsequent steps involved in any rulemaking process, such as the proposal and adoption of new rules before the expiration of Rule 15b12-1. Moreover, a longer time period may be unnecessary because the Commission should have sufficient time to consider and take any action prior to the expiration of the sunset provision. As an alternative, the Commission could adopt a final rule without a sunset provision or allow the temporary rule to lapse without adopting any final rule.[54] We believe, however, that in light of the CFTC's interpretation regarding conversion trades in the context of the retail forex market, as well as comments received both in support of and against final Commission rules to permit broker-dealers to engage in retail forex transactions, the arguments raised warrant further consideration. Although one commenter argued that Congress intended the ban on retail forex to go into effect,[55] we note that Congress specifically authorized the Commission and other Federal regulatory agencies to permit their regulated entities to engage in retail forex transactions by taking regulatory action the agencies determined was appropriate.[56] Furthermore, in addition to the Commission's Interim Rule, the CFTC and bank regulatory agencies have all adopted final rules to permit their regulated entities to engage in retail forex transactions.[57] The Commission will also consider any new information obtained with respect to the retail forex market, including

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54 One commenter stated that exchange listed currency ETFs, which as exchange-traded products are outside the scope of retail forex, provide an alternative to retail forex for hedging purposes and could give investors a greater return at a lower cost. See Philadelphia Financial Letter. See also the discussion of ETFs in the Economic Analysis section of this release. Other commenters, however, argue that investors should be allowed to engage in retail forex transactions with broker-dealers and that the current regulatory framework offers sufficient protections. See Greeneye Comment Email and SIFMA/ISDA Letter.

55 See Better Markets Letter. Another commenter argued that retail forex transactions are essentially gambling and should be regulated and taxed as such. See Philadelphia Financial Letter.

56 7 U.S.C. 2(c)(2)(E)(ii)(I) and (iii)(I).

57 See supra note 14. See also supra note 45.

any evidence of abusive practices or misconduct by BD-FCMs, prior to the expiration of the sunset period to determine whether additional limitations or action may be warranted. Any new requirements could be imposed either through Commission or SRO rules.

The rule we are adopting today, Rule 15b12-1, has the same terms and conditions as the Interim Rule that was adopted in 2011 and extended in 2012, except with respect to the expiration date of the rule as specified in paragraph (d) of the rule. Broker-dealers will continue to be required to comply with existing Exchange Act and SRO rules as they are applicable to retail forex transactions. We believe that the same reasons behind the adoption of the Interim Rule in 2011 and its extension in 2012 and discussed throughout this release continue to apply to the retail forex rule we are adopting today.[58]

A. Rule 15b12-1(a): Definitions

Rule 15b12-1(a) sets forth the definitions used in the rule,[59] which have not changed since the Commission adopted the Interim Rule in 2011.[60] Many of the definitions have the same meaning as in the Exchange Act.[61] These terms and definitions were selected because their meanings are readily understood in the industry. Other terms, such as "retail forex business" and "retail forex transaction," are substantially similar to terms in the OCC, FDIC, and Board final rules.[62]

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58 See 2011 Interim Rule Release at 41678 for a discussion of the rationale for adoption of the Interim Rule. See also 2012 Extension Release.

59 Rule 15b12-1(a).

60 See 2011 Interim Rule Release at 41678-79 for a discussion of these definitions.

61 These include the definition of broker, dealer, person, registered broker or dealer, and self-regulatory organization. See 2011 Interim Rule Release at 41677.

62 See 2011 Interim Rule Release at 41677-78 for a discussion of these definitions.

As we noted in the 2011 Interim Rule Release, the definition of retail forex transaction is based on the CEA and incorporates the terms described in CEA sections 2(c)(2)(B) and 2(c)(2)(C).[63] In addition, the definition is substantially the same as the definitions in the FDIC Final Rule, the OCC Final Rule, and the Board Final Rule.[64] Further, we noted in the 2011 Interim Rule Release that the definition of retail forex transaction has at least two important features. First, certain transactions in foreign currency are excluded from the definition, including spot transactions, contracts of sale that create an enforceable obligation to deliver between a buyer and seller that have the ability to deliver and accept delivery, respectively, in connection with their line of business, and forex transactions executed or traded on an exchange or designated contract market.[65] As we discussed previously, the exclusion for spot transactions was significantly expanded after the CFTC issued an interpretation, following the Commission's extension of the Interim Rule, that conversion trades are considered to be spot transactions and are therefore outside the scope of retail forex.[66]

The second important feature of the definition is that a "rolling spot" forex transaction (also known as a Zelener contract),[67] is not excluded from the definition as a spot transaction. Although a rolling spot forex transaction normally requires delivery of currency within two days, in practice these contracts are indefinitely renewed every other day and no currency is actually

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63 7 U.S.C. 2(c)(2)(B) and 7 U.S.C. 2(c)(2)(C).

64 See FDIC Final Rule at 40781, OCC Final Rule at 41376-41377, and Board Final Rule at 21020-21021.

65 See 2011 Interim Rule Release at 41678-79.

66 See supra note 27.

67 See CFTC v. Zelener, 373 F.3d 861 (7th Cir. 2004); see also CFTC v. Erskine, 512 F.3d 309 (6th Cir. 2008) (discussing Zelener contracts).

delivered until one party affirmatively closes out the position.[68] The Commission believes that a contract with a retail customer for a rolling spot forex transaction is economically more similar to a retail forex future, as described in CEA section 2(c)(2)(B)(i)(I), than a spot forex contract.[69] This interpretation is consistent with the approach of other Federal regulatory agencies acting pursuant to section 742 of the Dodd-Frank Act to treat all agreements, contracts, and transactions in foreign currency described in CEA section 2(c)(2)(B)(i)(I) and all agreements, contracts, and transactions in foreign currency that are functionally or economically similar to agreements, contracts, or transactions described in CEA section 2(c)(2)(B)(i)(I), similarly.[70]

The Commission received comments from two groups of commenters on the definitions included in section (a) suggesting that the Commission amend terms to clarify that conversion trades should not be regulated.[71] As discussed above, these comments both requested changes that are no longer necessary in light of the CFTC's interpretation regarding conversion trades.[72]

B. Rule 15b12-1(b): Broker-dealers Engaged in a Retail Forex Business

Rule 15b12-1(b) requires that a broker-dealer comply with the Exchange Act, the rules and regulations thereunder, and the rules of the SROs of which the broker-dealer is a member, insofar as they are applicable to retail forex transactions.[73] These include rules related to the requirements of rules and regulations for retail forex in Section 2(c)(E)(iii)(I) of the CEA,[74]

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68 See 2011 Interim Rule Release, note 34, at 41679. See also CFTC Proposing Release at 3284-3285 for a discussion of Zelener contracts and the CFTC's regulation of these contracts.

69 See 2011 Interim Rule Release at 41679.

70 See supra note 14.

71 See SIFMA/ISDA Letter and ABA/GFMA Letter.

72 See supra note 31.

73 Rule 15b12-1(b).

74 7 U.S.C. 2(c)(2)(iii)(I).

including but not limited to rules for disclosure, recordkeeping (or documentation), capital and margin, reporting, and business conduct.[75] The Commission initially adopted this section (b) in the same form in 2011 and the rationale for our adoption of this section has not changed.

Provided below are examples of obligations also discussed in the 2011 Interim Rule Release, including certain SRO requirements, relating to disclosure, recordkeeping (or documentation), capital and margin, reporting, and business conduct that are applicable to broker-dealers' retail forex transactions.

Disclosure Requirements

Broker-dealers that engage in a retail forex business must comply with the disclosure requirements in NASD Rule 2210.[76] NASD Rule 2210 requires all communications with the public by members of FINRA – including forex-related communications – to be based on principles of fair dealing and good faith, to be fair and balanced, and to provide a sound basis for evaluating the facts regarding the market generally and a customer's specific transaction.[77] NASD Rule 2210 further prohibits broker-dealers from making "any false, exaggerated, unwarranted, or misleading statement or claim in any communication with the public."

Recordkeeping Requirements

Exchange Act Rules 17a-3 and 17a-4 require a broker-dealer to make, keep current, and preserve records regarding its business. For example, Exchange Act Rule 17a-3(a)(2) requires a broker-dealer to make and keep current a general ledger, which provides details relating to all

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75 See 2011 Interim Rule Release at 41679-81 for a discussion of some of the Exchange Act and SRO rules that are applicable to broker-dealer retail forex transactions.

76 See FINRA Forex Notice.

77 See id.

assets, liabilities, income and expense and capital accounts, which could include entries related to retail forex.

Net Capital and Margin Requirements

Each broker-dealer must comply with Exchange Act Rule 15c3-1, which prescribes minimum regulatory net capital requirements for broker-dealers. The Commission notes that, under Exchange Act Rule 15c3-1(c)(2)(iv), any unsecured receivable arising from a retail forex transaction must be deducted when computing the broker-dealer's net capital.[78] The provisions of the net capital rule dealing with contractual commitment charges under Rule 15c3-1(c)(2)(viii) also apply to commitments with respect to foreign currency. Generally, broker-dealer margin requirements are set by Regulation T[79] and SRO rules.[80]

Reporting Requirements

A broker-dealer is required to file with the Commission periodic financial and operational reports (e.g., annual audited financial statements and periodic FOCUS Reports), as prescribed by Exchange Act Rule 17a-5, that may include relevant information regarding a broker-dealer's retail forex business, if any.[81] In addition, FINRA has advised its member firms that a broker-

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78 17 CFR 240.15c3-1(c)(2)(iv).

79 12 CFR 220.

80 See supra note 47.

81 Retail forex data may factor into a broker-dealer's financial reports; however, the presentation of such data on these reports would be aggregated with other financial data associated with the broker-dealer's activities and would not be specifically identified as relating to retail forex. See, e.g., Form X-17A-5, 17 CFR 249.617. In addition, FINRA Rule 4524 requires broker-dealers to file supplemental FOCUS information, including information about commissions attributable to foreign exchange products in the supplemental statement of income ("SSOI") and information about the gross amount of all foreign exchange forward transactions in the supplemental schedule for derivatives and other off-balance sheet items ("OBS"). See Exchange Act Release No. 66364 (February 9, 2012), 77 FR 8938 (February 15, 2012), and Exchange Act Release No.

dealer's expansion of its business to include retail forex transactions constitutes a material change in business operations pursuant to NASD Rule 1017(a), and a broker-dealer must first apply for and receive approval from FINRA to conduct this activity.[82] Additionally, Exchange Act Rule 17a-8 requires a broker-dealer to report to the U.S. Treasury Department's Financial Crimes Enforcement Network certain enumerated types of transactions, including suspicious transactions in foreign currencies and foreign currency futures and options.[83]

Business Conduct Requirements

In the course of complying with certain Exchange Act requirements, rules and regulations thereunder, and SRO rules relating to business conduct, broker-dealers must address their retail forex business.[84] For example, FINRA Rule 2010 (formerly NASD Rule 2110), which requires broker-dealers, in the conduct of their business, to observe high standards of commercial honor and just and equitable principles of trade, applies to all of a broker-dealer's business, including

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68832 (February 5, 2013), 78 FR 9754 (February 11, 2013) (Commission orders approving the SSOI and OBS, respectively).

82 See FINRA Forex Notice.

83 See Exchange Act Release No. 18321 (Dec. 10, 1981); 46 FR 61454 (Dec. 17, 1981); see also FINRA Rule 3310 (formerly NASD Rule 3011) (requiring FINRA member firms to establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of suspicious transactions). As FINRA noted, "FINRA member firms engaging in retail forex activities should ensure their Anti-Money Laundering Program addresses the risks associated with the business and includes procedures for monitoring, detecting, and reporting suspicious transactions associated with their retail forex activities." See FINRA Forex Notice.

84 The suitability requirement under FINRA Rule 2111 requires, in part, that a broker-dealer or associated person "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the [firm] or associated person to ascertain the customer's investment profile." This requirement would generally not apply in the context of a retail forex transaction unless it is part of a recommended investment strategy that also involves a security.

its retail forex business.[85] FINRA has stated that to comply with FINRA Rule 2010, a member firm must adequately disclose to its retail customers that the firm is acting as a counterparty to a transaction, the risks associated with forex trading, and the risks and terms of leveraged trading.[86] Broker-dealers also need to address retail forex transactions in connection with the customer reserve bank account requirements under Exchange Act Rule 15c3-3. In calculating what amount, if any, a broker-dealer must deposit on behalf of its customers in a reserve bank account pursuant to Exchange Act Rule 15c3-3(e), the broker-dealer must use the formula set forth in Exchange Act Rule 15c3-3a.

As we noted in the Interim Rule Release, these examples are not inclusive of all regulatory requirements administered by the Commission that must be complied with by a broker-dealer engaging in a retail forex business.[87] The Commission does not intend to suggest that other provisions, rules and regulations, including antifraud provisions and SRO rules, may not apply to broker-dealers' retail forex business.

While the Commission did not receive any comments that directly addressed Rule 15b12-1(b), it received comments that set forth recommendations for potential regulations that could apply to broker-dealers' retail forex businesses.[88] As discussed above, the Commission believes it is appropriate to give additional consideration to the recommendations provided by all of the commenters and is adopting the rule to permit additional time for the Commission to assess the market for retail forex and potentially develop more targeted rules for retail forex and to consider any rules that an SRO may propose regarding its members' retail forex activities.

85 See FINRA Forex Notice.

86 Id.

87 See 2011 Interim Rule Release at 41681.

88 See Philadelphia Financial Letter and Second Greeneye Comment Email. See also supra note 34.

C. Rule 15b12-1(c): Broker-dealers Deemed to be Acting Pursuant to a Commission Rule

Rule 15b12-1(c) provides that any registered broker or dealer that engages in a retail forex business in compliance with paragraph (b) of the rule on or after the effective date of the rule will be deemed, until the expiration date specified in paragraph (d) of the rule, to be acting pursuant to a rule or regulation described in CEA section 2(c)(2)(E)(ii)(I), as amended by section 742 of the Dodd-Frank Act.[89] The Commission adopted this section (c) in the same form in 2011 and did not receive any comments that addressed this section.

D. Rule 15b12-1(d): Expiration

Rule 15b12-1(d) contains the expiration date of the rule.[90] The Commission is revising this paragraph of the rule to extend the expiration date to July 31, 2016. As discussed above, this revision to paragraph (d) will allow the rule to continue to apply while the Commission considers whether any additional requirements are necessary with respect to broker-dealer's retail forex activities. The Commission will also consider other possible alternative actions, including whether Rule 15b12-1 should be proposed, without a sunset provision, in its current form. The Commission will also consider whether the rule should be allowed to expire without further Commission action after the effective period ends.

III. ECONOMIC ANALYSIS

A. Introduction

Section 3(f) of the Exchange Act requires the Commission to consider or determine whether an action is necessary or appropriate in the public interest, and to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and

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89 Rule 15b12-1(c).

90 Rule 15b12-1(d).

capital formation whenever it engages in rulemaking under the Exchange Act.[91] 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.[92] Section 23(a)(2) of the Exchange Act prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate to further the purposes of the Exchange Act.[93]

Many of the benefits and costs discussed below are difficult to quantify. For example, we believe that a key benefit to the adoption of Rule 15b12-1 is the prevention of inefficient disruptions in retail customers' access to foreign exchange markets. However, in the absence of current data on investor participation in the retail forex market, the magnitude of these inefficiencies is difficult to estimate. Specifically, if the alternative to conducting retail forex through a broker is to open an account with an FCM, then an estimate of the aggregate costs associated with the necessary account transfers would likely require information about the number of customer accounts that would be affected and the notional value of retail forex activity in those accounts.

Similarly, as discussed below, we recognize that investors who choose to use exchange-traded products to hedge currency risk will face the risk that a hedging instrument does not perfectly replicate the exposure to be hedged. While we might be able to estimate the quantity of basis risk for a particular position, a measure of the economic significance of this basis risk across the investor base to which a prohibition on retail forex would apply requires information about the foreign currency exposures that retail customers might seek to hedge. Although one

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91 See 15 U.S.C. 78c(f).

92 See 15 U.S.C. 78w(a)(2).

93 See id.

comment letter provided some data on the scope of the market,[94] the Commission does not have sufficient data about retail forex participation to produce precise estimates of the aggregate economic effects of adopting Rule 15b12-1 and possible alternatives to this rulemaking. As a result, much of the discussion on costs and benefits that follows is qualitative in nature. However, where possible, the Commission has attempted to quantify some economic effects.

We understand that under the current regulatory regime, retail customers typically enter into foreign exchange transactions with broker-dealers for a number of reasons. Industry participants have informed us that the most common foreign exchange transactions are conversion trades, in which a currency trade is made in connection with a foreign securities transaction. These are excluded from the scope of retail forex transactions and thus from the Commission's rule as discussed above.[95] Based on data one commenter provided from a small sampling of larger broker-dealers, in terms of notional amount, foreign exchange conversion trades would account for approximately 90% of foreign exchange transactions conducted through broker-dealers, and 99% of all broker-dealer customer accounts are involved in conversion trades, though not all trades within an account may be conversion trades.[96]

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94 See Morgan Lewis Letter which provides some estimate on the overall scope of the retail forex market. See also supra section I.E. for a discussion of this comment letter.

95 See Morgan Lewis Letter. As explained above, the ABA/GFMA Letter requested from the CFTC an interpretation that excluded conversion trades from the prohibition under CEA section 2.

96 See Morgan Lewis Letter, which provided data from five large-broker dealers, but, only some of the broker-dealers provided information for every type of transaction that is cited in the letter. The data included a sampling of five large broker-dealer firms for forex data during the calendar year 2010 (or in one firm's case, June 2010 through June 2011) showing that the estimated aggregate notional value of conversion trades for the firms that provided data for the year was $13.55 billion while the estimated aggregate notional value of non-conversion trades was $1.43 billion. The data also showed that the estimated annual number of accounts involved in conversion trades for the time period was 17,600 and the number of non-conversion accounts was 187. See id.

Commenters have also conveyed to us that retail customers often enter into forex transactions with broker-dealers as part of a hedging strategy. For instance, retail customers may engage in forex transactions through broker-dealers in order to hedge currency risk in securities or in a portfolio held in the customer's brokerage account. They may also engage in these transactions in order to obtain exposure to foreign markets as part of their overall investment strategy.[97]

Congress prohibited the retail forex transactions described in CEA section 2(c) except pursuant to rules adopted by the relevant Federal regulatory agencies allowing the transactions. As we noted in the 2011 Interim Rule Release, some of these transactions, such as hedging transactions may be beneficial to investors as they provide a mechanism for mitigating risks.[98] At the same time, the Commission is aware of potentially abusive practices that can occur in the retail forex market. Such practices may include, for example, misleading or lack of disclosure about fees and forex pricing, or misleading advertising directed to retail investors.[99]

As discussed above, on April 18, 2012, a group of commenters asked the CFTC to take the view that forex transactions that are solely incidental to, and are initiated for the sole purpose of, permitting a client to complete a transaction in a foreign security, through conversion trades would not be subject to the retail forex prohibition under section 2 of the CEA.[100] In August 2012, the CFTC issued an interpretation in a joint rulemaking with the Commission that clarifies that conversion trades are not retail forex transactions subject to the prohibition under the CEA. This interpretation permits broker-dealers to engage in conversion trades without a rulemaking

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97 SIFMA/ISDA Letter at 4, Annex A at 1 – 2.

98 See 2011 Interim Rule Release at 41684.

99 See id.

100 See ABA/GFMA Letter.

by the Commission. It also significantly reduces the level of broker-dealer foreign exchange activity that is subject to the prohibition in section 2(c) of the CEA and thus to the final rule.[101]

Although the CFTC interpretation excludes conversion trades from the definition of retail forex, hedging and speculative trading in foreign currency (other than bona fide spot transactions) continue to fall within the scope of the definition. Broker-dealers and BD-FCMs are therefore prohibited from engaging in such retail forex activities absent a Commission rule allowing them to do so.

Adopting Rule 15b12-1 will maintain the regulatory framework that currently exists for broker-dealers under the Interim Rule, and will not create new regulatory obligations. Furthermore, the rule will preserve the ability of broker-dealers to provide, among other services, hedging to retail customers while the Commission considers what further steps to take, if any.

The Commission previously considered and discussed its economic analysis of Rule 15b12-1T.[102] When the Commission initially adopted the Interim Rule in 2011, we solicited comment on the economic analysis and received one comment that addressed the economic analysis.[103] We adopted Rule 15b12-1T on an interim final basis to allow the existing regulatory framework for retail forex transactions to continue for a defined period, to avoid potentially unintended consequences from broker-dealers immediately discontinuing their retail forex business, and to provide the Commission time to consider the appropriate regulatory framework

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101 This is in contrast to the estimated level of broker-dealer foreign exchange activity that was understood to exist when the Commission initially acted to adopt the Interim Rule in 2011 and when it extended the Interim Rule in 2012.

102 For a detailed description of the costs and benefits of Rule 15b12-1T, see 2011 Interim Rule Release at 41684.

103 See Better Markets Letter.

regarding retail forex transactions.[104] Furthermore, parties who commented on the rule asked the Commission to preserve the ability of investors to engage in retail forex transactions through their broker-dealers.[105] In July 2012, the Commission extended the effective date of the Interim Rule to July 16, 2013 and received four comments (from two commenters) on the extension, none of which addressed the economic analysis in the 2012 Extension Release.[106]

B. Economic Baseline

The baseline for our economic analysis of the rule is the state of the retail forex market in existence today after the adoption of the Interim Rule and its extension, in which broker-dealers and BD-FCMs are permitted to conduct retail forex transactions in compliance with the existing federal securities laws and the rules of an SRO of which the broker-dealer or BD-FCM is a member. As is indicated in the discussion of economic effects and potential alternatives that follows, estimates of the economic impacts of this rule crucially depend on current participation in retail forex, both aggregate notional amounts and risk exposures to different foreign currencies. Broker-dealers are not required to report the foreign currency exposure of their retail clients and commenters did not provide data on the foreign currency exposure of their retail clients. Accordingly, the Commission only has limited data on the level of participation in the retail forex market. However, we have some information regarding the current size of the retail forex market and the use of foreign exchange instruments by retail investors from comment

104 See 2011 Interim Rule Release at 41683. As noted above, as of the time the Commission adopted the Interim Rule and extended it, the CFTC had not issued its interpretation that conversation trades were not retail forex transactions.

105 Fourteen of sixteen commenters were in favor of the rule and supported the ability of broker-dealers to conduct retail forex transactions. See, e.g. SIFMA/ISDA Letter.

106 See supra note 37.

letters and other research.[107] In attempting to evaluate and confirm the estimates of the size of the broker-dealer retail forex market, which as noted above included conversion trades that now are excluded from the definition of retail forex, the Commission also looked at information from the Bank of International Settlements (BIS). This information indicates a recent increase in retail participation in forex markets.[108] Though BIS did not separately compute statistics for the subset of activity defined as retail forex by the CEA, nevertheless this may provide an indication of a general trend spanning both retail forex and foreign exchange transactions by retail customers that falls outside the definition of retail forex.

In addition, as mentioned above, one commenter provided data on participation in forex markets taken from a small sampling of large broker-dealers. According to this commenter, in terms of notional amount, foreign exchange conversion trades account for approximately 90% of all foreign exchange transactions (including transactions with both ECPs and non-ECPs) conducted by these broker-dealers.[109] This supports the premise that a large portion of foreign exchange activity flowing through broker-dealers falls outside of the scope of retail forex. Further, 99% of all broker-dealer customer accounts in this sample were involved in conversion trades. However, not all foreign exchange transactions engaged in by retail customers were conversion trades. The same commenter estimated transactions with a notional value of $550 million per month in currency forwards, options and rolling spot with non-ECPs.[110] Accordingly, while conversion trades might comprise the bulk of foreign exchange transactions

107 See e.g. Morgan Lewis Letter and Philadelphia Financial Letter.

108 See King, Michael and Dagfinn Rime. "The $4 trillion question: what explains FX growth since the 2007 survey?" BIS Quarterly Review, December, 2010 (attributing increased foreign exchange turnover to retail investor participation, facilitated by electronic execution platforms).

109 See SIFMA Letter.

110 See id.

engaged in by retail investors, their participation in other forms of foreign exchange transactions that fall within the scope of retail forex may be significant.

C. Benefits

Rule 15b12-1 is designed to preserve retail customers' access to the forex markets through broker-dealers and thus promote efficiency by, for example, permitting retail customers to continue to enter into forex transactions in connection with trades in foreign securities, as part of their brokerage activities until such time as Rule 15b12-1 expires by its terms or the Commission takes further regulatory action in this area. In the absence of Rule 15b12-1, broker-dealers would be required to exit certain types of retail forex business, which could require retail customers to engage in forex transactions through an FCM that is not dually registered as a broker-dealer or other service provider which could be economically inefficient.[111] In particular, to the extent that access to the forex markets through broker-dealers provides hedging opportunities for foreign investments, economic benefits may accrue to retail customers. Furthermore, by continuing to preserve a channel for broker-dealers' retail customers to access forex transactions through broker-dealers, the adoption of the final rule will continue to prevent any loss of competition in the retail forex market that could result if broker-dealers or BD-FCMs were required to exit the business. Adopting the rule also avoids potentially unintended consequences from broker-dealers immediately discontinuing their retail forex business, including costs or inefficiencies that may result if retail customers have to open new accounts

111 Establishing an account with an FCM may not bear a monetary cost, however, a deposit of several thousand dollars is frequently required to maintain an open account. A customer could experience increased costs from maintaining separate deposit minimums for securities and commodities accounts. In addition, other costs may also apply, such as resources associated with transferring accounts.

with FCMs that are not BD-FCMs or with other entities in order to trade in retail forex or seek to trade in products that may perform as substitutes to retail forex, such as currency ETPs.

The adoption of the rule would not necessarily promote competition between broker-dealers and the other regulated intermediaries because broker-dealers would continue to offer retail forex services under Rule 15b12-1 which imposes requirements that already apply to broker-dealers under the existing regulatory regime, while other regulated entities were required to comply with new rules applicable to them. Further, all broker-dealers engaging in a retail forex business must comply with the final rule; therefore, competition among broker-dealers would most likely not be affected by adoption of the rule.

Adopting Rule 15b12-1 will impose no new burden on competition and should maintain competition among intermediaries. Under Rule 15b12-1T, regulatory requirements for broker-dealers operating in the retail forex market would remain unchanged. As a result, retail customers would continue to be able to choose between hedging their own portfolios of foreign securities in a securities account or relying on other intermediaries or products for hedging. Similarly, since the rule preserves the existing regulatory structure, the Commission does not expect that adopting the rule will result in any impact on efficiency or impairment of the capital formation process.

D. Costs

Because Rule 15b12-1 preserves the regulatory regime that had been in place prior to the effective date of Section 742(c) of the Dodd-Frank Act, the adoption of the rule imposes no new regulatory burdens beyond those that already existed for broker-dealers. The Commission recognizes that broker-dealers will face regulatory costs and requirements associated with perating in the retail forex market, but these are not new costs or requirements imposed by the rule.[112] As discussed above, the Commission is aware of potentially abusive practices that may occur in the retail forex market.[113] To the extent that such practices occur after adoption of this rule retail customers may bear the costs associated with these abuses.[114] The Commission notes that due to the CFTC's interpretation of the definition of retail forex,[115] the scope of retail forex transactions has narrowed significantly after the Commission adopted and extended the Interim Rule. As noted above, while the Commission only has limited information about the size of the retail forex market, we believe the scope of the retail forex market is much smaller than anticipated when the Commission adopted and extended the Interim Rule and that the number of transactions currently engaged in by broker-dealers, and therefore covered by a Commission retail forex rule, is much more limited.[116] The Commission believes, on balance, that the potential market disruption that may occur if the Commission does not adopt Rule 15b12-1 justifies the cost of maintaining the current regulatory regime while the Commission considers, during the time period set in the rule, whether further regulatory action is warranted.

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112 These costs include costs related to disclosure, recordkeeping and documentation, capital and margin, reporting, and business conduct. A broker-dealer that currently engages in forex transactions with retail customers, for example, incurs costs associated with establishing, maintaining, and implementing policies and procedures to comply with regulatory requirements; preparing disclosure documents; establishing and maintaining forex-related business records; and preparing filings with the Commission, which may include legal and accounting fees. See, e.g., 2011 Interim Rule Release at 41684.

113 See 2011 Interim Rule Release at 41684.

114 See Forex Bulletin.

115 See supra note 26 and note 27.

116 See, e.g., Morgan Lewis Letter and SIFMA Letter. As noted by commenters and discussed above, most forex activity engaged in by retail customers is conversion trades and would no longer be subject to a Commission rule on retail forex.

E. Alternatives Considered

The Commission considered certain alternatives to adopting Rule 15b12-1. One alternative would be to allow Rule 15b12-1T to expire without adopting a final rule, and therefore preclude broker-dealers from engaging in a retail forex business, although they could continue to enter into conversion trades. A benefit of this alternative could be that certain abuses Congress sought to address through the prohibition in Section 742 of the Dodd-Frank Act could be addressed through a complete prohibition. The cost of this alternative would be that an outright prohibition on retail forex activity would interfere with certain business activities conducted by broker-dealers that are potentially beneficial for their customers, including hedging activities.[117]

A retail investor seeking to hedge currency risks in a portfolio would have to choose between alternative means of doing so. Trading in currency futures is one such alternative, but under this approach, retail customers of broker-dealers would be required to open an account with a FCM that is not dually registered as a broker-dealer. Moreover, mark-to-market margin requirements associated with futures contracts would expose hedging customers to additional cash flow risk. While shifting to services provided by a different intermediary would impose additional costs, retail customers could, however, potentially benefit from the protection of rules to which those intermediaries are subject.

In comment letters responding to the solicitation of comment in the 2011 Interim Rule Release, one commenter suggested another way for retail investors to obtain currency exposure is through ETPs.[118] Another commenter suggested that the Commission had not thoroughly

117 See 2011 Interim Rule Release at 41684.

118 See Philadelphia Financial Letter. See also Better Markets Letter. As described above, the commenters referred to using currency ETFs. In the discussion here, the term ETPs is

analyzed the extent to which other products or trading strategies represent substitutes for retail forex.[119]

In response to the commenters' concerns, we noted in the 2012 Extension Release that currency ETPs are generally designed to provide broad exposure to exchange rate movements.[120] In this regard, the Commission notes that factors such as accrued interest or sponsor fees may cause an ETP to deviate from its benchmark. We also note that a market participant who uses ETPs as a hedging tool could face risks from executing hedges on an exchange that may be markedly different from the execution risk associated with transacting through a broker-dealer.[121] As such, and consistent with statements in the 2012 Extension Release, it does not appear that currency exchange-traded funds will necessarily function as effectively in mitigating the currency risk of particular securities transactions as retail forex.[122]

In the 2012 Extension Release, the Commission solicited specific comment on currency ETFs, including on the concerns raised in the comment letters received in response to the 2011 Interim Rule Release,[123] the benefits and costs to retail customers of using currency ETFs as a substitute for retail forex, and on the use of currency ETFs to hedge currency risk.[124] The Commission did not receive any comments in response to this solicitation of comment regarding

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used to encompass a broader range of potential instruments (including ETFs) that may be used to gain exposure to forex.

119 See Better Markets Letter.

120 See 2012 Extension Release at 41675.

121 See, e.g., Kostovetsky, Leonard. "Index mutual funds and exchange-traded funds." The Journal of Portfolio Management 29.4 (2003), while comparing ETFs to index funds, the author describes the different sources of tracking error incurred by ETF investors, including management fees and transaction costs in the form of bid-ask spreads.

122 Id.

123 See supra note 118.

124 See 2012 Extension Release at 41674.

currency ETFs, and the Commission continues to believe that ETPs represent an imperfect substitute for retail forex. In evaluating further the concerns expressed, however, Commission staff supplemented the analysis regarding the additional risks that investors who use ETPs as hedging instruments may have to bear discussed in the 2012 Extension Release and above.

Specifically, staff attempted to estimate the basis risk borne by an investor using an ETP to hedge EURUSD exposure.[125] While, on an annual basis, the average difference between ETP returns and EURUSD spot returns is small, the volatility of these differences from day-to-day is high, approximately 0.50% at a daily frequency. This volatility is indicative of the additional risk associated with hedging using ETPs, particularly for short holding periods or frequent rebalancing. Under Rule 15b12-1, the same investor could consider using a forward contract for EURUSD in her brokerage account. While the average difference in daily returns is higher in this case than with an ETP, due to the interest rate differential between Europe and the United States, the volatility of these differences is much lower, less than one basis point at a daily frequency.[126]

125 Commission staff chose EURUSD for its analysis due to ready availability of data on ETPs, equity indices and foreign exchange rates related to the Euro area, and because an ETP tracking EURUSD was more liquid than ETPs tracking other currencies during the sample period. As a result of the additional liquidity, Commission staff expects this ETP to result in less exposure to basis risk with respect to EURUSD than other ETPs in the same family constructed to track other currency pairs.

126 Calculated based on data from *Daily/Monthly U.S. Stock Files* © 2012 Center for Research in Security Prices (CRSP), The University of Chicago Booth School of Business, and Thomson Reuters Datastream. To compute these statistics, Commission staff used daily WM Spot closing prices, short-term interest rates and prices for the CurrencyShares Euro ETN (ARCA: FXE) from 9/4/2007-12/31/2012 obtained from Datastream (interest rates and exchange rates) and CRSP (ETN returns). With these data, staff computed daily returns to (i) a EURUSD forward contract; and (ii) to the CurrencyShares Euro ETN. To compute the additional risk faced by a EURUSD hedger using each of these instruments, staff produced time series of the differences in daily returns and computed the average and standard deviations of these series.

Finally, we note that if market participants prefer to transact in ETPs in order to obtain currency exposure, they may do so regardless of whether the Commission has or has not adopted rules for retail forex. In this regard, while the Commission continues to believe that ETPs have their own attendant risks, during the time Rule 15b12-1 is in place until its expiration date, the Commission will continue to evaluate the retail forex market, including alternative means of hedging currency risk and the availability of substitutes to retail forex. As such, as discussed throughout the release, the Commission believes that it is appropriate to allow broker dealers to continue engaging in retail forex transaction subject to existing requirements during that time.

If, as an alternative to the final rule, the Commission allowed the Interim Rule to expire, investors with international portfolios who are restricted from retail forex may choose to leave currency exposures unhedged. The risk of a portfolio of foreign securities that is not hedged, with returns computed in U.S. dollar terms, comprises (i) the risk of the underlying securities in local currency; (ii) the risk of the local currency relative to the U.S. dollar; and (iii) the correlation between the underlying security returns in local currency and currency returns. Allowing investors to hedge currency exposures removes components (ii) and (iii), leaving investors to bear only the risk associated with the underlying securities.[127]

Further, inefficiencies stemming from an inability to pursue currency hedging strategies in international portfolios, or higher costs of doing so, could cause investors to reduce their allocation to international investments. In the limit, investors may respond by exiting

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127 Based on data from Thomson Reuters Datastream, Commission staff used monthly returns for the period 9/4/2007-12/31/2012 to estimate the annualized risk and return for (i) the MSCI Europe index, unhedged in USD and (ii) the MSCI Europe index, hedged to USD. Staff chose these indices to simplify the computation of portfolio returns for various hedge ratios. Based solely on point estimates, partially-hedged portfolios offered higher total return per unit of risk.

international markets. The resulting lack of diversification could represent a reduction in portfolio efficiency.[128]

The Commission also considered adopting Rule 15b12-1 without a sunset provision. While the direct costs and benefits of this alternative would be similar to those applicable under the rule being adopted (as it would simply continue the existing regulatory requirements for broker-dealers engaging in retail forex transactions), it nevertheless could limit the Commission's ability to fully consider, prior to issuing permanent rules, potential changes to the retail forex market; in part changes resulting from actions by other regulators that have recently adopted rules relating to retail forex that impose different requirements on market intermediaries than those the Commission imposes on broker-dealers under Rule 15b12-1. The Commission anticipates that it will reconsider the rule prior to its expiration in light of developments in the retail forex market during that time, as well as the Commission's and SROs' experiences with retail forex trading pursuant to this Rule.

F. Conclusion

The adoption of Rule 15b12-1 will not change the regulatory requirements for broker-dealers operating in the retail forex market. Similarly, the rule does not alter the existing regulatory structure. To the extent that potentially abusive practices continue in the retail forex market, the market will continue to bear the costs associated with any such abuses and the resultant inefficient provision of services across the market. The rule will continue to allow retail customers access to hedging transactions and other forex transactions through broker-dealers, without the need to shift business and open new accounts at other market intermediaries.

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128 See, e.g., French, Kenneth R. and James M. Poterba. "Investor Diversification and International Equity Markets," American Economic Review, Vol. 81, No. 2, 1991, noting that large variation in expected returns across countries is required to justify lack of diversification in a mean-variance optimization setting.

If the Commission or an SRO imposes any additional burdens on retail forex transactions the new burdens will be considered in conjunction with those new rules.

IV. OTHER MATTERS

The Administrative Procedure Act generally requires that an agency publish a substantive rule in the Federal Register 30 days before it becomes effective.[129] This requirement, however, does not apply if the agency finds good cause for making the rule effective sooner.[130] The Commission notes that Rule 15b12-1 does not impose any new regulatory requirements on broker-dealers and that the rule is identical in substance to the Interim Rule, which requires that broker-dealers comply with existing Commission and SRO rules as they are applicable to retail forex transactions. A 30-day effective date is therefore not necessary for broker-dealers to prepare to comply with the rule. Furthermore, broker-dealers are currently permitted to engage in a retail forex business under the Interim Rule. A gap in the effective dates of the Interim Rule and the final rule would cause the statutory prohibition to go into effect for a short period of time and could potentially create disruption and unintended consequences to broker-dealers and their customers.[131] For these reasons,[132] the Commission finds that there is good cause for making the rule effective earlier than 30 days after publication in the Federal Register.

V. PAPERWORK REDUCTION ACT

The Commission notes that Rule 15b12-1 does not impose any new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995

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

130 Id. at 553(d)(3).

131 See, generally, the discussion in section III.C. regarding the effect on retail customers if broker-dealers are not permitted to engage in retail forex transactions.

132 The Commission also notes that, as discussed above, there have been some recent developments related to retail forex transactions, including the adoption in April 2013 of final rules by the Federal Reserve. See Board Final Rule (effective May 13, 2013).

("PRA"),[133] nor does it create any new filing, reporting, recordkeeping, or disclosure reporting requirements for broker-dealers that are or plan to be engaged in a retail forex business. Accordingly, the Commission did not submit the rule to the Office of Management and Budget for review in accordance with the PRA.

In the 2011 Interim Rule Release and the 2012 Extension Release, the Commission requested comment on its conclusion that there are no collections of information in connection with the Interim Rule.[134] The Commission received no comments relating to the PRA analysis in the 2011 Interim Rule Release or the 2012 Extension Release.

VI. REGULATORY FLEXIBILITY ACT CERTIFICATION

In the 2011 Interim Rule Release, the Commission certified that pursuant to 5 U.S.C. 605(b) the Interim Rule, which is substantively the same as Rule 15b12-1 (with the exception of the sunset date), will not have a significant economic impact on a substantial number of small entities. The Commission received no comments on the certification included in the 2011 Interim Rule Release. The Commission also made this certification in the 2012 Extension Release and the Commission received no comments on that certification. Like the Interim Rule, Rule 15b12-1 applies to broker-dealers that may engage in retail forex transactions. However, the rule does not impose new regulatory obligations, costs, or burdens on such broker-dealers. While the rule applies to broker-dealers that may be small businesses, any costs or regulatory burdens incurred as a result of the rule are the same as those incurred by small broker-dealers prior to the effective date of section 742 of the Dodd-Frank Act. Broker-dealers have already incurred those costs and regulatory burdens through establishing compliance with the rules adopted by the Commission under the Exchange Act applicable to broker-dealers, as well as

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[133] 44 U.S.C. 3501 et seq.

[134] See 2011 Interim Rule Release at 41683-84.

relevant SRO rules. Further, the rule does not change the burdens on small broker-dealers relative to large broker-dealers. Accordingly, the rule will not have a significant economic impact on a substantial number of small entities.

VII. STATUTORY AUTHORITY AND TEXT OF RULE AND AMENDMENT

Pursuant to section 2(c)(2) of the Commodity Exchange Act, as well as the Exchange Act as amended, the Commission is adopting Exchange Act Rule 15b12-1.

List of Subjects in 17 CFR Part 240

Brokers, Consumer protection, Currency, Reporting and recordkeeping requirements. In accordance with the foregoing, the Securities and Exchange Commission is amending Title 17, chapter II, of the Code of Federal Regulations as follows:

TEXT OF THE RULE AND AMENDMENT

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, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78o-10, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, 7201 et. seq., and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; and Pub. L. 111-203, 939A, 124 Stat. 1376, (2010), unless otherwise noted.

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2. Revise § 240.15b12-1 to read as follows:

§ 240.15b12-1 Brokers or dealers engaged in a retail forex business.

(a) Definitions. In addition to the definitions in this section, the following terms have the same meaning as in the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.): "broker," "dealer," "person," "registered broker or dealer," and "self-regulatory organization."

(1) Act means the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.).

(2) Retail forex business means engaging in one or more retail forex transactions with the intent to derive income from those transactions, either directly or indirectly.

(3) Retail forex transaction means any account, agreement, contract or transaction in foreign currency that is offered or entered into by a broker or dealer with a person that is not an eligible contract participant as defined in section 1a(18) of the Commodity Exchange Act (7 U.S.C. 1a(18)) and that is:

(i) A contract of sale of a commodity for future delivery or an option on such a contract;

(ii) An option, other than an option executed or traded on a national securities exchange registered pursuant to section 6(a) of the Act (15 U.S.C. 78(f)(a)); or

(iii) Offered, or entered into, on a leveraged or margined basis, or financed by a broker or dealer or any person acting in concert with the broker or dealer on a similar basis, other than:

(A) A security that is not a security futures product as defined in section 1a(47) of the Commodity Exchange Act (7 U.S.C. 1a(47)); or

(B) A contract of sale that:

(1) Results in actual delivery within two days; or

(2) Creates an enforceable obligation to deliver between a seller and buyer that have the ability to deliver and accept delivery, respectively, in connection with their line of business.

(b) Any registered broker or dealer may engage in a retail forex business provided that such broker or dealer complies with the Act, the rules and regulations thereunder, and the rules of the self-regulatory organization(s) of which the broker or dealer is a member, including, but not limited to, the disclosure, recordkeeping, capital and margin, reporting, business conduct, and documentation requirements, insofar as they are applicable to retail forex transactions.

(c) Any registered broker or dealer that is engaged in a retail forex business in compliance with paragraph (b) of this section on or after the effective date of this section shall be deemed to be acting pursuant to a rule or regulation described in section 2(c)(2)(E)(ii)(I) of the Commodity Exchange Act (7 U.S.C. 2(c)(2)(E)(ii)(I)).

(d) This section shall expire and no longer be effective on July 31, 2016.

By the Commission.

Elizabeth M. Murphy
Secretary

Dated July 11, 2013

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. 69967 / July 11, 2013

Admin. Proc. File No. 3-13481

In the Matter of

LINUS N. NWAIGWE

ORDER VACATING BAR

Linus N. Nwaigwe seeks to vacate a Commission order barring him from associating with any broker or dealer.[1] The order was issued in an administrative proceeding instituted against Nwaigwe under Section 15(b) of the Securities Exchange Act of 1934 based on his conviction in 2009 for participating in a conspiracy to commit securities fraud. On August 2, 2012, the United States Court of Appeals for the Second Circuit vacated the criminal conviction.[2]

In seeking to vacate the bar order against him, Nwaigwe argues that the basis for the bar order was his criminal conviction and that he no longer stands convicted. The Division of Enforcement does not oppose Nwaigwe's motion.

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1 *David G. Ghysels, Kenneth E. Mahaffy, Jr., and Linus N. Nwaigwe*, Initial Decision Release No. 391 (Dec. 11, 2009); Exchange Act Release No. 61581 (Feb. 25, 2010) (notice that initial decision became final with respect to Nwaigwe).

2 *U.S. v. Mahaffy*, 693 F.3d 113, 119 (2d Cir. 2012) (finding, among other things, that the prosecution failed to turn over investigative transcripts required to be disclosed under *Brady v. Maryland*, 373 U.S. 83 (1963), and that this failure undermined confidence in the jury verdict). The Second Circuit also vacated the convictions of Kenneth Mahaffy and David G. Ghysels, the other respondents in the administrative proceeding. On December 18, 2012, after Mahaffy filed a motion to vacate, the Commission vacated the bars ordered against Mahaffy in the administrative proceeding. *Kenneth E. Mahaffy, Jr.*, Order Vacating Bars, Exchange Act Release No. 68462, 2012 SEC LEXIS 4020 (Dec. 18, 2012).

We have held that administrative bar orders will remain in place in the usual case and are vacated only in compelling circumstances.[3] We have found such compelling circumstances where the statutory basis for the bar imposed, in this case Nwaigwe's 2009 criminal conviction, has been vacated.[4] Under these circumstances, it is appropriate to vacate the order.

In light of the foregoing, IT IS ORDERED that the February 25, 2010 order entered against Linus N. Nwaigwe is hereby vacated.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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3 *See, e.g.*, *Salim B. Lewis*, Order Granting and Denying in Part Petition to Vacate Administrative Bar Order, Exchange Act Release No. 51817, 58 SEC 491, 2005 SEC LEXIS 1360 (June 10, 2005).

4 *See, e.g.*, *Jimmy Dale Swink, Jr.*, Exchange Act Release No. 36042, 52 SEC 379, 1995 SEC LEXIS 2033, at *2 (Aug 1, 1995) (vacating findings and administrative bar order when an appellate court reversed the criminal conviction that was the basis for the proceeding); *cf. Terry Harris*, Investment Advisers Act Release No. 2622, 2007 SEC LEXIS 1645, at *7 (July 26, 2007) (ordering dismissal of administrative proceeding after finding that "none of the three bases for proceeding under Advisers Action Section 203(f) that were alleged in the [order instituting proceedings] remains valid on the record before us on appeal").

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Release No. 69968 / July 11, 2013

Admin. Proc. File No. 3-14640

In the Matter of the Application of

CLEANTECH INNOVATIONS, INC.
c/o Paula D. Shaffner
Joshua R. Dutill
Stradley, Ronon, Stevens & Young, LLP
2600 One Commerce Square
Philadelphia, PA 19103

For Review of Action Taken by
The NASDAQ Stock Market, LLC

OPINION OF THE COMMISSION

NATIONAL SECURITIES EXCHANGE—DELISTING FROM THE NASDAQ STOCK MARKET, LLC

Intentionally Withholding Documents Requested by NASDAQ Staff

National securities exchange delisted issuer's securities based on its finding that issuer intentionally withheld documents requested by staff of exchange while staff was considering issuer's listing application. *Held*, delisting decision *set aside*.

APPEARANCES:

Paula D. Shaffner and *Joshua R. Dutill*, Stradley, Ronon, Stevens & Young, LLP, for CleanTech Innovations, Inc.

Edward S. Knight, *John M. Yetter*, *Arnold P. Golub*, and *T. Sean Bennett*, for The NASDAQ Stock Market, LLC.

Appeal filed: November 28, 2011
Last brief received: March 1, 2012

I.

CleanTech Innovations, Inc. seeks review of the decision of The NASDAQ Stock Market, LLC[1] to delist CleanTech's common stock from the NASDAQ Capital Market. NASDAQ based its delisting decision on its finding that CleanTech intentionally withheld documents requested by NASDAQ staff while the staff was considering CleanTech's application to list its shares and thus violated NASDAQ Listing Rules 5205(e) and 5250(a)(1).[2] We base our findings on an independent review of the record.

II.

This case concerns CleanTech's provision of information about financing transactions involving affiliates of Benjamin Wey, allegedly a promoter of reverse takeovers,[3] that closed on December 13, 2010 (the "December Financing"). NASDAQ staff repeatedly sought information about CleanTech's involvement with Wey while CleanTech's listing application was under review, and CleanTech responded to those information requests. On December 10, 2010, NASDAQ staff informed CleanTech that its listing application had been approved. One business day later, the December Financing closed, and three days after that, CleanTech filed a Form 8-K with the Commission disclosing the December Financing. NASDAQ staff then contacted CleanTech and obtained nearly 200 e-mails related to the December Financing that had not previously been disclosed, the earliest of which was written on November 30, 2010. NASDAQ found that by failing to provide documents about the December Financing before the listing was approved, CleanTech had intentionally withheld documents requested by the staff. The staff characterized this conduct as "an extremely serious violation of the Company's obligations under Nasdaq's rules," and delisted CleanTech's securities.[4]

A. CleanTech applied for NASDAQ listing.

CleanTech, through wholly owned subsidiaries in China, designs, manufactures, tests, and sells structural towers for on-land and off-shore wind turbines and other specialty metal products. The company was formed in July 2010 by a reverse merger of a Chinese entity and a United States shell company; it traded in the Pink Sheets.[5]

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1 The name of the market appears in the record as both "Nasdaq" and "NASDAQ." For consistency, we use "NASDAQ," except in quotations.

2 Rules 5205(e) and 5250(a)(1) provide that NASDAQ may deny an issuer initial or continued listing if any communication by the issuer to NASDAQ contains a material misrepresentation or omits material information necessary to make the communication to NASDAQ not misleading.

3 *See infra* note 9 and accompanying text (discussing Wey).

4 *CleanTech Innovations, Inc.*, No. NQ 5872C, at 8 (unnumbered) (NASDAQ July 22, 2011).

5 The Pink Sheets was the name commonly associated with an electronic quotation system that displayed quotes and last sale information for many over-the-counter securities. It is now operated by OTC Markets Group, Inc. with three operating systems: OTCQX, OTCQB, and

(continued...)

On July 14, 2010, shortly after its formation, CleanTech filed a listing application with NASDAQ. The application asked CleanTech to provide, among other things, a list of bridge financings and private placements consummated within the prior six months. The application also required a company officer of CleanTech to sign a certification that he or she would "notify NASDAQ promptly of any material changes to the information provided in the application."[6] Bei Lu, CleanTech's Chief Executive Officer, signed this certification. The law firm of Stevens & Lee, PC ("Listing Counsel") represented CleanTech in seeking NASDAQ listing.

B. NASDAQ staff reviewed CleanTech's application.

As the staff reviewed CleanTech's application, it contacted the company from time to time to request additional information. Some of the staff's requests were written, others were made orally in telephone calls or meetings. The record contains very little contemporaneous evidence of the exact terms of the oral inquiries. In many instances, the best evidence about oral requests and responses is provided by an affidavit by William W. Uchimoto, a partner with CleanTech's Listing Counsel, that was submitted in the delisting appeal before NASDAQ.[7]

On August 28, 2010, while NASDAQ staff was considering CleanTech's application, *Barron's* published an article about the growing frequency with which Chinese mid-market companies were reverse-merging with registered United States shell corporations to gain entrance to United States securities markets.[8] The article specifically discussed, and criticized, Benjamin Wey, introducing him as "[o]ne of the most controversial promoters of Chinese reverse takeovers" and identifying CleanTech as "Wey's latest success story."[9]

(...continued)

OTC Pink. *See History of the OTC Markets Group,* http://www.otcmarkets.com/about/otc-markets-history (all websites referenced in this opinion were last visited July 10, 2013).

6 Excerpt from Listing Application, Ex. J to CleanTech's Submission in Support of Appeal to NASDAQ Listing and Hearing Review Council, Docket NQ 5872C-11.

7 Affidavit of William W. Uchimoto (July 1, 2011) (hereinafter "Uchimoto Aff."). We have considered this affidavit, which is consistent in many respects with other documentary record evidence, for the truth of the factual representations it contains. *See, e.g., Jeffrey L. Gibson,* Exchange Act Release No. 57266, 2008 SEC LEXIS 236, at *22 (Feb. 4, 2008) (including affidavits among the categories of evidence that may be introduced to support a position), *petition denied*, 561 F.3d 548 (6th. Cir. 2009). In contrast, unsworn representations by counsel contained in briefs or memoranda are not evidence of the facts they purport to recount. *See Dennis Todd Lloyd Gordon*, Exchange Act Release No. 57655, 2008 SEC LEXIS 819, at *70 n.98 (Apr. 11, 2008) ("The assertions contained in Applicants' briefs are not evidence.").

8 Bill Alpert & Leslie P. Norton, *Beware this Chinese Export*, BARRON'S (Aug. 28, 2010), http://online.barrons.com/article/SB50001424052970204304404575449812943183940.html.

9 *Id.* The article also alluded to Wey's disciplinary history, which had been discussed in an earlier *Barron's* article. The specifics of Wey's disciplinary history are not relevant to our resolution of this matter, because NASDAQ did not base its delisting on the fact of Wey's

(continued...)

On September 1, prompted by the *Barron's* article, NASDAQ staff e-mailed CleanTech to request information about Wey and the services he had provided to the company. CleanTech responded the following day with an e-mail that described Wey as the owner and president of New York Global Group ("NYGG US"), which has a business relationship with New York Global Group China ("NYGG China").[10]

On October 15, CleanTech filed with the Commission a Form 8-K disclosing a financing transaction that closed on October 14 involving Strong Growth Capital Ltd., an entity affiliated with Wey (the "October Financing"). On October 18, NASDAQ staff, by e-mail, requested a conference call with CleanTech's counsel for the stated purpose of "ask[ing] a few questions regarding [CleanTech's] involvement with [Wey]."[11] On October 28, the staff sent CleanTech an e-mail requesting, among other things, "[a]ll documents, including e-mails and attachments, relating to all loans and/or similar arrangements to or from Benjamin Wey, NYGG [US], NYGG China, and/or affiliated persons and/or entities."[12] The request did not include any instruction to update responses on an ongoing basis.

The company gave the staff responsive documents other than e-mails on November 4. CleanTech proposed that Wey "personally appear before [the staff] to answer questions directly in lieu of producing email documents."[13] The staff agreed to meet with Wey, and did so on November 5.[14]

After talking with Wey, the staff still had questions about him and NYGG US. In a conference call on November 16, the staff asked CleanTech to describe the services that NYGG US and NYGG China "[had] performed, [were] currently performing, or [were] anticipated to

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(...continued)
involvement (or that of his affiliates) with CleanTech, but rather on its finding that CleanTech deliberately failed to provide information about that involvement.

10 The record contains references to "New York Global Group China," "New York Global Group Asia," and "New York Global Group China / Asia." We understand these references to refer to a single entity. To avoid confusion, we use the term "NYGG China" to refer to this entity.

11 E-mail from Michael Wolf, NASDAQ OMX, to James M. Connolly (Oct. 18, 2010, 3:28 p.m.). The record does not show whether the conference call took place.

12 E-mail from Michael Wolf, NASDAQ OMX, to William W. Uchimoto (Oct. 28, 2010, 11:19 a.m.).

13 Uchimoto Aff. ¶10.

14 NASDAQ introduced no evidence as to whether it understood that the meeting was to take the place of e-mail production, or whether it expected CleanTech to produce the requested e-mails notwithstanding the meeting.

perform" for CleanTech.[15] CleanTech responded by e-mail dated November 17.[16] There is no indication that CleanTech was asked to update its response on an ongoing basis.

The staff also orally asked CleanTech to provide e-mails on three occasions after the November 5 meeting with Wey. On November 8, the staff requested CleanTech's e-mails; the exact terms of this request are not in the record.[17] CleanTech provided those e-mails it considered non-privileged on November 12.[18] On November 22, the staff asked CleanTech to produce e-mails of the company's corporate counsel, the Newman Law Firm ("Corporate Counsel"). On November 24, after CleanTech's chief executive officer agreed to waive the attorney-client privilege, CleanTech responded, stating that it was providing the documents in response to the staff's November 22 oral request for "all retained e-mail communications of the Company's U.S. legal and disclosure counsel, Robert Newman, Esquire of the Newman Law Firm Pllc that [are] between, cop[y] or mention[] [NYGG China] or [NYGG US], including [NYGG US's] President, Benjamin Wey."[19] The record does not show that the staff told CleanTech that it had an ongoing obligation to update its response.[20]

One week later, on December 1, the staff orally requested e-mails from CleanTech's Listing Counsel.[21] In a conference call on December 2, the staff informed Listing Counsel that "'if every requested [Listing Counsel] email was not produced, [CleanTech's] listing review would not continue and the application would be denied.'"[22] Once again, CleanTech's CEO agreed to waive the attorney-client privilege, and Listing Counsel sent 182 pages comprising 262

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15 Uchimoto Aff. ¶ 13. CleanTech's e-mail response to the call summarized the request in almost identical language.

16 CleanTech's response listed twelve types of services, including "[i]ntroductions of potential institutional investors and bridge lenders" and "provision of short term loan for working capital through [NYGG China] affiliate." E-mail from William W. Uchimoto, Stevens & Lee, P.C., to Traynham E. Mitchell Jr. (Nov. 17, 2010, 11:03 a.m.).

17 The Uchimoto affidavit states only, "On November 8, 2010, Mr. Sundick called me to request the Company's emails." Uchimoto Aff. ¶ 12.

18 The record is unclear as to whether CleanTech told the staff that it was withholding documents it viewed as privileged when it produced e-mails on November 12.

19 Letter from William W. Uchimoto, Stevens & Lee, to NASDAQ OMX Listing Qualifications, Attn: Traynham E. Mitchell Jr., Chief Counsel, Listing Investigations (Nov. 24, 2010).

20 In his affidavit, Uchimoto stated that he "was not aware of any NASDAQ staff request to me or any other Company representative to provide any updates as to previously submitted responsive documents." Uchimoto Aff. ¶ 21.

21 The exact terms of this request are not in the record.

22 Uchimoto Aff. ¶ 15 (purporting to quote Michael Emen, Senior Vice President, Listing Qualifications, NASDAQ).

e-mails, dated between August 2 and December 3, 2010, to the staff on December 3.[23] The record does not establish that the staff told CleanTech that it had an ongoing obligation to update its response.

By December 6, NASDAQ staff had received the e-mails sent on December 3, and a conference call between Listing Counsel and the staff to review those e-mails was scheduled for December 7. During the December 7 call, there was some additional discussion of Wey, but by the end of the call, the staff had shifted focus and had begun asking questions about CleanTech's contract with Toshiba, one of its suppliers. At the end of the call, Uchimoto had the impression that "the NASDAQ staff appeared comfortable with Mr. Wey and his consulting firm's role with the Company throughout the entire listing process."[24] The record does not show that there were any outstanding requests for information about Wey when the call concluded.[25]

C. NASDAQ staff approved CleanTech's application, after which CleanTech disclosed new financing arrangements.

On December 10, 2010, the staff sent CleanTech a letter stating that it had approved its application. The listing approval letter noted that the approval was based on information provided to the staff by the company or filed by the company with the Commission, and it instructed CleanTech to notify the staff promptly of any material change to such information.

Less than a week later, on December 16, CleanTech filed a Form 8-K disclosing the December Financing. The Form 8-K described the December Financing as involving "a closing of US $20,000,000 in a combination of equity and debt offerings through accredited institutional investors."[26] NASDAQ staff thereupon contacted CleanTech and obtained the e-mails at issue.[27]

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23 The Uchimoto affidavit states, "All requested emails in existence at that time were produced, whether privileged or not." Uchimoto Aff. ¶ 16.

24 *Id.* ¶ 18.

25 In recounting the facts of this matter in the delisting letter, the staff wrote: "Staff discussed [certain e-mails that CleanTech had not initially produced because they were also sent or copied to counsel] at length with the Company's outside counsel on December 7th, and the Company thereafter provided additional documents pursuant to this discussion." Letter from Gary N. Sundick, Vice President, Listing Qualifications, The NASDAQ Stock Market, LLC, to Bei Lu, Chairman & Chief Executive Officer, CleanTech Innovations, Inc., at 2 (Jan. 13, 2011). The record does not show whether these "additional documents" related to Wey. Moreover, we are unaware of any evidence (as opposed to filings by the parties) showing that CleanTech provided documents to the staff between December 3 and 16, 2010, when CleanTech filed its Form 8-K. *See supra* note 7 (distinguishing between affidavits, which may serve as evidence, and assertions made in briefs, which are not evidence).

26 http://www.sec.gov/Archives/edgar/data/1382219/000114420410066849/v205629_8k.htm (Dec. 16, 2010).

27 The record does not show the terms of the request that resulted in this production.

D. NASDAQ delisted CleanTech's stock.

On January 13, 2011, NASDAQ staff informed CleanTech by letter that, "[b]ased on [its] review of public documents and information provided by the Company," the staff believed that the continued listing of CleanTech's securities on NASDAQ was no longer warranted.[28] The staff found that CleanTech "failed to provide Staff with material information in violation of . . . the applicable Listing Rules."[29] The staff based its conclusion "on Nasdaq's broad discretionary authority contained in Listing Rule 5101 to deny continued inclusion of securities in order to maintain the quality of, and the public's confidence in, Nasdaq and the failure of the Company to comply with Listing Rules 5205(e) and 5250(a)(1),"[30] which provide that a company may be denied initial or continued listing if "any communication to Nasdaq contains a material misrepresentation or omits material information necessary to make the communication to Nasdaq not misleading."[31]

The delisting letter characterized the December Financing as "two material financing transactions," an equity portion and a debt portion, and found that

> neither of these material transactions was disclosed to Nasdaq prior to the filing of the Form 8-K on December 16th, despite the fact [that the] Staff had previously requested any such information with regard to Mr. Wey and Mr. Li or their affiliated entities; the [Company had a] general obligation to update Staff throughout the listing process concerning any material information; and the [listing application contained a specific question] concerning any bridge financings and private placements by the Company. . . . Substantial e-mail traffic was provided to Staff showing that these transactions were developed throughout the very period that Staff was considering whether to approve the Company's application. A number of these emails were copied to Mr. Wey and were required to have been produced to Staff by the clear terms of Staff's requests and discussions with Company counsel.[32]

The staff concluded that CleanTech's failure to inform NASDAQ of the December Financing "displays a blatant disregard for the integrity of the listing process and Nasdaq's Listing Rules," and that CleanTech's actions in "not only proceeding with the [December Financing], but also [hiding it] from Nasdaq . . . raise the risk that the company will continue to

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28 Sundick letter, *supra* note 25, at 1.

29 *Id.* The delisting letter also alluded to a violation of CleanTech's obligations under its listing application, but as discussed below, NASDAQ did not base its decision on this ground, so we do not consider it.

30 *Id.* (footnote omitted).

31 *Id.* at 1 n.2.

32 *Id.* at 3-4.

act in a manner inconsistent with its obligations under the Nasdaq Listing Rules and the federal securities laws."[33] The staff therefore concluded that CleanTech's actions raised significant public interest concerns and that the delisting of the company's securities from NASDAQ was warranted.

E. NASDAQ reviewed the delisting decision.

CleanTech appealed the delisting decision, requesting a hearing before a NASDAQ Listing Qualifications Panel. On February 28, 2011, the hearing panel found that "the Company's failure to provide prior notice to Nasdaq of the [December Financing] displays an unacceptable disregard for the Company's obligations as a listing applicant and for staff's stated concerns regarding the association with Mr. Wey," and it determined to delist CleanTech's shares.[34] The hearing panel made few factual findings, stating that the underlying facts "are largely uncontroverted."[35]

CleanTech immediately asked the NASDAQ Listing and Hearing Review Council to review the hearing panel's decision. An acknowledgement letter, dated March 4, confirmed receipt of CleanTech's request for review, asked the staff to provide the Review Council with an updated qualifications sheet and any additional information that the staff believed would assist the Review Council, and informed CleanTech that it was allowed to submit any additional information that it wanted the Review Council to consider. In response to the acknowledgment letter, the staff submitted an updated qualifications summary sheet and a list of record documents. CleanTech submitted a brief and nineteen exhibits, including copies of record documents as well as newly prepared letters from NYGG US, Listing Counsel, and Corporate Counsel.

On May 19, the Review Council remanded the matter to the hearing panel because it found that the record lacked sufficient fact and detail on two issues critical to the staff's determination to delist CleanTech:

"1. Did the Company intentionally withhold information from Staff concerning Mr. Wey and his affiliates, and/or the December Financing[?]

2. At what point did the Company become aware that listing approval was imminent? "[36]

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[33] *Id.* at 4-6.

[34] Letter from Amy Horton, Chief Counsel, NASDAQ Office of General Counsel, Hearings, to A. David Strandberg III, Donohoe Advisory Associates LLC, at 3 (Feb. 28, 2011) (unnumbered).

[35] *Id.* at 2.

[36] *CleanTech Innovations, Inc.*, No. NQ 5872C (NASDAQ Listing and Hearing Review Council May 19, 2011).

But one week later, on May 26, the Review Council's remand decision was stayed based on a determination that CleanTech made an ex parte communication by not providing the staff with a copy of its submission and in so doing violated NASDAQ Rule 5835(a)(1).[37] The record was reopened to allow the staff to respond to the issues raised by CleanTech, and both CleanTech and the staff were directed to address the factual issues noted in the remand decision so that the Review Council would be able to deliberate on a complete record in its reconsideration of its decision. The parties filed additional briefs and evidence. The staff submitted as evidence selected e-mails and correspondence from the period August to December 2010 and a business card for Ming Li, identified as "Senior Managing Director" and "Chief China Representative" for NYGG US. CleanTech submitted, among other things, the Uchimoto affidavit, in which Uchimoto disavowed any knowledge of an ongoing obligation to update responses to staff information requests.

The Review Council affirmed the decision of the hearing panel on July 22. In so doing, it found that CleanTech's "repeated failure to provide information requested by Staff is likely sufficient by itself to warrant delisting . . ."[38] But rather than basing its decision solely on that ground, the Review Council also considered, and agreed with, the staff's contention that CleanTech's failure to disclose information about the December Financing was intentional. It found that "[b]ecause delisting is warranted on this basis," *i.e.*, CleanTech's intentional failure to disclose, it "need not address whether the Company also violated the duty imposed by the listing application, which requests information on financings and requires the applicant to 'notify NASDAQ promptly of any material changes' to its application."[39]

On November 23, 2011, CleanTech was notified that the Review Council's decision had become the final action of NASDAQ when the NASDAQ Board of Directors declined to call it for review.[40] This appeal followed.

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37 *See* NASDAQ Rule 5835(a)(1) (prohibiting ex parte communications relevant to the merits of a proceeding). CleanTech strongly disputed the characterization of its submission as an ex parte communication, and in its brief to the Commission, CleanTech further argues that it is unclear whether the determination that it was an ex parte communication was made in accordance with NASDAQ's rules. Our disposition of this matter makes it unnecessary to address these issues.

38 *CleanTech Innovations, Inc.*, *supra* note 4, at 5.

39 *Id.* at 5 n.12.

40 NASDAQ represented in its brief to the Commission that, on December 9, 2011, CleanTech requested that the Board of Directors reconsider its determination not to review the Review Council's decision, to which NASDAQ responded by letter dated December 12, 2011, informing CleanTech that NASDAQ rules did not provide for the Board of Directors to call a decision for review after it had already declined once to do so.

III.

Our review is governed by § 19(f) of the Securities Exchange Act of 1934, which provides that we must dismiss CleanTech's appeal if we determine that the specific grounds on which the delisting is based exist in fact, that the delisting is in accordance with the applicable NASDAQ rules, and that those rules are consistent with, and were applied in a manner consistent with, the purposes of the Exchange Act.[41] NASDAQ has broad discretion in determining whether to permit a security's initial or continued listing on the Exchange,[42] and we are not free to substitute our discretion for NASDAQ's.[43] But in this proceeding, the record does not show that the specific grounds on which NASDAQ based its delisting decision exist in fact, and the considerable discretion afforded to NASDAQ therefore does not permit its delisting decision.[44]

NASDAQ based its delisting determination on its finding that "the record evidence warrants the conclusion that, when the Company failed to produce documents [regarding the December Financing] to Staff, it did so intentionally."[45] The Review Council identified four bases for its conclusion that CleanTech's withholding of information was intentional:

> (1) the Company was aware that Staff was closely examining its relationship and dealings with Mr. Wey and that Staff had requested all documents on the issue; (2) the Company knew that Staff would likely view the December Financing as a subject for further examination, as indeed it did; (3) the Company failed to provide information on the December Financing even as it was producing other

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41 15 U.S.C. § 78s(f); *cf. Fog Cutter Capital Grp., Inc.*, Exchange Act Release No. 52993, 58 SEC 1049, 2005 SEC LEXIS 3280, at *13-14 (Dec. 21, 2005) (applying § 19(f) standard to NASD delisting decision), *petition denied*, 474 F.3d 822 (D.C. Cir. 2007). CleanTech has not alleged, and the record does not establish, that NASDAQ's action has created "any burden on competition not necessary or appropriate in furtherance of the purposes of [the Exchange Act]" such that the Commission is required by § 19(f) to set aside NASDAQ's action.

42 *See* NASDAQ Listing Rule 5101 (providing that NASDAQ "has broad discretionary authority over the initial and continued listing of securities in Nasdaq in order to maintain the quality of and public confidence in its market, to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest").

43 *Cf. Tassaway, Inc.*, Exchange Act Release No. 11291, 1975 SEC LEXIS 2057, at *7 (Mar. 13, 1975) (stating that Commission may not substitute its discretion for NASD's in determining whether security should be removed from automated quotation system).

44 NASDAQ's arguments in support of the grounds on which it based its delisting decision are not supported by facts established by the record, but only by assertions made in its briefs. As noted above, *see supra* note 7, unsworn representations by counsel contained in briefs or memoranda are not evidence of the facts they purport to recount, and we have declined to base findings on such representations. *Gordon*, 2008 SEC LEXIS 819, at *70 n.98.

45 *CleanTech Innovations, Inc.*, *supra* note 4, at 6.

documents regarding Mr. Wey; and (4) the Company had previously failed to provide all requested information.[46]

We address these bases in turn.

A. Although the record evidence establishes that CleanTech knew that the staff was interested in its relationship to and dealings with Wey, it does not support a finding that the staff had requested the documents related to the December Financing that are at issue in this proceeding.

The record shows that CleanTech was aware that NASDAQ staff was closely examining its relationship and dealings with Wey and that the staff had requested many documents related to that subject. But NASDAQ's statement that the staff had requested "all documents on the issue" of CleanTech's relationship and dealings with Wey—and thus, presumably, the documents related to the December Financing—is overly broad and is not supported by the record. The documents in question are the e-mails dated between November 30 and December 10, 2010 that were not produced until after CleanTech filed the Form 8-K disclosing the December Financing.[47] CleanTech cannot have intentionally withheld those documents while the staff was considering the listing application unless the staff made a request that encompassed them. But because the earliest of the documents at issue did not exist until November 30, CleanTech can be found to have intentionally failed to produce those documents only if the staff requested them on or after November 30 or a request made before November 30 included a requirement to provide updated responses that covered those documents.[48] The record evidence supports neither finding.

1. There is no evidence that pre-November 30 requests covered the documents related to the December Financing.

We find in the record no instruction to update that would have required CleanTech to provide the contested e-mails. Although Bei Lu certified, when she filed the application on July 14, 2010, that she would "notify NASDAQ promptly of any material changes to the information provided in the application,"[49] NASDAQ did not base its decision on a violation of that duty; it explicitly declined to address "whether [CleanTech] also violated the duty imposed by the listing

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46 *Id.*

47 NASDAQ did not base its decision on a finding that CleanTech's failure to notify NASDAQ of the consummated December Financing between December 13 and December 16 violated the listing rules.

48 As noted above, NASDAQ explicitly stated that it was not addressing whether CleanTech "violated the duty imposed by the listing application, which requests information on financings and requires the applicant to 'notify NASDAQ promptly of any material changes' to its application." *CleanTech Innovations, Inc.*, *supra* note 4, at 5 n.12.

49 Excerpt from Listing Application, *supra* note 6.

application, which requests information on financings and requires the applicant to 'notify NASDAQ promptly of any material changes' to its application."[50]

The October 28, 2010 e-mail to CleanTech from the staff contains a comprehensive request for "all documents, including e-mails and attachments, related to Benjamin Wey (a/k/a/ Wei), Ming Li, New York Global Group, NYGG China, and/or any other associated/affiliated persons and/or entities," and "all documents, including e-mails and attachments, relating to all loans and/or similar arrangements to or from Benjamin Wey, NYGG [US], NYGG China, and/or affiliated persons and/or entities."[51] But the e-mail contains no language that imposed an ongoing duty to update information provided in response, and NASDAQ points to nothing else in the record or in the NASDAQ Listing Rules that would impose an ongoing obligation to update responses. Moreover, Uchimoto stated in his affidavit that he "was not aware of any NASDAQ staff request to me or any other Company representative to provide any updates as to previously submitted responsive documents."[52]

If the staff did not ask for updates of information submitted in response to its requests, it was not unreasonable for CleanTech to interpret those requests as terminating once it submitted responsive information.[53] Nor is it, on the record before us, unreasonable for CleanTech to have believed that its answers to repeated staff questions about Wey had assuaged the staff's concerns on that subject.

2. There is no evidence that post-November 30 requests covered the documents related to the December Financing.

The record shows that there was only one request for documents made on or after November 30. That was the December 1 oral request for e-mails from CleanTech's Listing Counsel. After CleanTech's CEO waived the attorney-client privilege, Listing Counsel produced responsive documents on December 3. The record does not purport to quote the request

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[50] *CleanTech Innovations, Inc.*, *supra* note 4, at 5 n.12. The only other instance in the record where we have found that NASDAQ instructed CleanTech that it should update its responses was in the December 10 listing approval letter, in which the staff instructed CleanTech to notify the staff promptly of any material change to the information provided to the staff by the company or filed by the company with the Commission. But a failure to produce documents while NASDAQ was considering the listing application cannot be based on a duty imposed only at the time the application was granted.

[51] E-mail from Wolf to Uchimoto, *supra* note 12.

[52] Uchimoto Aff. ¶ 21.

[53] Moreover, because both CleanTech's application and the letter notifying CleanTech of the listing approval imposed an obligation to update information submitted, CleanTech reasonably could have concluded that the staff's decision not to include such language in other contexts was intentional. It was therefore not unreasonable for CleanTech to assume that absent such language, there was no continuing obligation to update its response once it had responded fully to a request.

verbatim, but if we understand "e-mails from CleanTech's Listing Counsel" to mean that the request was for e-mails to or from Listing Counsel, or on which Listing Counsel was copied, then that request would not have encompassed any of the e-mails that NASDAQ found to have been intentionally withheld, because none of those e-mails fit into that category. It was not Listing Counsel, but Corporate Counsel, who was involved in the December Financing. As far as we can tell, Listing Counsel did not send or receive any of the 190 e-mails at issue, nor was it copied on any of those e-mails.[54] Thus, the record does not establish that CleanTech's failure to produce any of the contested e-mails in response to the December 1 request constituted intentional withholding of requested documents.[55]

Thus, given the language of the staff's requests, CleanTech's awareness that the staff had been highly interested in its relationship to and dealings with Wey at some points while its application was under consideration does not establish that CleanTech intentionally withheld information about the December Financing in late November and early December.[56]

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[54] Not all of the senders or recipients of the e-mails are identified in the record, but NASDAQ does not contend that Listing Counsel was among them.

[55] The Uchimoto affidavit provides the following explanation, the accuracy of which NASDAQ does not contest:

> [Stevens & Lee, PC], as Listing Counsel, was not counsel to nor involved with the then proposed financing transaction that is the subject of this proceeding. In this regard, [James Connolly, an attorney at Stevens & Lee who assisted Uchimoto in the CleanTech listing engagement] and I were not copied on any of the emails regarding this transaction and, therefore, the production of all 182 pages, comprising all of S&L's emails in existence on December 3, 2010, to NASDAQ did not include any mention of this transaction. Because the submission of the Newman Law Firm (corporate counsel) emails requested by the NASDAQ staff had been sent on November 24, 2010, and the financing transaction related emails did not start until November 30, 2010, they did not appear in the November 24 production since none of them existed on November 24.

Uchimoto Aff. ¶ 19.

[56] Nothing in this opinion should be construed to suggest that applicants may engage in a game of semantics with NASDAQ staff, whereby applicants scrutinize every staff request for loopholes so as to avoid providing information that the staff clearly indicated it wanted. On the other hand, the fact that many of the document requests in this matter were made orally limits our ability to discern exactly what those requests encompassed. Our review must be based on the record before us, and we cannot rely on unsworn representations to fill evidentiary gaps.

B. Awareness on CleanTech's part that the staff would be interested in the December Financing would not, without more, lead to the conclusion that CleanTech intentionally failed to provide the staff with the information in question while its listing application was pending.

Even if CleanTech knew that the staff would be interested in the December Financing, the record does not show that such knowledge demonstrates that CleanTech intentionally failed to provide NASDAQ with any of the contested e-mails before December 10, when the listing application was granted. The application expressly required CleanTech to provide information only about consummated financings, and CleanTech filed the 8-K after the December Financing was consummated. CleanTech had filed a Form 8-K after the October Financing, with no apparent objection from NASDAQ. In any event, NASDAQ did not base its decision on the violation of the duty to update imposed by the listing application.[57] In the November 16 call, the staff asked for a narrative that would include "anticipated future services" to be provided by NYGG US and NYGG China,[58] but the record does not show that CleanTech anticipated the December Financing on November 17, when it responded to that request. Moreover, Uchimoto stated in his affidavit:

> I did not understand the November 16 Request to be a duty imposed by the NASDAQ staff to continuously update submitted responses, nor could such request reasonably be viewed as such. I understood the meaning of the request for a written statement including "all services anticipated to be provided in the future" to mean ***any expected future services which were then known.***[59]

It appears that CleanTech complied with this understanding of the request, and nothing in the record shows this understanding to have been unreasonable. NASDAQ's second finding thus does not support the conclusion that CleanTech was intentionally withholding information about the December Financing.

C. Although CleanTech produced certain documents in early December in response to a staff request, there is no evident reason that CleanTech should have considered the documents in question to have been encompassed by that request.

As discussed above, all of the contested e-mails postdate the staff's request for Corporate Counsel's e-mails and CleanTech's response, and the record does not establish that there was any direction to update. Although CleanTech provided e-mails from Listing Counsel on December 3, after some of the e-mails regarding the December Financing had been written, Listing Counsel

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57 *See supra* note 48.

58 *See supra* note 15 and accompanying text (discussing wording of November 16 request).

59 Uchimoto Aff. ¶ 21 (emphasis in original).

neither wrote nor received the e-mails about the December Financing, so there is no evident reason that CleanTech should have considered those e-mails encompassed by the request.

D. The record does not substantiate NASDAQ's assertions regarding CleanTech's alleged pattern of withholding documents.

The Review Council found that

> After the Company's initial production on November 12, and despite the Company's assurance that it "ha[d] been responsive to all requests made," Staff discovered that the Company had not produced e-mails, including non-privileged e-mails, that were sent or copied to the Company's counsel. After Staff repeatedly pressed the Company on this and subsequent omissions, the Company produced additional documents on three separate occasions—November 24, December 3, and December 7—all while repeatedly assuring Staff that all responsive documents had been produced. Not only was this representation inaccurate because the Company had not produced documents bearing on the December [F]inancing, the Company's repeated pattern of withholding documents itself warrants an inference that the withholding was intentional.[60]

There is insufficient record evidence about the staff's requests and the company's responses to support all of these findings. For example, it is not clear what record evidence the Review Council was relying on in making the finding that the company "repeatedly assur[ed] Staff that all responsive documents had been produced."[61] The November 17 e-mail providing a narrative response about services provided and to be provided by Wey contains the statement, "Based upon the information provided in this correspondence, we believe we have been responsive to the requests made by your Department," which supports the quoted finding to a limited extent.[62] But this is one e-mail, which cannot alone constitute repeated assurances. And the e-mail was sent before any of the e-mails about the December Financing were written. In its brief to the Commission, NASDAQ states that on December 7, the staff "was assured by the company that all responsive e-mails had been produced,"[63] but NASDAQ cites only to a memorandum submitted to the hearing panel by the staff, and assertions in such memoranda are not evidence of the underlying facts.[64] Moreover, because for the reasons set out above there is

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60 *CleanTech Innovations, Inc.*, *supra* note 4, at 7. As noted above, *see supra* note 25, the record does not show what, if any, documents were produced on December 7.

61 *Id.*

62 E-mail from Uchimoto, to Mitchell, *supra* note 16. This may have been the language to which the Review Council was alluding when it referred to "the Company's assurance that it 'ha[d] been responsive to all requests made.'" *CleanTech Innovations, Inc.*, *supra* note 4, at 7. But in the November 17 e-mail, CleanTech did not use the phrase "all requests," so the company's representation is less sweeping than the Review Council's language would indicate.

63 NASDAQ Br. in Opp'n at 4.

64 *See supra* note 7.

no record evidence of an outstanding request (including a request to update) that would have encompassed the contested e-mails, the record does not show that such a statement made on December 7 would have been inaccurate.

Additionally, although the Review Council states that the staff "repeatedly pressed the Company on this and subsequent omissions,"[65] it is unclear from the record what "subsequent omissions" the Review Council had in mind. Although the staff made a number of requests for information, it is impossible to tell from the record whether that was because CleanTech did not give the staff everything when it first asked, or whether documents provided by CleanTech suggested new avenues of inquiry to the staff, or whether there was a different reason altogether for the inquiries. Some of the "omissions" appear to have been due to CleanTech's assertion of the attorney-client privilege, which does not on its face suggest that CleanTech was being obdurate, and once the staff made clear that the application would be denied unless CleanTech produced the documents it asserted were privileged, CleanTech expeditiously obtained its CEO's consent and produced the requested documents.

IV.

For the reasons discussed above, we conclude that the record does not show that the grounds on which NASDAQ relied in delisting CleanTech exist in fact.[66] The record may give a distorted

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[65] *CleanTech Innovations, Inc.*, *supra* note 4, at 7.

[66] Both parties seek to introduce new evidence on appeal. In its brief on appeal, NASDAQ asked us to consider several articles published in January 2012 that, NASDAQ alleges, report that the FBI raided both Wey's home and his office, apparently in early 2012. NASDAQ cited the articles on the theory that it "was entitled at least to consider any relevant information regarding Wey before deciding whether to list CleanTech's securities." NASDAQ Br. in Opp. at 18 (emphasis in original). In a later motion, NASDAQ asked the Commission to allow the submission of a Form 12b-25 filed by CleanTech on May 15, 2012 and to take note that CleanTech did not timely file the underlying Form 10-Q, which, NASDAQ asserts, was due on May 15, 2012. NASDAQ contends that the Form 12b-25 and the Company's failure to file its Form 10-Q demonstrate non-compliance with NASDAQ listing standards and the Commission's filing requirements, further supporting the conclusion that listing of the Company's securities on NASDAQ is unwarranted. NASDAQ asserts that, although CleanTech's failure to timely file its Form 10-Q "was not a basis for NASDAQ's decision to delist [CleanTech], this additional failure is a basis to deny relisting the Company under the Commission's de novo review." NASDAQ's Mot. for Leave to Adduce Add'l Evidence at 3 n.1 (May 24, 2012). CleanTech opposes the motion, but asks that if the Commission allows the Form 12b-25 into evidence, the Commission should also allow CleanTech's Form 10-Q, filed on June 25, 2012, into evidence, "to complete the record." CleanTech's Mot. for Leave to Adduce Add'l Evidence at 1 (July 2, 2012).

Rule of Practice 452 permits the introduction of new evidence on review if the party seeking to adduce the evidence shows that it is material and there were reasonable grounds for failure to adduce such evidence previously. 17 C.F.R. § 201.452. The question in this proceeding is whether the grounds on which NASDAQ based its delisting decision exist in fact. As NASDAQ concedes, CleanTech's failure to file its Form 10-Q in May 2012 was not a basis for the delisting

(continued...)

picture: much of the communication about document production between the staff and the company was oral, and there may not be detailed written records of those conversations. But when the Review Council originally decided that the record was insufficient to enable it to determine whether CleanTech intentionally withheld information and allowed the parties to submit additional evidence, CleanTech submitted the Uchimoto affidavit, providing evidence from someone who was involved in those conversations. The staff did not provide similar evidence. If there were requests that clearly encompassed the contested e-mails, or directions to update that would have required their production, we cannot discern this from the record. We therefore set aside NASDAQ's delisting decision.

An appropriate order will issue.[67]

By the Commission (Chair WHITE and Commissioners WALTER, AGUILAR, PAREDES and GALLAGHER).

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

(...continued)
decision–indeed, it could not have been, because the alleged untimely filing occurred months after CleanTech was notified in November 2011 that the delisting decision had become final. (The January 2012 "FBI raids" discussed in the articles NASDAQ seeks to admit similarly postdate the delisting decision, as does CleanTech's filing of its Form 10-Q in June 2012.) Thus, none of the proposed evidence is material, and it therefore does not satisfy the requirements of Rule 452. We therefore deny the motions to adduce new evidence.

[67] We have considered all the arguments advanced by the parties. We reject or sustain them to the extent that they are inconsistent or in accord with the views expressed herein. Because the issues have been thoroughly briefed and can be adequately determined on the basis of the record filed by the parties, Applicants' request for oral argument is denied. Rule of Practice 451, 17 C.F.R. § 201.451.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 69968 / July 11, 2013
Admin. Proc. File No. 3-14640

In the Matter of the Application of

CLEANTECH INNOVATIONS, INC.
c/o Paula D. Shaffner
Joshua R. Dutill
Stradley, Ronon, Stevens & Young, LLP
2600 One Commerce Square
Philadelphia, PA 19103

For Review of Action Taken by
The NASDAQ Stock Market, LLC

ORDER SETTING ASIDE DELISTING DECISION

On the basis of the Commission's opinion issued this day, it is

ORDERED that the delisting action taken by The NASDAQ Stock Market, LLC against CleanTech Innovations, Inc. is hereby set aside.

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. 69969 / July 11, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3625 / July 11, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15374

In the Matter of **DAVID KUGEL,** **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 David Kugel ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, Respondent consents to the 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. Kugel was an arbitrage securities trader and trading compliance analyst at Bernard L. Madoff Investment Securities, Inc. (BMIS), an investment adviser and broker-dealer registered with the Commission. Kugel was also a registered representative associated with BMIS. Kugel, 67 years old, is a resident of Manhasset, New York.

2. On November 28, 2011, a final judgment was entered by consent against Kugel, permanently enjoining him from (a) violating or aiding and abetting violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, (b) violating or aiding and abetting violations of Sections 206(1) and 206(2) of the Advisers Act, (c) aiding and abetting violations of Sections 15(c) and 17(a) of the Exchange Act and Rules 10b-3 and 17a-3 thereunder, and (d) aiding and abetting violations of Section 204 of the Advisers Act and Rule 204-2 thereunder in the civil action entitled Securities and Exchange Commission v. David Kugel, Civil Action Number 11-CV-8434, in the United States District Court for the Southern District of New York.

3. The Commission's complaint alleged that, from the 1970s to 2008, Kugel knowingly participated in the creation of false account statements supplied to BMIS's clients. The complaint also alleged that Kugel helped create fictional trades that were recorded on trade tickets, trade confirms, and client account statements, and aided and abetted the fraud that Bernard Madoff and BMIS perpetrated on BMIS's investment advisory ("IA") clients.

4. On November 21, 2011, Respondent pled guilty to securities fraud, falsifying records of an investment adviser, falsifying records of a broker-dealer, bank fraud, and conspiracy to commit securities fraud, to falsify records of a broker-dealer, and to falsify records of an investment adviser, before the United States District Court for the Southern District of New York, in United States v. David Kugel, Crim. Information No. S4 10 CR 228.

5. The counts of the criminal information to which Kugel pled guilty alleged, inter alia, that beginning in or about the 1970s, Respondent provided historical information to other BMIS employees from which they created fake trades for the firm's investment advisory clients.

IV.

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

barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and

barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 69971 / July 11, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3626 / July 11, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15375

In the Matter of **ERIC LIPKIN,** **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 Eric Lipkin ("Lipkin" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, Respondent consents to the 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. Lipkin, age 38, a resident of Ridgewood, New Jersey, has been an employee of Bernard L. Madoff Investment Securities LLC ("BMIS") since 1992. BMIS, founded in 1960, was a broker-dealer and investment adviser registered with the Commission that purportedly engaged in three different operations: investment adviser services, market-making services, and proprietary trading.

2. On June 14, 2011, a Partial Judgment on Consent Imposing Permanent Injunction was entered by consent against Lipkin, permanently enjoining him from future violations, and from aiding and abetting future violations, of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 15(c) of the Exchange Act and Rule 10b-3 thereunder, Section 17(a) of the Exchange Act and Rule 17a-3 thereunder, and Sections 206(1), 204 and 206(2) of the Advisers Act and Rule 204-2 thereunder, in the civil action entitled Securities and Exchange Commission v. Eric Lipkin, Civil Action Number 11 CV 3826 (LTS), in the United States District Court for the Southern District of New York.

3. The Commission's complaint alleged that for over a decade, Lipkin assisted Bernard L. Madoff ("Madoff") in defrauding investors and misleading auditors and regulators. As an employee in the investment advisory ("IA") operations, Lipkin assisted BMIS employees with carrying out Madoff's entirely fictitious "split-strike conversion" strategy that BMIS claimed to be pursuing on behalf of its clients. Lipkin also made repeated material misrepresentations to a group of non-split-strike investors and created false records of the investors' account holdings. In so doing, Lipkin prepared numerous fictitious account statements and other documents that he knew or was reckless in not knowing would be shown to investors. Lipkin also aided and abetted other books and records violations by creating, at Madoff's direction, numerous fake Depository Trust Clearing Corporation ("DTCC") reports that he knew would be used to mislead auditors and regulators and by processing payroll records for "no-show" employees.

4. On June 6, 2011, Lipkin pleaded guilty before the United States District Court for the Southern District of New York, to one count of falsifying, and one count of conspiracy to falsify, records of a broker-dealer, to falsify records of an investment adviser, in violation of 15

U.S.C. §§ 78q(a), 78qff, 80b-4 and 80b-17, 17 C.F.R. §§ 240.17a-3 and 240.204-2, and 18 U.S.C. § 2. Lipkin also pleaded guilty to one count of bank fraud, and one count of conspiracy to commit bank fraud, in violation of 18 U.S.C. §§ 1344 and 2; and one count of false statements to facilitate a theft concerning ERISA, and conspiracy to falsify statements to facilitate a theft concerning ERISA, in violation of 18 U.S.C. §§ 1027 and 2. United States v. Lipkin, Crim. Information No. 1:10-cr-228-LTS.

5. The counts of the criminal information to which Lipkin pleaded guilty alleged, inter alia, that Lipkin created false statements related to investment accounts at BMIS, fake DTC reports, and false payroll books and records.

IV.

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

barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and

barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

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

By the Commission.

Elizabeth M. Murphy
Secretary

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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 69973 / July 11, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3627 / July 11, 2013

ADMINISTRATIVE PROCEEDING
File No. 3- 15376

In the Matter of **ENRICA COTELLESSA-PITZ,** **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 Enrica Cotellessa-Pitz ("Cotellessa-Pitz" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, Respondent consents to the 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. Cotellessa-Pitz, age 54, a resident of New York, New York, had been an employee of Bernard L. Madoff Investment Securities LLC ("BMIS") since 1978. BMIS, founded in 1960, was a broker-dealer and investment adviser registered with the Commission that purportedly engaged in three different operations: investment adviser services, market-making services, and proprietary trading.

2. On January 12, 2012, a Partial Judgment on Consent Imposing Permanent Injunction was entered by consent against Cotellessa-Pitz, permanently enjoining her from future violations of Section 17(a) of the Securities Exchange Act of 1934 and Rules 17a-3, 17a-4, and 17a-5 thereunder, and Section 204 of the Investment Advisers Act of 1940 and Rule 204-2 thereunder, in the civil action entitled Securities and Exchange Commission v. Enrica Cotellessa-Pitz, Civil Action Number 11 CV 9302 (LTS), in the United States District Court for the Southern District of New York.

3. The Commission's complaint alleged that Cotellessa-Pitz, who worked at BMIS for more than 30 years, assisted in falsifying BMIS's internal accounting records in order to misclassify hundreds of millions of dollars of income purportedly generated by BMIS's investment advisory operations. Cotellessa-Pitz also falsified financial statements filed with the SEC and other regulators as well as materials that were prepared to mislead SEC staff examiners, federal and state tax auditors, and other external reviewers.

4. On December 19, 2011, Cotellessa-Pitz pled guilty before the United States District Court for the Southern District of New York, to falsifying the records of a broker-dealer, to falsifying the records of an investment adviser, to causing the filing of false documents with the Commission, and conspiring to falsify the records of a broker-dealer, to falsify records of an investment adviser, and causing the filing of false documents with the Commission, in violation of 15 U.S.C. §§ 78q(a), 78ff, 80b-4 and 80b-17, 17 C.F.R. §§ 240.17a-3, 240.17a-5, and 240.204-2, and 18 U.S.C. § 2. United States v. Cotellessa-Pitz, Crim. Information No. 1:10-cr-228-LTS.

5. The counts of the criminal information to which Cotellessa-Pitz pleaded guilty alleged, inter alia, that she created false and misleading entries in the books and records of

BMIS and in reports filed with the SEC. The false and misleading entries were used to disguise transfers of funds from BMIS's Investment Advisory business to BMIS's Market Making and Proprietary Trading operations. The transfers made the Market Making and Proprietary Trading operations of BMIS appear profitable when they were not.

IV.

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

> barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and
>
> barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

INVESTMENT ADVISERS ACT OF 1940
Release No. 3628 / July 11, 2013

Admin. Proc. File No. 3-14572

In the Matter of

ALFRED CLAY LUDLUM, III
P.O. Box 3924
Wilmington, DE 19807

OPINION OF THE COMMISSION

INVESTMENT ADVISER PROCEEDING

Ground for Remedial Action

Respondent, who was associated with an investment adviser, agreed to be permanently enjoined from violating the antifraud provisions of the federal securities laws. *Held*, it is in the public interest to additionally bar him from association with any investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

APPEARANCES:

Alfred Clay Ludlum, III, pro se.

Dean M. Conway and *Devon Leppink Staren*, for the Division of Enforcement.

Appeal filed: January 19, 2012
Last brief received: March 30, 2012

I.

Alfred Clay Ludlum, III, was a registered investment adviser and the founder, president, and sole control person of Printz Capital Management, LLC, Printz Financial Group, Inc., and PCM Global Holdings, LLC (collectively, the "Printz Entities").[1] On December 20, 2010, the Commission filed a civil injunctive action against him for fraud and other violations.[2] After Ludlum agreed to be permanently enjoined from (among other things) future violations of the antifraud provisions of the federal securities laws,[3] the Commission instituted a follow-on administrative proceeding to determine whether the statutory predicate for further remedial action existed and, if so, whether it was appropriate in the public interest to take such action on the facts of this case.[4]

The administrative law judge found there was no genuine issue as to any material fact and that the Division of Enforcement was entitled to summary disposition as a matter of law.[5] She also found that "[t]he overwhelming evidence is that the public interest requires that Ludlum be barred from participating in the securities industry in the broadest possible way."[6] Although she barred Ludlum from association with any investment adviser, broker, dealer, municipal securities dealer, or transfer agent, she did not bar him from association with a municipal advisor or nationally recognized statistical rating organization.[7] Those last two forms of relief were authorized by Congress in the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010.[8] Ludlum's misconduct occurred before the passage of that Act, and the ALJ believed applying those sanctions would be impermissibly retroactive, though noting that the Commission had yet to decide the issue.[9]

This appeal followed. In the interim, we decided *John W. Lawton*, which held that collateral bars imposed pursuant to § 925 of Dodd-Frank are not impermissibly retroactive as applied in follow-on proceedings addressing pre-Dodd-Frank conduct because such bars are

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1 Printz Capital, a Delaware limited liability company, was formed in May 2006. It registered with the Commission as an investment adviser in September 2006. Its registration was revoked on June 27, 2011. *Printz Capital Mgmt., LLC*, Investment Advisers Act Release No. 3233, 2011 WL 2544469, at *2 (June 27, 2011). Printz Financial is a holding company for Printz Capital and other businesses controlled by Ludlum. PCM Global was formed to raise money to invest in Costa Rican real estate.

2 *SEC v. Ludlum*, Lit. Release No. 21785, 2010 WL 5167673 (Dec. 20, 2010).

3 *SEC v. Ludlum*, Lit. Release No. 22110, 2011 WL 4526103 (Sept. 29, 2011).

4 *Alfred Clay Ludlum III*, Admin. Proc. File No. 3-14572, 2011 WL 4526100 (Sept. 29, 2012).

5 *Alfred Clay Ludlum III*, Initial Dec. Release No. 447, 2012 WL 681581, at *2 (Jan. 4, 2012).

6 *Id.* at *7.

7 *Id.*

8 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

9 2012 WL 681581, at *7.

prospective remedies whose purpose is to protect the investing public from future harm.[10] We affirm the ALJ's grant of the Division's motion for summary disposition, but we conclude that, for the reasons set forth in *Lawton*, all of the remedies authorized in § 925 of Dodd-Frank are legally available in this case. And, as discussed below, we find it appropriate in the public interest on the facts of this case to impose a full collateral bar against Ludlum.

II.

On December 20, 2010, we filed a civil enforcement action against Ludlum in the U.S. District Court for the Eastern District of Pennsylvania.[11] Those proceedings concerned unregistered securities offerings in the Printz Entities between 2006 and 2009. The complaint alleged that, through these offerings, Ludlum defrauded investors, including at least twenty-one advisory clients of Printz Capital, out of approximately $852,000. In particular, the complaint alleged that Ludlum raised approximately $700,000 from twenty-seven investors through unregistered offerings of equity and debt securities in the Printz entities, fraudulently obtained $80,000 in loans from an advisory client, and misappropriated approximately $72,000 from three advisory clients' accounts. The complaint further alleged that the "Printz Entities failed to register their securities offerings with the Commission, even though no exemption from registration applied . . . ."[12] Although Ludlum told investors that their funds would be used "to grow and operate the businesses of the Printz Entities," he instead used the investors' funds "to support his lavish lifestyle, pay his personal expenses, and repay other investors."[13]

According to the complaint, Ludlum "induced investors to invest by creating the illusion of a legitimate business"[14] and "promised investors superior rates of return when he knew or was reckless in not knowing that the Printz Entities did not have the revenues to pay such returns."[15] "Specifically," the complaint stated, "Ludlum continued to solicit new promissory note-holders by promising an 8% annual return when he knew that many of the interest payments that were owed to existing note-holders in the Printz Entities had not been paid."[16] Ludlum also failed to disclose to prospective investors that "none of his businesses had ever made a profit and that the Printz Entity expenses (as well as his personal expenses) were largely paid out of newly-raised investor funds."[17] These investors included "many who did not have significant investing

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10 Advisers Act Release No. 3513, 2012 WL 6208750, at *10 (Dec. 13, 2012).

11 *Ludlum*, 2010 WL 5167673.

12 Compl. ¶ 3.

13 *Id.*

14 *Id.* ¶ 28.

15 *Id.* ¶ 27.

16 *Id.*

17 *Id.* ¶ 29.

experience and, instead, relied almost exclusively on the investment advice they received from Ludlum."[18]

Once he raised funds through these offerings, Ludlum commingled the investors' funds with personal and business assets and used approximately $251,000 of those funds "to support a lavish lifestyle for himself and his friends," including $44,000 in rent for a luxury condominium and $56,000 of expenses in bars and restaurants.[19] Ludlum then took various steps to conceal his fraud by knowingly or recklessly making false statements to investors, including telling one investor that her funds had been invested in a Costa Rican real estate deal, when in fact he had transferred her money into his personal bank account. Ludlum also "attempted to placate the concerns of at least two other investors and the son of a retired couple who also invested by telling them that the Commission's investigation of his fraud was nothing more than a routine audit."[20] And, during the Commission's subsequent investigation into his misconduct, Ludlum falsely testified under oath that he had disclosed on a background questionnaire all of the bank and securities accounts he had controlled over the past three years. According to the complaint, Ludlum controlled at least thirty-six additional accounts, which he failed to disclose.

As Printz Capital's sole control person, Ludlum was also responsible for the firm's withholding documents requested by Commission staff and for the firm's filing inaccurate forms with the Commission. In particular, the complaint alleged that Ludlum aided and abetted Printz Capital's failure to make available complete and accurate records concerning its business in response to Commission subpoenas and requests. The complaint also alleged that Ludlum caused Printz Capital to falsely claim on its Forms ADV that "the firm had more than $25 million under management when, in fact, Printz Capital never had more than $10 million under management."[21] Ludlum also caused Printz Capital to falsely state on its Forms ADV that neither Printz Capital nor any related person recommended securities to advisory clients in which Printz Capital or any related person had an ownership interest. Throughout the period covered by the Forms ADV, however, Ludlum recommended that his clients purchase securities offered by the Printz Entities.

The complaint concluded that, because of this misconduct, Ludlum violated, or aided and abetted violations of, registration and antifraud provisions of the securities laws, including §§ 5(a), 5(c), and 17(a) of the Securities Act of 1933,[22] § 10(b) of the Securities Exchange Act of

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[18] *Id.* ¶ 30.

[19] *Id.* ¶ 35.

[20] *Id.* ¶ 45.

[21] *Id.* ¶ 48. Form ADV is the uniform form used by investment advisers to register with both the Commission and state securities authorities.

[22] 15 U.S.C. §§ 77e(a) (prohibiting the sale of unregistered securities), 77e(c) (prohibiting the "offer to sell" any securities, unless a registration statement has been filed as to such securities or an exemption is available), and

1934[23] and Rule 10b-5 thereunder,[24] and §§ 206(1) and 206(2) of the Investment Advisers Act of 1940.[25] The complaint further alleged that Printz Capital violated the antifraud provisions and the books-and-records provisions of the Advisers Act (namely, §§ 203A, 204, and 207);[26] that Ludlum aided and abetted those violations; and that Printz Financial violated Securities Act Rule 503(a) of Regulation D, which pertains to notice that must be provided to the Commission on Form D.[27]

On September 12, 2011, Ludlum consented to the entry of a judgment against him imposing permanent injunctions, disgorgement, and civil penalties to be determined by the court. As part of that settlement, Ludlum expressly agreed not to contest the factual allegations of the

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77q(a) (prohibiting, among other things, the use of "any device, scheme, or artifice to defraud" in the "offer or sale of any securities").

23 15 U.S.C. § 78j(b) (prohibiting "any manipulative or deceptive device" in connection with the purchase or sale of securities).

24 17 C.F.R. § 240.10b-5 (prohibiting the use of "any device, scheme, or artifice to defraud . . . mak[ing] any untrue statement of a material fact or to omit to state a material fact . . . [or] engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security").

25 15 U.S.C. §§ 80b-6 (making it unlawful for any investment adviser "(1) to employ any device, scheme, or artifice to defraud any client or prospective client; or (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or perspective client").

26 15 U.S.C. §§ 80b-3a(a) (generally prohibiting an investment adviser with less than $25 million of assets under management from registering with the Commission), 80b-4 (setting recordkeeping requirements involving the treatment and maintenance of records), and 80b-7 (making 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 under section 203, or 204").

27 17 C.F.R. § 230.503(a). Regulation D of the Securities Act provides an exemption from registration for limited offerings or sales of securities if certain conditions are met. *Id.* §§ 230.501–508. Rule 503(a) describes the notice that an issuer must provide to the Commission on Form D pertaining to sales made in reliance on a Regulation D exemption. *Id.* § 230.503(a).

complaint in any subsequent disciplinary proceeding based on the injunction.[28] The district court entered the judgment against Ludlum on September 21, 2011.[29]

III.

On September 29, 2011, we initiated an administrative follow-on proceeding against Ludlum, pursuant to Advisors Act § 203(f),[30] to determine whether he had been enjoined from, among other things, violating the antifraud and registration provisions of the securities laws and, if so, what, if any, remedial action was appropriate in the public interest.[31] On January 4, 2012, the administrative law judge granted a motion for summary disposition filed by the Division, agreeing with the Division that there was no dispute that Ludlum had been enjoined from violating various provisions of the federal securities laws.[32] The law judge also found that "[t]he likelihood of future violations if Ludlum is allowed to participate in the securities industry is enormous" and that "[t]he overwhelming evidence is that the public interest requires that Ludlum be barred from participating in the securities industry in the broadest possible way."[33] In doing so, however, the law judge noted that the conduct on which the injunction was based occurred before Congress authorized the Commission to impose collateral bars (*i.e.*, bars from associating in capacities other than those in which the respondent was associated at the time of the violative conduct) under § 925 of the Dodd-Frank Act. Because of this, the law judge analyzed whether imposing the collateral bars requested by the Division would be impermissibly retroactive. She found no retroactive effect in barring Ludlum from associating with brokers, dealers, municipal securities dealers, or transfer agents. She reasoned that such bars were permissible because the

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28 The consent stated that,

> in any disciplinary proceeding before the Commission based on the entry of the injunction in this action, [Ludlum] understands that he shall not be permitted to contest the factual allegations of the complaint in this action. . . . [Ludlum] understands and agrees to comply with the Commission's policy "not to permit a defendant or respondent to consent to a judgment or order that imposes a sanction while denying the allegations in the complaint or order for proceedings." 17 C.F.R. § 202.5. In compliance with this policy, [Ludlum] agrees . . . not to take any action or to make or permit to be made any public statement denying, directly or indirectly, any allegation in the complaint or creating the impression that the complaint is without factual basis . . . .

Consent at 5.

29 *SEC v. Ludlum*, No. 2:10-cv-07379-MSG (E.D. Pa. Sept. 21, 2011) (enjoining Ludlum from violating Securities Act §§ 5 and 17(a), Exchange Act § 10(b) and Rule 10b-5 thereunder, and Advisers Act §§ 206(1) and 206(2), and from aiding and abetting violations of Advisers Act §§ 203, 204, and 207).

30 15 U.S.C. § 80b-3(f).

31 *Ludlum*, 2011 WL 4526100, at *2.

32 *Ludlum*, 2012 WL 681581, at *2. Our Rule of Practice 250 provides that 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.

33 *Ludlum*, 2012 WL 681581, at *6–7.

Exchange Act provided the Commission with pre-existing authority to impose such bars in subsequent proceedings. Regarding bars from associating with municipal advisors and NRSROs, however, the law judge found an impermissible retroactive effect because, she concluded, such bars "did not exist at the time of Ludlum's conduct, and they attach new legal consequences to his conduct."[34]

This appeal by Ludlum followed.[35]

IV.

A. The imposition of an industry-wide bar is appropriate.

Advisers Act § 203 authorizes us to censure, place limitations on, suspend, or bar any person associated with an investment adviser who was enjoined "from engaging in or continuing any conduct or practice . . . in connection with the purchase or sale of any security."[36] The record establishes, and Ludlum does not dispute, that he was enjoined from engaging in fraudulent conduct in connection with the purchase or sale of securities and that, at the time the enjoined conduct occurred, he was associated with an investment adviser. We find, therefore, that the statutory requirements for the imposition of sanctions have been satisfied.

We next turn to assessing what additional sanctions, if any, are in the public interest. In doing so, 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.[37] Our "inquiry into . . . the public interest is a flexible one, and no one factor is dispositive."[38]

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34 *Id.* at *7 (citing 15 U.S.C. § 80b-3(f) and *Landgraf v. USI Film Prods.*, 511 U.S. 244, 269–70 (1994) (holding that a statute is impermissibly retroactive when it "attaches new legal consequences to events completed before [the statute's] enactment")).

35 Ludlum, representing himself, did not challenge the basis for the ALJ's decision. Instead, he raised issues that have no relevance to the ALJ's decision. In light of the law judge's analysis concerning collateral bars, we advised the parties, pursuant to Rule of Practice 411(d), of our decision on our own initiative to review what sanctions, if any, were appropriate in this matter. Order Granting Pet. For Review and Scheduling Brs., dated Jan. 30, 2012, at 1. *See* 17 C.F.R. § 201.411(d) ("Review by the Commission of an initial decision shall be limited to the issues specified in the petition for review or the issues, if any, specified in the briefing schedule order issued pursuant to Rule 450(a)."). Neither party, however, addressed that particular issue in its briefs.

36 15 U.S.C. §§ 80b-3(e)(4) and 80b-3(f).

37 *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981).

38 *David Henry Disraeli*, Exchange Act Release No. 57027, 2007 WL 4481515, at *15 (Dec. 21, 2007) (quoting *Conrad P. Seghers*, Advisers Act Release No. 2656, 2007 WL 2790633, at *4 (Sept. 26, 2007)), *petition denied*, 548 F.3d 129 (D.C. Cir. 2008).

Here, the complaint to which Ludlum consented makes clear that his actions were egregious. Ludlum defrauded investors—including several to whom he owed a fiduciary duty[39]—out of $852,000. We have previously found that violating the trust placed in a fiduciary amounts to egregious behavior.[40] Ludlum's fraud was particularly egregious given that many of the clients Ludlum defrauded were financially unsophisticated, with little investment experience, and relied almost exclusively on his advice.[41] Further demonstrating the egregiousness of Ludlum's misconduct and the need for significant sanctions were Ludlum's efforts to mislead regulators and thwart their investigations. Ludlum, for instance, lied to Commission staff about the number of cash and securities accounts under his control, and he withheld Printz Capital's records from Commission staff despite requests and subpoenas. Such efforts to frustrate Commission investigations are "especially serious"[42] and "justify[] strong sanctions."[43] Similarly troubling was Ludlum's attempt to grossly mislead regulators—and the public—about the extent of Printz Capital's assets under management by aiding and abetting the firm's filing of inaccurate Forms ADV.[44]

Ludlum's misconduct was also neither brief nor isolated. Instead, Ludlum committed multiple securities law violations, spanning at least three years and involving, among other

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39 *See SEC v. Wash. Inv. Network*, 475 F.3d 392, 404 (D.C. Cir. 2007) (stating that investment advisers act "as fiduciaries" to their clients).

40 *James C. Dawson*, Advisers Act Release No. 3057, 2010 WL 2886183, at *4 (Jul. 23, 2010) ("[W]e have consistently viewed misconduct involving a breach of fiduciary duty . . . as egregious.").

41 *See Epstein v. SEC*, 416 F. App'x 142, 146 (3d Cir. 2010) (affirming Commission's imposition of permanent bar where the Commission had determined that violations were egregious because they were perpetrated against elderly and unsophisticated clients and did not stem from a mistake of fact); *see also Butcher & Singer Inc.*, Exchange Act Release No. 23990, 48 SEC 640, 1987 WL 757641, at *7 (Jan. 13, 1987) (describing "fraudulent representations to an unsophisticated customer" as egregious).

42 *Hal S. Herman*, Exchange Act Release No. 44953, 55 SEC 395, 2001 WL 1245910, at *5 (Oct. 18, 2001) (affirming bar and noting that representative's submission of false information "emphas[izes] the appropriateness of the sanction imposed here"); *see also PAZ Sec., Inc.*, Exchange Act Release No. 57656, 2008 WL 1697153, at *4 (Apr. 11, 2008) ("The possibility of receiving a bar for a failure to cooperate may have a very specific deterrent effect on all current and future SRO members and associated persons.").

43 *Schield Mgmt. Co.*, Exchange Act Release No. 53201, 58 SEC 1197, 2006 WL 231642, at *9 (Jan. 31, 2006). Adding to the egregiousness of Ludlum's misconduct was his failure to ensure that the offerings at issue complied with the registration provisions of the Securities Act, which serve to "protect investors by promoting full disclosure of information thought necessary to informed investment decisions." *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953); *see also SEC v. Cap. Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963) (stating that a fundamental purpose of the securities laws is "to substitute a philosophy of full disclosure for the philosophy of caveat emptor").

44 Providing accurate information on forms such as an ADV "assures regulatory organizations . . . and members of the public that they have all material, current information about the securities professional with whom they are dealing." *Richard A. Neaton*, Exchange Act Release No. 65598, 2011 WL 5001956, at *6 (Oct. 20, 2011) (imposing bar for failure to disclose accurate information on a Form U4 and noting the importance of Forms U4, which, like Forms ADV, are used by regulatory agencies to determine the fitness of securities professionals).

things, the misuse of customer funds and misrepresentations to clients.[45] Ludlum also displayed a high degree of scienter by inducing clients to invest substantial sums through false claims about the legitimacy of his businesses and what rate of return the investors could expect. He then lied to the investors about what he had done with their money, lied to Commission staff during their investigation into that misconduct, and misled investors about the nature of the Commission's investigation.[46] Throughout these proceedings, Ludlum has also shown no willingness to accept responsibility—or show remorse—for his actions,[47] and he has made clear that he intends to return to the securities industry if given the chance.[48] Such factors all strongly support the need for imposing a broad industry-wide bar.[49]

By the same token, we can find nothing in the record or in Ludlum's briefs that mitigates his misconduct. In challenging the imposition of a bar, for instance, Ludlum cites to his "character," stating that he attended the Citadel (a military academy with what Ludlum describes as "a student run honor system") and that he was a "Captain in the New York Army National

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45 *See, e.g., Impax Labs., Inc.*, Exchange Act Release No. 57864, 2008 WL 2167956, at *7–8 (May 23, 2008) (finding issuer's failure to file six quarterly and two annual reports over the course of eighteen months to constitute serious and recurrent violations); *Jeffrey L. Gibson*, Exchange Act Release No. 57266, 2008 WL 294717, at *3 (Feb. 4, 2008) (finding that conduct was recurrent when it occurred over three years and involved a large number of respondent's clients), *petition denied*, 561 F.3d 548 (6th Cir. 2009); *Seghers*, 2007 WL 2790633, at *7 (finding conduct was not isolated when it occurred over a four-month period).

46 *See, e.g., Sherwin Brown*, Advisers Act Release No. 3217, 2011 WL 2433279, at *6 (Jun. 17, 2011) (finding that "Brown's scienter is demonstrated by his conduct and his attempts to disguise his actions"); *Phillip J. Milligan*, Exchange Act Release No. 61790, 2010 WL 1143088, at *5 (Mar. 26, 2010) (stating that "attempts to conceal misconduct indicate scienter"); *Justin F. Ficken*, Exchange Act Release No. 58802, 2008 WL 4610345, at *3 (Oct. 17, 2008) (finding that concealment of improper trading demonstrated scienter).

47 Ludlum's brief claims that "the Division of Enforcement came up with two infractions that are factual[ly] correct," but he does not explain or provide any support for why or how the Division's other allegations of violations are incorrect. Appellant's Br. in Supp. of Pet. for Review at 1. Instead, Ludlum offers excuses, without any support, for the two violations that he admits he committed (claiming that the Division ordered him not to submit a Regulation D filing and that he "was advised by a representative of FINRA to register [with the Commission] at the Federal instead of state level"). *Id.* at 2. However, none of these excuses, even if true, eliminate Ludlum's underlying violations. Ludlum's brief also discusses a whistleblower report he allegedly filed against Bank of New York concerning supposed insider trading at the bank. He does not provide, nor can we find, any connection between this alleged report and Ludlum's misconduct that led to the injunction entered against him.

48 *See, e.g.*, Appellant's Br. in Supp. of Pet. for Review at 2 (asserting that, if the Commission overturns the law judge's decision, he would "continue to operate in a conscious and honorable fashion within this industry").

49 *See Lawton*, 2012 WL 6208750, at *12 (finding that Lawton's lack of remorse heightened the risk that he would cause future harm to the industry and thus supported imposition of an industry-wide bar); *Brown*, 2011 WL 2433279, at *7 (expressing "particular concern" with Brown's desire to remain in the securities industry and imposing a bar by noting, in part, that "Brown's continued participation in the industry would provide opportunity for further violations"); *see also Geiger v. SEC*, 363 F.3d 481, 489 (D.C. Cir. 2004) (noting that "the existence of a violation raises an inference that it will be repeated"); *Seghers*, 2007 WL 2790633, at *7 (noting that the securities industry "presents continual opportunities for dishonesty and abuse").

[G]uard."[50] Although Ludlum claims he will "continue to act under [the Citadel's honor] code,"[51] he offers no explanation about what behavior this honor code would preclude or how it might prevent future violations. Indeed, this honor code did not prevent Ludlum from repeatedly defrauding his clients and investors between 2006 and 2009. We therefore see no reason to expect that Ludlum's background would preclude future misconduct.

Ludlum also claims that he has "worked on Wall Street for over 20 years with a perfect record."[52] However, we have previously found that "lack of disciplinary history is not mitigating for purposes of sanctions because an associated person should not be rewarded for acting in accordance with his duties as a securities professional."[53] This is particularly true in cases like this, where the misconduct involves extended, egregious violations of the law.[54] We have also consistently found that antifraud violations like those committed by Ludlum are "'especially serious and [should be] subject to the severest sanctions.'"[55]

Given the scope and severity of Ludlum's misconduct, we believe that an appropriate sanction against him should include a bar from associating with any investment adviser, plus a bar from associating with any broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or NRSRO.[56] Ludlum's repeated and egregious misconduct evidences an unfitness to participate in the securities industry that goes beyond just the professional capacity in which

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50 Appellant's Br. in Supp. of Pet. for Review at 2.

51 *Id.*

52 *Id.*

53 *Philippe N. Keyes*, Exchange Act Release No. 54723, 2006 WL 3313843, at *6 (Nov. 8, 2006); *see also, e.g.*, *Milligan*, 2010 WL 1143088, at *5 (affirming an associational bar despite a previously clean record); *Marshall E. Melton*, Exchange Act Release No. 48228, 56 SEC 695, 2003 WL 21729839, at *7 (July 25, 2003) (affirming associational bar and noting that respondent's previously clean record did not outweigh his recurrent, egregious conduct).

54 *See Eric S. Butler*, Advisers Act Release No. 3262, 2011 WL 3792730, at *4 (Aug. 26, 2011) (finding repeated dishonesty towards customers reflected a lack of care or understanding of the law); *see also Geiger*, 363 F.3d at 489 ("As the Commission noted, Kirby still thinks he did nothing wrong, which casts doubts on his promise that he will mend his ways."); *Melton*, 2003 WL 21729839, at *7 (noting that extended egregious action warrants a bar in order to prevent possible future violations).

55 *Martin A. Armstrong*, Advisers Act Release No. 2926, 2009 WL 2972498 , at *3 (Sept. 17, 2009) (quoting *Jose P. Zollino*, Exchange Act Release No. 55107, 2007 WL 98919, at *5 (Jan. 16, 2007)); *accord Melton*, 2003 WL 21729839, at *9 (finding that a person who has been enjoined from violating the antifraud provisions "has especially serious implications for the public interest" and that "ordinarily, in the absence of evidence to the contrary," a bar is appropriate in such circumstances).

56 Although the Division did not appeal the law judge's decision against imposing a bar from association with any municipal advisor or NRSRO, and neither party addressed that issue on appeal, we determined, on our own initiative, to review the sanctions imposed in this case pursuant to Rule of Practice 411(d). *See supra* note 35.

Ludlum was acting when he engaged in the misconduct underlying these proceedings.[57] As we have concluded in similar situations, Ludlum's "willingness to violate his fiduciary duty to his clients is more than sufficient to demonstrate his unfitness to take on another role as a fiduciary,"[58] and municipal advisors, like investment advisers, are bound by fiduciary duties to their clients.[59] Furthermore, "[b]rokers, dealers, municipal securities dealers, and transfer agents routinely gain access to sensitive financial and investment information of investors and other market participants, and persons associated with municipal advisors and NRSROs routinely learn confidential and potentially market-moving information about securities, issuers, and potential transactions."[60] To gain access to such information, "securities professionals must take on heightened responsibilities to safeguard that information and to avoid temptations to fraudulently misuse their access for inappropriate—but potentially lucrative or self-serving—ends."[61] Ludlum's repeated abuse of his investors' and clients' trust and misuse of their funds for his own purposes demonstrate that he cannot be trusted with such heightened responsibilities.

B. Barring Ludlum from associating with a municipal advisor or NRSRO is not impermissibly retroactive.

The law judge's pre-*Lawton* ruling that barring Ludlum from associating with a municipal advisor or NRSRO would be impermissibly retroactive is erroneous for the reasons we explained in *Lawton.* The Dodd-Frank Act amended § 203(f) of the Advisers Act to authorize us to bar investment advisers from association with municipal advisors and NRSROs—bars that were not previously available under the securities laws. Although Congress enacted the Dodd-Frank amendment after Ludlum committed his misconduct, we held in *Lawton* that imposing bars from association with municipal advisors or NRSROs "are not impermissibly retroactive as applied in follow-on proceedings addressing pre-Dodd-Frank conduct because such bars are prospective remedies whose purpose is to protect the investing public from future harm."[62] Ludlum's conduct, as detailed above, "demonstrates that allowing him to enter the securities industry in *any capacity* would create too great a risk that future efforts to detect securities violations would be impaired, causing harm to the public."[63]

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57 *See, e.g.*, *Gary M. Kornman*, Exchange Act Release No. 59403, 2009 WL 367635, at *7 (Feb. 13, 2009) (noting that "the importance of honesty for a securities professional is so paramount that we have barred individuals even when the conviction was based on dishonest conduct unrelated to securities transactions or securities business" and citing cases).

58 *Lawton*, 2012 WL 6208750, at *11.

59 Dodd-Frank Act § 975(c), 124 Stat. at 1851; *see also Lawton*, 2012 WL 6208750, at *11.

60 *Lawton*, 2012 WL 6208750, at *11.

61 *Id.*

62 *Id.* at *10.

63 *Id.* at *12 (emphasis in original) (imposing bar in a follow-on proceeding against investment adviser from association with any investment adviser, broker, dealer, municipal securities dealer, transfer agent, municipal advisor, or NRSRO).

C. Ludlum's procedural objections have no merit.

In his petition for review, Ludlum argues, without further explanation, that he has not "yet been able to present the facts for this proceeding."[64] This presumably refers to the law judge's granting the Division's motion for summary disposition, which our Rules of Practice allow an ALJ to do "if there is no genuine issue with regard to any material fact."[65] Ludlum, however, signed a consent that specifically precludes him from contesting in this disciplinary proceeding the allegations in the complaint in the underlying civil injunction action.[66] That agreement is consistent with our repeated holdings that a party may not collaterally attack the factual allegations in a complaint brought by the Commission when, as here, the party consents to the entry of an injunction based on such allegations.[67] Moreover, Ludlum fails to identify, or even allege, any facts or circumstances that might create a genuine issue concerning the two dispositive findings relevant under § 203(f): (i) that Ludlum was associated with an investment adviser at the time of his conduct and (ii) that Ludlum was enjoined from violating the securities laws.[68] Because Ludlum cannot challenge the underlying judgment in these proceedings and he has not offered evidence of circumstances that might mitigate the seriousness of his conduct,[69] we find no error in the law judge's decision to proceed by summary disposition.[70]

Ludlum also contends in his brief, without further explanation, that the Division "went on a character defamation campaign to embolden their agenda."[71] As with his other claims, Ludlum offered no support, or even an explanation, for this claim, nor can we find any evidence relevant to such a claim in the record. To the extent that Ludlum is alleging that the Division engaged in selective prosecution, we note that he must "demonstrate not only that he was unfairly singled out, but that his prosecution was motivated by improper considerations such as race, religion, or

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64 Pet. for Review at 1.

65 17 C.F.R. § 201.250.

66 *See supra* note 28 and accompanying text.

67 *See, e.g., Schield Mgmt. Co.*, 2006 WL 231642, at *6 (precluding respondents from disputing allegations in injunctive complaint after consenting to entry of injunction); *see also Kornman*, 2009 WL 367635, at *8 (finding criminal conviction based on guilty plea has collateral estoppel effect precluding relitigation of issues in Commission proceedings); 17 C.F.R. § 202.5(e) (stating that respondent who consents to judgment may not deny allegations of the complaint).

68 *See supra* note 47 (discussing Ludlum's arguments on appeal regarding the Division's allegations).

69 *Cf. Schield Mgmt.*, 2006 WL 231642, at *6 (noting that "a respondent in a 'follow-on' proceeding may introduce evidence regarding the 'circumstances surrounding' the conduct [at issue] as a means of addressing 'whether sanctions should be imposed in the public interest'" (quoting *Blinder, Robinson & Co. v. SEC*, 837 F.2d 1099, 1109 (D.C. Cir. 1988)).

70 *Butler*, 2011 WL 3792730, at *5 (imposing a bar and noting that "we have long held that follow-on proceedings based on a criminal conviction are not an appropriate forum to 'revisit the factual basis for,' or legal defenses to, the conviction" (quoting *Zollino*, 2007 WL 98919, at *4)).

71 Appellants' Br. in Supp. of Pet. for Review at 1.

the desire to prevent the exercise of a constitutionally-protected right."[72] Ludlum has not alleged any facts, nor can we find any, that even suggest he was singled out or that his prosecution was motivated by such considerations.

Ludlum defrauded investors out of approximately $852,000 over an extended period, took steps to conceal that fraud, and provided inaccurate and incomplete documents and testimony to the Commission. Ludlum's misrepresentations to investors and Commission staff and his refusal to recognize the wrongfulness of his actions displays a fundamental misunderstanding or lack of regard for his responsibilities toward his clients and weighs strongly in favor of our conclusion that imposing a bar will protect the investing public from the likelihood that Ludlum will commit future violations of the federal securities laws.[73] A bar will also "'have the salutary effect of deterring others from engaging in the same serious misconduct.'"[74] We therefore find that barring Ludlum from association with any investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or NRSRO serves the public interest and is remedial.

An appropriate order will issue.[75]

By the Commission (Chair WHITE and Commissioners WALTER and AGUILAR); Commissioners PAREDES and GALLAGHER, concurring in part and dissenting with respect to the bar from association with municipal advisors and nationally recognized statistical rating organizations.

Jill M. Peterson

Elizabeth M. Murphy
Secretary

By: Jill M. Peterson
Assistant Secretary

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[72] *Richard J. Puccio*, Securities Act Release No. 37849, 1996 WL 603681, at *4 (Oct. 22, 1996).

[73] *Scott B. Gann*, Exchange Act Release No. 2684, 2009 WL 938033, at *6 (Apr. 8, 2009) (noting that a refusal to recognize wrongful conduct reveals "a fundamental misunderstanding of the duties of a securities industry professional that presents a significant likelihood that he will commit similar violations in the future").

[74] *Andrew P. Gonchar*, Exchange Act Release No. 60506, 2009 WL 2488067, at *13 (Aug. 14, 2009) (quoting *Dennis Todd Lloyd Gordon*, Exchange Act Release No. 57655, 2008 WL 1697151, at *13 (April 11, 2008)) (upholding NASD disciplinary action barring securities representatives from the industry for interposing a third party between member firm and customers and charging customers undisclosed, excessive markups), *petition denied*, 409 F. App'x 396 (2d Cir. 2010).

[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

INVESTMENT ADVISERS ACT OF 1940
Release No. 3628 / July 11, 2013

Admin. Proc. File No. 3-14572

In the Matter of

ALFRED CLAY LUDLUM, III
P.O. Box 3924
Wilmington, DE 19807

ORDER IMPOSING REMEDIAL SANCTIONS

On the basis of the Commission's Opinion issued this day, it is

ORDERED that Alfred Clay Ludlum, III, be, and he hereby is, barred from association with any investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES ACT OF 1933
Rel. No. 9417 / July 12, 2013

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 69982 / July 12, 2013

Admin. Proc. File No. 3-14266

In the Matter of

JOHNNY CLIFTON
c/o Pace & Pace, LLP
Meadows Building, Suite 940
5646 Milton Street
Dallas, TX 75206

OPINION OF THE COMMISSION

BROKER-DEALER PROCEEDING

CEASE-AND-DESIST PROCEEDING

Grounds for Remedial Action

Fraud in the Offer and Sale of Securities

Failure to Supervise

Respondent, who was president, chief executive officer, and principal of a former registered broker-dealer, made material misrepresentations and omissions in the offer and sale of oil-and-gas limited partnership interests, and failed reasonably to supervise at least one registered representative with a view towards preventing his securities law violations. *Held*, it is in the public interest to: (i) bar respondent from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; (ii) enter a cease-and-desist order; and (iii) assess a third-tier civil money penalty.

APPEARANCES:

Jonathan Pace and *William Pace*, of Pace & Pace, LLP, for Johnny Clifton.

Toby M. Galloway and *D. Dee Raibourn III*, for the Division of Enforcement.

Appeal filed: December 29, 2011
Last brief received: March 6, 2012

I.

Johnny Glen Clifton, who was the president, chief executive officer, and principal of MPG Financial, LLC, a former Commission-registered broker-dealer, appeals from an administrative law judge's initial decision.[1] The law judge found that from 2009 to 2010 Clifton willfully violated §§ 17(a)(1), 17(a)(2), and 17(a)(3) of the Securities Act of 1933[2] by engaging in fraud in connection with the offer and sale of oil-and-gas limited partnership (LP) interests. The law judge also found that Clifton violated § 15(b) of the Securities Exchange Act of 1934[3] by failing reasonably to supervise MPG Financial sales representatives with a view towards detecting and preventing their securities law violations. For this violative conduct, the law judge (i) barred Clifton from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent, but not from association with any municipal advisor or nationally recognized statistical rating organization (NRSRO); (ii) entered a cease-and-desist order; and (iii) assessed a single third-tier civil money penalty of $130,000.

We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal. We find that Clifton violated Securities Act §§ 17(a)(1), 17(a)(2), and 17(a)(3) because he made material misrepresentations and omissions in the offer and sale of LP interests and, through those misrepresentations and omissions and other misconduct, engaged in a fraudulent scheme and course of business that operated as a fraud on prospective investors.[4] We further find that Clifton failed reasonably to supervise at least one MPG Financial sales representative[5] with a view towards detecting and preventing his Securities Act violations. Consistent with our recently issued decision in *John W. Lawton*,[6] we conclude that it is in the public interest on the facts of this case to impose a full collateral bar on Clifton, in addition to a cease-and-desist order and a third-tier civil money penalty. We have increased the amount of the civil money penalty from $130,000 to $150,000 to reflect the statutory maximum that may be assessed against an individual for one third-tier violation occurring during the relevant period.[7]

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[1] *Johnny Clifton*, Initial Decision Rel. No. 443, 2011 WL 7444649 (Nov. 29, 2011).

[2] 15 U.S.C. §§ 77q(a)(1), 77q(s)(2), 77q(a)(3)..

[3] *Id.*, § 78o(b).

[4] The Order Instituting Proceedings charged Clifton with making or, in the alternative, causing material misrepresentations and omissions in the offer and sale of LP interests, in violation of Securities Act §§ 17(a)(1), 17(a)(2), and 17(a)(3). *See Johnny Clifton*, Securities Exchange Act Rel. No. 63926, 2011 WL 553587, at *3 (Paragraphs 14 and 18 of OIP) (Feb. 17, 2011). In light of our finding that Clifton committed primary violations of Securities Act § 17(a), we do not address his liability for causing material misrepresentations and omissions.

[5] Because the registered representative was not named as a respondent in this proceeding, we refer to that representative throughout this opinion as "Registered Representative No. 1."

[6] Investment Advisers Act Rel. No. 3513, 2012 WL 6208750, at *10-13 (Dec. 13, 2012).

[7] *See* 17 C.F.R. § 201.1004 (adjusted maximum penalty amounts for violations occurring after March 3, 2009).

II.

A. Clifton

Clifton entered the securities industry in May 1990. Over the ensuing years, he obtained several securities licenses, including supervisory licenses.[8] Before April 2009, Clifton worked in the financial services industry, primarily in the insurance business. From April 2009 to April 2010, he was the president, chief executive officer, and principal of MPG Financial, a registered broker-dealer located in Richardson, Texas.[9] MPG Financial was owned by, and shared office space with, Managed Petroleum Group, Inc., a Texas corporation engaged in the oil-and-gas exploration business.[10]

In August 2007, FINRA censured and fined Clifton $7,500 for publishing a securities-related website without prior approval.[11] As part of the settlement, Clifton consented to findings that his website "contained unfair, unbalanced, misleading and exaggerated statements; and utilized testimonials without making required disclosures."[12]

B. MPG Financial offered and sold LP interests in a six-well oil-and-gas drilling project.

Most of the facts are not in dispute.[13] Prior to April 2009, MPG Financial, on behalf of Managed Petroleum, began offering LP interests in a six-well oil-and-gas drilling project in Osage County, Oklahoma.[14] Specifically, the broker-dealer offered fifteen units at $71,250 each, for a total offering of $1,068,750. According to the Osage project's private placement memorandum

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[8] His securities licenses included Series 6, 7, 24, 26, 27, 63, 65, and 66 licenses.

[9] MPG Financial filed a Form BD withdrawing its registration on December 31, 2010. *See* http://brokercheck.finra.org/Support/ReportViewer.aspx?SearchGroup=Firm&FirmKey=146670&BrokerKey=-1.

[10] Managed Petroleum is not registered with the Commission in any capacity and has no securities registered with the Commission.

[11] Letter of Acceptance, Waiver and Consent No. 2005002947301: Re: Johnny Glen Clifton (Aug. 8, 2007). *See* FINRA Rule 9216(a). AWCs are the means through which many FINRA disciplinary actions are settled prior to the filing of a complaint. *Notice of Filing of a Proposed Rule Change by the NASD, Inc. to Proposed Changes in the By-Laws of the NASD, NASD Reg., Inc., the NASDAQ Stock Mkt., Inc., the Plan of Alloc. and Deleg. of Functions by the NASD to Subs., Membership Application Procedures, Discip. Proceedings, Other Proceedings, and Other Conforming Changes*, Exchange Act Rel. No. 38545, 1997 WL 211525, at *38 (Apr. 24, 1997) (Part 1 of 6).

[12] Letter of Acceptance, Waiver and Consent No. 2005002947301, at 3. Although Clifton neither admitted nor denied FINRA's findings for purposes of the AWC, he specifically agreed that the "AWC will become part of [his] permanent disciplinary record and may be considered in any future actions brought by [FINRA] or any other regulator against him." *Id.* at 2. In addition, Clifton testified during the hearing that the website did, in fact, contain unfair, unbalanced, misleading, and exaggerated statements.

[13] In his petition for review, Clifton "admitted he made omissions and misrepresentations of material fact" during a December 23, 2009 conference call; admitted that "[t]he Division's Exhibits show a number of emails from two brokers [under his supervision] that are misleading and omit material facts"; and "admitted he did not follow the procedures instituted for supervision of the brokers." Pet. for Review at 1, 2.

[14] The six wells, in the order drilled, were Osage 1-5, Osage 1-1, Osage 1-4, Osage 1-6, Osage 1-2, and Osage 1-3.

(PPM) dated April 15, 2009, the minimum investment was one-half a unit, or $35,625, although investments for as little as one-eighth a unit, or $8,906, were accepted. In total, MPG Financial raised approximately $500,000 from twenty-two retail investors by the time the offering closed at the end of 2009. In February 2010, Managed Petroleum notified investors that it was shutting down the project and refunded twenty-five percent of their principal.

C. Project developments

Managed Petroleum began drilling on the Osage project using seed money provided by industry partners.[15] Drilling on the first well, Osage 1-5, was completed in early April 2009. Well testing data showed an initial production of twenty to thirty barrels of oil per day (BOPD), but after completion actual oil production was only one to five BOPD due to excess salt water in the well. This meant that the well was not commercially viable because the salt water had to be transported approximately seventy-five miles to a salt water disposal well (SWDW) at substantial additional cost.

Drilling on the second well, Osage 1-1, began in May 2009 and was completed in June 2009. Well testing data showed some potential to produce gas, but it turned out that Osage 1-1, like Osage 1-5, produced too much salt water to be commercially viable. Managed Petroleum decided to convert Osage 1-1 into an SWDW to eliminate water transportation costs for Osage 1-5 and nearby wells. Because obtaining a permit to convert Osage 1-1 into an SWDW would take several months, in August 2009, Managed Petroleum decided to "shut in," or turn off, Osage 1-5 until it could secure the conversion permit. Ultimately, Osage 1-5 was never reopened, and Managed Petroleum never obtained an SWDW permit for Osage 1-1.

In early October 2009, Managed Petroleum's president, Brian Anderson, attended a meeting at MPG Financial at which Clifton and MPG Financial's sales representatives were present.[16] Anderson updated the sales representatives on the Osage project's status, informing them that the first well had been drilled and was "shut in," the second well would be converted into an SWDW, and drilling on the third well would begin in the "next few months."[17] Anderson testified that no one at MPG Financial was "surprised or alarmed" by this news.[18]

Managed Petroleum did not drill again until December 2009. Drilling on the third well, Osage 1-4, began on December 17, 2009. On December 20, Managed Petroleum asked the geologists to evaluate Osage 1-4's oil production potential because it was not showing promising results. That same day, Managed Petroleum decided to temporarily suspend drilling on the fourth

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[15] The PPM defined "industry partner" as "[a] person who shall own a portion of the Working Interest in the Lease outside of the Partnership." Div. Ex. 4 at 000179. Managed Petroleum raised $1.4 million from industry partners. No LP interest was sold until at least June 8, 2009, after the first two wells had been drilled.

[16] In his brief on appeal, Clifton stated that all of the sales representatives were present at this meeting.

[17] Tr. 261.

[18] *Id.*

well, Osage 1-6, because of its close proximity to Osage 1-4, pending the geologists' evaluation. On December 28, 2009, Clifton learned from Anderson that Osage 1-4 was unproductive—a "dry hole"—and would be plugged and abandoned. Drilling on Osage 1-6 did not resume.

Drilling on the fifth and sixth wells, Osage 1-2 and Osage 1-3, began in January 2010 and was finished that same month. Both wells were deemed to be dry holes and not commercially viable; they were plugged and abandoned. The Osage project was shut down in February 2010.

D. Clifton's timeline

Clifton stipulated that Managed Petroleum timely informed him of all project developments.

On March 1, 2010, Clifton prepared a timeline for Commission staff that set forth when he received information about the Osage project and from whom.[19] Its contents are as follows:

Date	Event
April 20, 2009	Clifton learned from Anderson that Osage 1-5 had been drilled and that geologists believed it could produce between twenty-seven and twenty-nine BOPD.
June 1, 2009	Clifton learned from Anderson that Osage 1-1 was drilled.
June 8, 2009	Clifton learned from Anderson that Osage 1-5 was having mechanical difficulties and producing at a "very low rate of 1-4 BOPD."
August 2, 2009	Clifton learned from Anderson that Osage 1-1 was not commercially viable as an oil-and-gas well and would be converted into an SWDW.
August 24, 2009	Clifton learned from Anderson that Osage 1-5 would be "shut in" pending the SWDW permit for Osage 1-1.
December 16, 2009	Clifton learned from Anderson that drilling on Osage 1-4 would begin on December 19, 2009.
December 28, 2009	Clifton learned from Anderson that the geologists confirmed that Osage 1-4 was not commercially viable as an oil-and-gas well and would be plugged and abandoned.[20]
February 1, 2010	Clifton learned from Anderson that Osage 1-2 and Osage 1-3 were dry holes and that there was "little hope" that Osage 1-6 would be viable.

[19] Div. Ex. 11. In a notation at the bottom of the timeline, Clifton wrote that he could not say "with certainty" that the dates and times within it were "exactly correct" and that they could be relied upon "only as estimates to the best of [his] recollection." *Id.* at 2.

[20] Although Clifton's timeline indicated that he received Anderson's call in the afternoon of December 28, 2009, Clifton testified at the hearing that he believed he received the call while driving to work in the morning, before 9:00 a.m. Clifton's testimony was corroborated by Anderson's testimony that he called Clifton before lunch and by MPG Financial sales representative Steve Allen's testimony that Clifton told him that MPG Financial received notice of the dry hole that morning.

Date	Event
February 4, 2010	Clifton received a copy of a letter to be sent to investors informing them that the Osage project would be shut down and they would be refunded a percentage of their investment.

E. Clifton's misrepresentations and omissions and other misconduct

On December 23, 2009, Clifton conducted a twenty-minute conference call for investors and prospective investors in the Osage project. As few as two, and as many as four, investors or prospective investors listened in. The call was recorded by MPG Financial, and no questions were allowed. During the call, Clifton omitted material information relating to the status of Osage 1-5 and Osage 1-1, and the information he provided concerning the six wells and potential pay zones was inaccurate.[21] Additionally, Clifton made several misrepresentations about the overall status of the project.

Clifton admitted during the hearing that by December 23, 2009, he knew that three of the six wells had been drilled; that the first well, Osage 1-5, had been "shut in"; that the second well, Osage 1-1, was going to be converted into an SWDW if a permit could be obtained; that the commercial viability of the third well, Osage 1-4, was uncertain; and that none of the wells was then producing any oil. He admitted that all of these facts were material to investors.[22] Nevertheless, he admitted that he did not disclose any of these facts during the call.

Clifton suggested during the call that drilling on the Osage project had not yet begun. He told those listening in that the Osage project was a new, "year-end" project when, in fact, drilling had already begun and the offering was soon to end.[23] He further told investors that he and others at the firm were "putting [their own] money in this deal" when, contrary to his representation, they did not have "skin in the game."[24]

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[21] "Pay zone" refers to each of the ten different depths of a well at which oil could be present. For the Osage project, with six wells, there were a total of sixty potential pay zones.

[22] Tr. 42, 63-64, 154-55. In *Matrixx Initiatives, Inc. v. Siracusano*, the Supreme Court stated that the materiality requirement is satisfied when there is "'a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.'" 131 S. Ct. 1309, 1318 (2011) (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988)).

[23] Clifton said, "We've got a *year-end* project that we're excited about." Div. Ex. 54 at 3 (emphasis added). At another point, he said, "[W]e've decided to put together here *at the end of the year* a six-well package located in Northeast Oklahoma in Osage County." *Id.* at 4 (emphasis added).

[24] Clifton said, "[Y]ou got to understand, we're putting our money in this deal, too. So, you know, we make money, our investors make money, and everyone's happy." *Id.* at 6. He also said, "[W]e have our own money involved in the deal." *Id.* at 15. At the hearing, Clifton explained that "[t]he point of saying that was to let the investors know that [MPG Financial sales representatives] also have skin in the game," *i.e.*, they invested their own personal funds in the project. Tr. 147.

Clifton misrepresented the production potential of the six wells, touting oil figures that were based on six producing wells when, in fact, the decision to convert Osage 1-1 into an SWDW left, at most, five potentially producing wells, and Osage 1-5 had been "shut in." He stated, "with six wells, that's . . . 60 opportunities that we have to . . . hit on this particular project."[25] He also stated, "each one of these wells can generate 10, 15, 20 barrels a day."[26] Clifton conceded in testimony that, in addition to omitting information relating to the status of Osage 1-5 and Osage 1-1, he did not communicate the uncertainty of Osage 1-4's viability as a commercial well.

Clifton also participated in misleading other prospective investors in the Osage project. At approximately 11:46 a.m. on December 28, 2009, Clifton e-mailed a hyperlink to the recording of the December 23 call to an MPG Financial sales representative who wanted to send it to other prospective investors. After that date, MPG Financial completed the transfer of funds from three or four additional investors who had submitted subscription paperwork pursuant to the PPM, without disclosing to those investors that, among other things, Osage 1-4 was a dry hole. In the last few days of December 2009, Clifton advised Registered Representative No. 1 that the Osage project was the "best deal" MPG Financial was offering and a "good place" for customers to invest money.[27] Based on Clifton's advice and encouragement, Registered Representative No. 1 had his customer, Nelson Wheeler, invest in the Osage project.

F. Registered Representative No. 1's misrepresentations and omissions

Registered Representative No. 1 was hired by Clifton in June or July 2009 and worked at MPG Financial as a sales representative until he resigned in July 2010.[28] In sworn investigative testimony, Registered Representative No. 1 stated that he learned in July 2009 that the first well, Osage 1-5, had been "shut in." At the hearing, however, Registered Representative No. 1 contradicted his sworn investigative testimony and stated that he did not learn about Osage 1-5's "shut in" status until February 2010.[29] He also testified at the hearing that he learned sometime between June and August 2009 that the second well, Osage 1-1, would be converted into an SWDW.

In e-mails to prospective investors between August and December 2009, Registered Representative No. 1: failed to disclose that Osage 1-5 had been "shut in" or that Osage 1-1 would be converted into an SWDW; misrepresented Osage 1-5's oil production rate as between 22 and 25

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25 Div. Ex. 54 at 4-5. *See also supra* note 21. In his hearing testimony, Clifton admitted that, for sixty pay zones to be true, all six wells would have to "hit" on all ten pay zones, and up until that point, there was no production from the first three wells. Div. Ex. 54 at 4-5.

26 *Id.* at 8-9.

27 *Id.*

28 A search of FINRA's BrokerCheck indicates that Registered Representative No. 1 is not currently registered with FINRA.

29 As previously discussed, Managed Petroleum's Anderson testified that MPG Financial sales representatives knew in early October 2009 that Osage 1-5 had been "shut in." *See supra* notes 16-18 and accompanying text.

BOPD when it actually was one to five BOPD;[30] falsely stated that drilling on the first two wells had been "complete[d] and [was] successful";[31] and misrepresented potential investment returns by basing his projections on the production of six wells when the decision to convert Osage 1-1 into an SWDW left, at most, five potentially producing wells. Registered Representative No. 1 testified that when he sent these e-mails he believed them to be accurate and truthful based on information received from Clifton and others.[32] But he also admitted that he left out material facts and that he could have been more careful with the content of his e-mails. MPG Financial's chief compliance officer ("CCO") Brad Simmons testified that when, in February 2010, he confronted Registered Representative No. 1 about his e-mails, particularly those sent in December 2009, Registered Representative No. 1 told Simmons that he knew that the information contained in those e-mails was wrong.[33]

In early December 2009, Registered Representative No. 1 contacted Tony Caudill, a part owner and president of a family-owned aerospace machine shop located in Grove, Oklahoma, about investing money in the Osage project. Caudill testified that Registered Representative No. 1 did not inform him that drilling had already begun or that Osage 1-5 had been "shut in"; instead, Registered Representative No. 1 led him to believe that none of the wells had been drilled. Caudill invested $14,000 in the Osage project on December 3, 2009. His investment resulted in a loss of about $12,000 by the time the project closed.[34]

G. Supervision of the sales representatives

MPG Financial had written supervisory procedures (WSPs) in place when Clifton was hired. Clifton testified that he received a copy and was familiar with them. CCO Simmons updated the WSPs in October 2009, and associated persons signed statements that they had received, read,

30 For example, in an e-mail sent on December 28, 2009, Registered Representative No. 1 wrote that the "1st well of the six came in @ 22 bopd." Div. Ex. 25. In another e-mail sent on December 29, 2009, he wrote that the "1st well of the six well project has initial production of 22-25 bopd." Div. Ex. 27.

31 Div. Exs. 21, 22. E-mails sent during this period by another MPG Financial registered representative (hereinafter "Registered Representative No. 2") also contained misrepresentations and omissions regarding the Osage project and status of the wells. Though subpoenaed by Clifton's counsel, Registered Representative No. 2 did not appear at the hearing.

32 Indeed, in an e-mail sent on December 28, 2009, Registered Representative No. 1 emphasized that there were "6 wells—10 pay zones EACH!!" Div. Ex. 25. This statement mimicked a similar statement that Clifton made during the December 23, 2009 conference call. Registered Representative No. 1 testified that he listened to Clifton's December 23 conference call while it was taking place.

33 When asked by Division staff on direct examination, "What do you think your mistake was, if any, in sending out e-mail," Registered Representative No. 1 replied, "By making sure—if I had to do it again, to make sure that everything I received from the parties. . . you know, from Johnny Clifton, from my supervisors, . . . was in writing and handed to me." Tr. 436.

34 Other than Caudill, only one other Osage project investor testified in this proceeding. Investor Melinda Mulcare testified that she and her brother jointly invested $17,000 based on misrepresentations and omissions made by a third MPG Financial registered representative (hereinafter "Registered Representative No. 3). Mulcare testified that she and her brother received a refund of only $4,000 of their principal after the project closed.

and understood the updated procedures. The WSPs assigned responsibility for supervising sales representatives to Clifton and for supervising "persons not involved in sales" to Simmons.[35]

1. Outgoing written and electronic correspondence

The WSPs specified that Clifton review and approve all outgoing written and electronic correspondence of the sales representatives because he was their designated supervisor. Clifton testified that MPG Financial's unwritten policy required random review of e-mail to ensure that correspondence sent by the sales representatives was truthful and not exaggerated.[36] Clifton drafted sample e-mails that the sales representatives could send without his pre-approval. The sales representatives sent approximately fifteen to twenty such e-mails each day. The sales representatives sent another five to twenty e-mails each day that required Clifton's pre-approval. The WSPs required the firm to retain records of the sales representatives' outgoing written and electronic correspondence.

Before Simmons joined MPG Financial, e-mails went directly into Clifton's in-box for review. Thereafter, Simmons implemented a new e-mail system that archived all outgoing e-mails in a central in-box to which both he and Clifton had access. Simmons also recommended a system to ensure that unapproved e-mails were not sent, but Clifton never implemented such a system because of its cost.

Although the WSPs specified that Clifton was responsible for reviewing and approving e-mails sent by the sales representatives, Clifton testified that he delegated to Simmons, as CCO and creator of the e-mail archive system, primary responsibility for reviewing e-mails sent by the sales representatives. But Simmons testified that Clifton was responsible for reviewing and approving those e-mails because Simmons worked part-time and Clifton "didn't feel that it was feasible" for Simmons "to be doing reviews and approvals."[37] Simmons testified that he only conducted keyword searches of e-mails that had already been sent.

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[35] Div. Ex. 46 at 8.

[36] The WSPs stated:

> All communication must be truthful and balanced. Items to consider when preparing and reviewing outgoing correspondence include: truthfulness; exaggerated, unwarranted, or misleading statements or claims are prohibited; promises or guarantees: past performance may not be used to promise, guarantee, or imply future profits or income from securities; projections and predictions are not permitted; tax advice must not be provided; the customer should be referred to the Private Placement Memorandum or his or her tax adviser for such issues; [and] photocopying and distributing copyrighted material may violate copyright laws.

Id. at 14.

[37] Tr. 320.

The Division adduced considerable documentary evidence showing that e-mails sent by Registered Representative No. 1 and Registered Representative No. 2[38] provided prospective investors with misleading information. As discussed, among other things, those e-mails misrepresented Osage 1-5's actual oil production rate, falsely stated that Osage 1-1 was producing "oil and gas,"[39] and falsely stated that drilling on Osage 1-5 and Osage 1-1 had been "complete[d] and [was] successful."[40] In his petition for review, Clifton referred to Registered Representative No. 1 and Registered Representative No. 2 as "rogue" brokers.[41] But Registered Representative No. 1 and Registered Representative No. 2 were supervised by Clifton, and Clifton admitted that he did not review their e-mails to prospective investors.

2. Project updates

Shortly after joining MPG Financial, Clifton established a "flow of information" system pursuant to which information about the Osage project was to flow from MPG Financial project manager Laura Elwell to Anderson, from Anderson to Clifton, and from Clifton to the sales representatives. Clifton updated the sales representatives about the Osage project during weekly meetings. His updates were oral, and he did not provide the sales representatives with any written materials, apart from the PPM. Although he instructed the sales representatives to use the PPM and the information he provided orally to market the Osage project, Clifton admitted that the PPM was not updated to reflect the drilling activities, negative developments, or status of individual wells.

Testimony established that Clifton did not always provide complete or timely information to sales representatives and at times sought to conceal information from them. On December 28, 2009, for instance, Allen learned from a customer that Osage 1-4 had been drilled and was a dry hole. Allen testified that Clifton asked him not to tell other sales representatives about it. Clifton corroborated Allen's testimony but claimed that he told Allen not to disclose the dry hole because Allen was "negative" and Clifton wanted to deliver the information himself.[42]

In January 2010, Registered Representative No. 3, not Clifton, told Allen that Osage 1-2 and Osage 1-3 were dry holes. Upon receiving this information, Allen approached Clifton, who indicated that he had not heard anything about the status of Osage 1-2 and Osage 1-3. Later that day, Clifton stopped by Allen's office, admitted that Osage 1-2 and Osage 1-3 were dry holes, and asked him and Registered Representative No. 3 not to share the updated information with the other sales representatives.

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[38] *See supra* note 31.

[39] Div. Ex. 19.

[40] Div. Exs. 21, 22.

[41] Pet. for Review at 2.

[42] Tr. 491-92.

issued an initial decision finding that Clifton committed the securities law violations alleged in the OIP and imposing sanctions.[50]

III.

A. **Securities Act § 17(a) violations**

Under Securities Act § 17(a), it is

> unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud; or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.[51]

1. **The LP interests were "securities" under the *Howey* test.**

As an initial matter, there is no dispute that the LP interests in the Osage project were "securities." Section 2(a)(1) of the Securities Act[52] and § 3(a)(10) of the Exchange Act[53] define the term "security" to include an "investment contract." In *SEC v. W.J. Howey Co.*,[54] the Supreme Court defined an "investment contract" as "a contract, transaction, or scheme whereby a person invests his or her money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[55] The evidence establishes that MPG Financial, on behalf of

50 *Clifton*, 2011 WL 7444649.

51 15 U.S.C. § 77q(a).

52 15 U.S.C. § 77b(a)(1).

53 *Id.*, § 78c(a)(10).

54 328 U.S. 293 (1946).

55 *Id.* at 298-99. The law judge ruled that a common enterprise was present because investors' funds were pooled. *Clifton*, 2011 WL 7444649, at *11; *see generally* THOMAS HAZEN, LAW OF SECURITIES REGULATION § 1.6[2][B] (6th ed. 2009) (stating that "[a] pooling of interests among more than one investor is the clearest example of a common enterprise"), *available at* Westlaw LAWSECREG. While we agree with the law judge's finding, we have held that a common enterprise is not a distinct requirement under *Howey*. *See Anthony H. Barkate*, Exchange Act Rel. No. 49542, 57 SEC 488, 2004 WL 762434, at *3 n.13 (Apr. 8, 2004), *aff'd*, 125 F. App'x 892 (9th Cir. 2005); *Joseph Abbondante*, Exchange Act Rel. No. 53066, 58 SEC 1082, 2006 WL 42393, at *6 n.40 (Jan. 6, 2006), *aff'd*, 209 F. App'x 6 (2d Cir. 2006). In any event, Clifton does not dispute the existence of a common enterprise here.

Managed Petroleum, sold investors LP interests in the Osage project, and investors expected their financial returns to come through the managerial efforts of Managed Petroleum and others, and not through their own participation. Accordingly, we conclude that the LP interests were "investment contracts" and therefore "securities" under § 17(a).

2. Clifton used means and instrumentalities of interstate commerce in offering the LP interests.

The jurisdictional requirements of § 17(a) are interpreted broadly, so as to be satisfied by intrastate telephone calls and ancillary mailings.[56] There is no dispute that the jurisdictional requirements have been satisfied in this proceeding. Clifton and MPG Financial sales representatives communicated with prospective investors by written and electronic correspondence and by telephone to offer and sell LP interests in the Osage project.

3. Clifton's conduct violated Securities Act § 17(a)(2).

To establish a claim under § 17(a)(2), the staff was also required to show that Clifton (i) directly or indirectly (ii) obtained money or property (iii) by means of any untrue statement of material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.[57] Scienter is not an element of the offense; a showing of negligence is sufficient.[58] The evidence establishes that Clifton committed primary violations of § 17(a)(2) by making material misrepresentations and materially misleading omissions to prospective investors in selling and offering to sell LP interests, earning commissions on the sales.

Clifton admitted that he personally made misrepresentations during the December 23, 2009 conference call.[59] He misled prospective investors into believing that the Osage project was a new, "year-end" project when, in fact, he knew that the project had been underway for eight months.[60] He falsely claimed that "we're putting our money in this deal" so they would believe that he and others at MPG Financial were personally invested in the success of the project.[61] He overstated the production potential of the Osage project by claiming that there were six producing wells, each with ten pay zones, for a purported "60 opportunities" to "hit" oil when he knew that there were, at best, five viable wells, even including Osage 1-5, which had been "shut in" since August 2009.[62]

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[56] *SEC v. Softpoint, Inc.*, 958 F.Supp. 846, 865 (S.D.N.Y. 1997), *aff'd*, 159 F.3d 1348 (2d Cir. 1998).

[57] 15 U.S.C. § 77q(a)(2); *Aaron v. SEC*, 446 U.S. 680, 696 (1980). *See generally* 3 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 12.22 (5th ed. 2005) (discussing the elements).

[58] *Aaron*, 446 U.S. at 697, 701-02.

[59] *See supra* note 13.

[60] *See supra* note 23 and accompanying text.

[61] *See supra* note 24 and accompanying text.

[62] *See supra* note 25 and accompanying text.

Clifton also admitted that he failed to disclose critical information during the December 23, 2009 conference call. He knew that three of the six wells had already been drilled. He knew that the first well, Osage 1-5, had been "shut in" since August 2009. He knew that the second well, Osage 1-1, was going to be converted into an SWDW if a permit could be obtained. He knew that the commercial viability of the third well, Osage 1-4, was uncertain. He knew that drilling on the fourth well, Osage 1-6, had been suspended. And he knew that the Osage project was not then producing any oil. But Clifton did not disclose this information during the conference call. Furthermore, after learning that the third well, Osage 1-4, was a dry hole on December 28, he accepted funds from three or four investors without disclosing this negative development to them.

Each of Clifton's misrepresentations and omissions was material. The test for materiality is whether a reasonable investor would have considered the information important in deciding to invest.[63] There can be no doubt that information about the development of the Osage project, the status of individual wells, and their oil production capacity was the type of information that a reasonable investor would consider important in deciding whether to invest in an oil-and-gas drilling project.

Clifton compounded these misrepresentations and omissions in the remaining days of December 2009 when he forwarded a hyperlink of the December 23, 2009 conference call for distribution to prospective investors, without correcting or updating any of the information discussed during the call. He further advised that Registered Representative No. 1 should have Wheeler invest in the Osage project, affirming that it was a "good place" for an investment, without discussing the fact that the third well, Osage 1-4, was a dry hole.[64]

Clifton directly or indirectly obtained money by means of his material misstatements and omissions. After learning on December 28, 2009 that the third well, Osage 1-4, was a dry hole, Clifton, through MPG Financial, accepted funds from three or four investors who had submitted subscription paperwork, pursuant to the terms of the PPM, without disclosing this negative development to them. In addition, he earned an "override" of around 3.75 percent of the commissions generated by MPG Financial sales representatives on the sales of LP interests,[65] or $18,750, based on approximately $500,000 worth of units sold. As a result, each sale of a unit or fraction of a unit resulted in money paid to Clifton.

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63 *See supra* note 22.

64 Tr. 440.

65 *Id.* at 477.

4. Clifton's conduct also violated Securities Act §§ 17(a)(1) and 17(a)(3).

We also find that Clifton violated §§ 17(a)(1) and 17(a)(3) of the Securities Act by engaging in a fraudulent scheme and a course of business that operated as a fraud on prospective investors. That misconduct involved the misrepresentations and omissions to investors discussed above and Clifton's affirmative actions, both to conceal material, adverse information about the project from the sales representatives and to ensure that sales representatives who learned such information also withheld it from prospective investors—all in order to keep the offering fraud going.[66]

In carrying out this fraudulent scheme, Clifton acted with a high degree of scienter.[67] He made statements to prospective investors that he knew were false. He knowingly omitted information about the Osage project that made his statements about the project materially misleading. He sent an e-mail to an MPG Financial sales representative that linked a recording of the December 23 conference call, knowing or recklessly disregarding that the recording contained materially misleading information, and knowing that the sales representative intended to distribute the link to the public. He encouraged Registered Representative No. 1 to have Wheeler invest in the Osage project in the face of the status of the first two wells and when he knew or was reckless in not knowing that Registered Representative No. 1 did not know that the third Osage well was a dry hole. He intentionally concealed material adverse information about the project from the sales representatives. And he sought to ensure that sales representatives who learned such information also withheld it from prospective investors.[68] That Clifton stood to gain financially from his fraudulent conduct further reinforces our finding that he acted with a high degree of scienter.[69]

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[66] *See United States v. Naftalin*, 441 U.S. 768, 774 (1976) (stating that each succeeding prohibition under § 17(a) is meant to cover additional illegalities, not to narrow the reach of the prior section).

[67] To establish a Securities Act § 17(a)(1) violation, the Division must establish scienter; no such showing is necessary to establish a violation of Securities Act § 17(a)(3). *Aaron*, 446 U.S. at 689-700; *Steadman*, 967 F.2d at 641 & n.3. Scienter is a mental state consisting of an intent to deceive, manipulate, or defraud, and includes recklessness, commonly defined as "an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the [respondent] or so obvious that the [respondent] must have been aware of it." *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 704 (7th Cir. 2008) (quoting *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 76 (2d Cir.), *cert. denied*, 534 U.S. 1071 (2001)). Because the evidence establishes that Clifton acted with scienter, a negligence analysis is unnecessary.

[68] *See, e.g., SEC v. Seghers*, 298 F. App'x 319, 334 (5th Cir. 2008) (motive to conceal problems with investments, "although not alone sufficient, is relevant to showing scienter"); *Robert D. Tucker*, Exchange Act Rel. No. 68210, 2012 WL 5462896, at *11 n.56 (Nov. 9, 2012) (stating that "efforts to conceal violative conduct demonstrate scienter").

[69] *See Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 325 (2007) (stating that "motive can be a relevant consideration" [in making the scienter determination], and "personal financial gain may weigh heavily in favor of a scienter inference").

On appeal, Clifton admits that he made material misrepresentations and omissions during the December 23, 2009 conference call, but argues that they "did not lead to any pecuniary loss" because no one invested based on the call.[70] The fact that none of the prospective investors who listened to the call subsequently purchased LP interests does not insulate Clifton from liability under Securities Act § 17(a). The Commission, unlike a private litigant, is not required to prove that an investor relied on the misrepresentations or that they caused an investor to lose money.[71]

Nor can Clifton avoid liability by claiming that information for the December 23, 2009 conference call came from the PPM. As discussed, Clifton knew that the PPM contained stale information and did not provide accurate disclosure about the current status of the wells when later investments in the project were solicited. His use of the PPM in connection with the December 23, 2009 call does not excuse the materially false and misleading statements that he made.

Clifton argues that the evidence was insufficient to sustain a finding that he knew that the third well was a dry hole when he forwarded to a sales representative a hyperlink to the recorded December 23, 2009 conference call. But Clifton's own sworn testimony, corroborated by the testimony of Anderson and Allen, supports a finding that Clifton knew about the dry hole on the morning of December 28, 2009, before he forwarded the hyperlink.[72] The only contradictory evidence was a single entry in Clifton's self-serving and unsworn timeline, and even there, he disclaimed the accuracy of dates and times, referring to them as only "estimates."[73] Although the law judge made no explicit finding as to Clifton's credibility, the substantial corroborating effect of Anderson's and Allen's testimony is persuasive evidence that Clifton forwarded the hyperlink knowing the third well was a dry hole.

For all of the foregoing reasons, we conclude that the preponderance of the evidence[74] establishes that Clifton willfully[75] violated Securities Act § 17(a).[76]

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70 Clifton's Br. at 2.

71 *See, e.g., SEC v. Morgan Keegan & Co., Inc.*, 678 F.3d 1233, 1244 (11th Cir. 2012); *SEC v. Pirate Investor LLC*, 580 F.3d 233, 239 n.10 (4th Cir. 2009), *cert. denied*, 130 S. Ct. 3506 (2010); *SEC v. Wolfson*, 539 F.3d 1249, 1256 (10th Cir. 2008); *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1364 (9th Cir. 1993); *Schellenbach v. SEC*, 989 F.2d 907, 913 (7th Cir. 1993); *SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir. 1985).

72 *See supra* note 20 and accompanying text.

73 *See supra* note 19.

74 *See generally Steadman v. SEC*, 450 U.S. 91 (1981) (applying preponderance of the evidence standard in Commission administrative proceedings).

75 A willful violation under the federal securities laws simply means "'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)).

76 *See, e.g., Jay Houston Meadows*, Exchange Act Rel. No. 37156, 52 SEC 778, 1996 WL 218638 (May 1, 1996) (sales representative violated Securities Act § 17(a), Exchange Act § 10(b), and Exchange Act Rule 10b-5 by misrepresenting to investors the risk of investing in shares of two companies, the likelihood that the ventures would be profitable, and the speed with which investors would recoup their investments), *aff'd*, 119 F.3d 1219 (5th Cir. 1997); *Thomas J. Fittin Jr.*, Exchange Act Rel. No. 29173, 50 SEC 544, 1991 WL 292516 (May 8, 1991) (firm president

(continued...)

B. Exchange Act § 15(b)

Exchange Act § 15(b)(6), incorporating Exchange Act § 15(b)(4)(E) by reference, allows us to sanction a person associated with a broker-dealer if that person "has failed reasonably to supervise, with a view to preventing [securities law] violations . . . , another person who commits such a violation, if such other person is subject to his supervision."[77] Exchange Act § 15(b)(4)(E) contains a "safe harbor" provision that protects supervisors from liability if the broker-dealer has "(i) . . . established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with."[78]

1. Registered Representative No. 1 violated Securities Act § 17(a).

Registered Representative No. 1 violated Securities Act § 17(a) by making untrue statements of material fact and/or misleading omissions of material fact to investors and prospective investors in the offer and sale of LP interests, earning commissions on the sales.[79] Between June and August 2009, Registered Representative No. 1 learned that Osage 1-1 would be converted into an SWDW, but he did not disclose that fact to prospective investors in his December 2009 e-mails. He falsely stated that drilling on the first two wells had been "complete[d] and [was] successful" when he knew, at a minimum, that the second well, Osage 1-1, was not producing oil and would be converted into an SWDW. He misrepresented potential investment returns because he based projections on six wells when he knew that the decision to convert Osage 1-1 into an SWDW left, at most, five potentially producing wells. He misled Caudill into believing that drilling on the wells had not yet begun when he knew that Osage 1-1 had been drilled and was not producing oil. As previously discussed, the information that Registered Representative No. 1 misrepresented and/or failed to disclose was material to investors.

Registered Representative No. 1 acted at least negligently when he failed to disclose in e-mails to prospective investors that the second well, Osage 1-1, would be converted into an SWDW, and falsely stated that drilling on the first two wells had been "complete[d] and [was] successful." We conclude that Registered Representative No. 1 willfully[80] violated Securities Act § 17(a).

(...continued)
violated antifraud provisions in connection with firm's sale of three private offerings of oil-and-gas limited partnerships; finding that the characterization of certain drilling programs as involving developmental wells, when they were actually exploratory, was materially misleading).

77 15 U.S.C. §§ 78o(b)(4)(E), 78o(b)(6).

78 *Id.*, § 78o(b)(4)(E).

79 Registered Representative No. 1 acknowledged at the hearing that he personally obtained commissions on his sales of LP interests, but the record is silent as to the exact amount of money that he made.

80 *See supra* note 75.

2. Clifton failed reasonably to supervise Registered Representative No. 1

As the president of MPG Financial, and under the firm's WSPs, Clifton was responsible for supervising Registered Representative No. 1.[81] As part of his supervisory duties, the WSPs required Clifton to review Registered Representative No. 1's outgoing e-mails. The WSPs also required that all correspondence be truthful and not exaggerated.[82] By Clifton's own admission, he did not review Registered Representative No. 1's e-mails to prospective investors. By failing to review Registered Representative No. 1's e-mails, Clifton failed to detect or prevent Registered Representative No. 1's violations of Securities Act § 17(a).

Clifton also acted unreasonably because he did not correct Registered Representative No. 1's misstatements during a late December 2009 telephone call with a prospective investor. Clifton heard the misstatements and therefore knew about them, yet failed to ensure that the prospective investor was provided with information that was truthful. Instead, he told Registered Representative No. 1 that he did a good job in marketing the Osage project, thereby placing his imprimatur on those misstatements.

We conclude that Clifton violated Exchange Act § 15(b)(6) by failing reasonably to supervise Registered Representative No. 1 with a view towards preventing and detecting his Securities Act § 17(a) violations. Clifton cannot establish an affirmative defense to his violation of Exchange Act § 15(b)(6) because, as he concedes,[83] he did not fulfill the duties charged to him by the WSPs that included reviewing and approving Registered Representative No. 1's e-mails.

Clifton does not dispute that the WSPs charged him with supervisory duties over Registered Representative No. 1 and required him to review Registered Representative No. 1's e-mails to ensure that they were truthful and not exaggerated. Rather, Clifton claims that he delegated to CCO Simmons the task of reviewing and approving sales representatives' e-mails. The weight of the evidence, however, fails to support his claim. As discussed, the WSPs identified Clifton as the supervisor responsible for reviewing and approving sales representatives' e-mails, and he drafted sample e-mails that could be sent without his pre-approval. At all times, Registered Representative No. 1 understood that Clifton was supposed to review and approve his e-mails before they were sent to the public. And Simmons testified that Clifton was responsible for reviewing and approving e-mails sent by the sales representatives. Furthermore, even if we accepted his claim that he delegated to CCO Simmons the authority to review and approve e-mails,

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[81] *See John B. Busacca* III, Exchange Act Rel. No. 63312, 2010 WL 5092726, at *10 (Nov. 12, 2010) ("We have frequently emphasized that 'the president of a brokerage firm is responsible for the firm's compliance with all applicable requirements unless and until he or she 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 or her duties.'") (quoting *Richard F. Kresge,* Exchange Act Rel. No. 55988, 2007 WL 1892137, at *8 (June 29, 2007)), *pet. denied,* 449 F. App'x 886 (11th Cir. 2011).

[82] *See supra* note 36.

[83] *See supra* note 13.

Clifton, as president, retained a duty to follow-up on that delegation, which he failed to do by not ensuring that Simmons was reviewing Registered Representative No. 1's e-mails.[84]

IV.

A. Collateral bar

The law judge barred Clifton from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent, but did not bar him from association with any municipal advisor or nationally recognized statistical rating organization. Those last two forms of relief were authorized by Congress in the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010.[85] As Clifton's misconduct occurred before the passage of that Act, the law judge believed applying those sanctions would be impermissibly retroactive,[86] though noting that the Commission had yet to decide the issue.[87] The law judge found no retroactive effect in barring Clifton from associating with investment advisers, municipal securities dealers, or transfer agents.[88]

In the interim, we decided *John W. Lawton*, which held that collateral bars (*i.e.*, bars from associating in capacities other than those in which the respondent was associated at the time of the misconduct) imposed pursuant to § 925 of Dodd-Frank are not impermissibly retroactive as applied in follow-on proceedings addressing pre-Dodd Frank conduct.[89] We see no basis for confining our holding in *Lawton* to follow-on proceedings and believe that our reasoning applies with equal force in the context of original proceedings.[90]

The law judge's pre-*Lawton* ruling that barring Clifton from associating with a municipal advisor or NRSRO would be impermissibly retroactive is erroneous for the reasons we explained in *Lawton*.[91] The Dodd-Frank Act amended Exchange Act § 15(b)(6)(A) to authorize us to bar industry members from association with municipal advisors and NRSROs – bars that were not previously available under the securities laws. Although Congress enacted the Dodd-Frank amendment after

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84 *Cf. Midas Sec., LLC*, Exchange Act Rel. No. 66200, 2012 WL 169138, at *13 (Jan. 20, 2012) (stating that even if firm's president delegated line-supervision, he still retained a duty to follow up on that delegation) & nn.75-77 (citing cases).

85 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

86 *Clifton*, 2011 WL 7444649, at *21.

87 *Id.* at 19.

88 *Id.* at 21. Before the law judge, Clifton objected generally to the imposition of a collateral bar under Dodd-Frank but did not argue the issue of retroactivity.

89 Investment Advisers Act Rel. No. 3513, 2012 WL 6208750, at *10 (Dec. 13, 2012).

90 Although the Division did not appeal the law judge's decision against imposing a bar from association with any municipal advisor or NRSRO, and neither party addressed that issue on appeal, we determined, on our own initiative, to review the sanctions imposed in this case pursuant to Rule of Practice 411(d). *Johnny Clifton*, Admin. Proc. File No. 3-14266, Order Granting Petition for Review and Scheduling Briefs (Jan. 3, 2012).

91 *Lawton*, 2012 WL 6208750, at *6-10.

Clifton committed his misconduct, we held in *Lawton* that imposing bars from associating with municipal advisors or NRSROs "are not impermissibly retroactive as applied to . . . proceedings addressing pre-Dodd-Frank conduct because such bars are prospective remedies whose purpose is to protect the investing public from future harm."[92]

In assessing the need for sanctions in 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 conduct, and the likelihood that the respondent's occupation will present opportunities for future violations.[93] Our "inquiry into . . . the public interest is a flexible one, and no one factor is dispositive."[94] Based on these factors, we conclude that a bar from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or NRSRO is warranted here.

Clifton's conduct was egregious and recurrent. He committed fraud through his material misrepresentations and omissions about the Osage project and through his actions to perpetuate the fraudulent scheme by concealing material, adverse information from sales representatives and ensuring that sales representatives withheld such information from prospective investors. That misconduct violated Securities Act §§ 17(a)(1), 17(a)(2), and 17(a)(3). As we have held, fraud is "especially serious and subject to the severest of sanctions."[95] In addition, Clifton failed to review materially false and misleading e-mails sent by Registered Representative No. 1, and failed to follow the procedures instituted for the supervision of sales representatives.

Clifton acted with a high degree of scienter. For instance, he knew that many of the statements he made during the December 23, 2009 conference call were wrong and that he omitted to disclose material facts. On one occasion, he knowingly sent information (*i.e.*, the hyperlink to the December 23, 2009 conference call) containing material misrepresentations and omissions to a sales representative for distribution to prospective investors. He instructed MPG Financial sales representatives Allen and Registered Representative No. 3 not to share updated material information with the other sales representatives. He encouraged Registered Representative No. 1 to have Wheeler invest in the Osage project when he knew, or must have known, that Registered Representative No. 1 was unaware of certain material adverse information, namely that the third well was a dry hole. After learning about the third well's dry hole on December 28, 2009, he accepted funds from three or investors without disclosing the dry hole to them.

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92 *Id.* at *8.

93 *Scott B. Gann,* Exchange Act Rel. No. 59729, 2009 WL 938033, at *4 & n.11 (Apr. 8, 2009) (citing *Steadman,* 603 F.2d at 1140), *aff'd per curiam, Gann v. SEC,* 361 F. App'x 556 (5th Cir. 2010) (unpublished).

94 *David Henry Disraeli,* Exchange Act Rel. No. 570727, 2007 WL 4481515, at *15 (Dec. 21, 2007), *aff'd,* 33 F. App'x 334 (D.C. Cir. 2008), *cert. denied,* 130 S.Ct. 1914 (2010).

95 *Marshall E. Melton,* Advisers Act Rel. No. 2151, 56 SEC 695, 2003 WL 21729839, at *9 (July 25, 2003).

We have stated that "[t]he proper functioning of the securities industry and markets depends on the integrity of industry participants and their commitment to transparent disclosure. Securities industry participation by persons with a history of fraudulent conduct is antithetical to the protection of investors."[96] Here, the pattern, self-serving nature, and egregiousness of Clifton's fraud demonstrate his unfitness to participate in the securities industry in any capacity. Indeed, the facts to which Clifton admitted at the hearing, including his admissions regarding the conduct underlying his 2007 settlement of a FINRA disciplinary action,[97] show a disturbing proclivity for fraudulent misrepresentations that transcends his current capacity.

In his petition for review, Clifton "admitted he made omissions and misrepresentations of material fact" during the December 23, 2009 conference call; admitted that "[t]he Division's Exhibits show a number of e-mails from two brokers [Registered Representative No. 1 and Registered Representative No. 2] that are misleading and omit material facts"; and "admitted he did not follow the procedures instituted for supervision of the brokers,"[98] Notwithstanding his willingness to make these admissions, which weighs in his favor in the consideration of appropriate sanctions,[99] Clifton attempts to minimize his misconduct by arguing that his failure to supervise violation was confined to "eight offending e-mails out of thousands."[100] This attempt shows that he does not fully understand the seriousness of his misconduct and how it violated the duties of a securities professional.[101] "'[F]ailure[] to recognize the wrongfulness of his conduct presents a significant risk that, given th[e] opportunity, he would commit further misconduct in the future.'"[102] "This risk is particularly significant here because opportunities for similar misconduct arise in each of the associational capacities covered by the collateral bar and [Clifton's] admitted conduct demonstrates fundamental and ongoing unfitness for any such association."[103] Clifton currently is

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96 *Lawton*, 2012 WL 6208750, at *11.

97 *See supra* notes 11-12 and accompanying text. Clifton tries to dilute those admissions by arguing that he "has never had a customer complaint prior to this action." Pet. for Review at 2. Even if true, we have repeatedly held that, while a respondent's relevant disciplinary history is an aggravating factor, the absence of one is not mitigating. *Cf. Siegel v. SEC*, 592 F.3d 147, 156-57 (D.C. Cir. 2010) (upholding Commission's refusal to consider as mitigating respondent's assertion that, among other things, he had no disciplinary history), *cert. denied*, 130 S.Ct. 3333 (2010); *Rooms v. SEC*, 444 F.2d 1208, 1214 (10th Cir. 2006) (holding that lack of disciplinary history is not a mitigating factor).

98 *See supra* note 13.

99 *See supra* note 93 and accompanying text. We have held that a respondent's failure to recognize the wrongfulness of his conduct presents "a significant risk that, given the opportunity, he would commit further misconduct in the future." *Lawton*, 2012 WL 6208750, at *12 & n.64

100 Clifton's Br. at 12.

101 Even if he had been more emphatic in assuring future compliance or expressing remorse, we would have good reason to doubt his sincerity, particularly given his empty promise to FINRA, in his 2007 AWC, that he would "act fully above reproach in all of [his] business dealings to insure that no further disciplinary actions would be brought against him." Div. Ex. 58 at 7.

102 *Lawton*, 2012 WL 6208750, at 12 & n.64 (quoting *Michael J. Markowski*, Exchange Act Rel. No. 44086, 55 SEC 21, 2001 WL 267660, at *4 (Mar. 20, 2001), *pet. denied*, 2002 WL 1932001 (D.C. Cir. Apr. 25, 2002) (unpublished)).

103 *Id.*, 2012 WL 6208750 at *12.

the owner and president of Wall & Company Securities, Inc., a registered broker-dealer, and at the hearing, he confirmed his intent to continue working in the securities industry.

Given the scope and severity of his misconduct, we believe that an appropriate sanction against Clifton should include a bar from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or NRSRO. His repeated and egregious conduct evidences an unfitness to participate in the securities industry that goes beyond the professional capacity in which he was acting when he engaged in the misconduct underlying these proceedings.[104] Imposing a full collateral bar will protect the investing public from the likelihood that Clifton will commit future violations of the federal securities laws. A bar will also "have the salutary effect of deterring others from engaging in the same serious misconduct."[105] We therefore find that barring Clifton from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or NRSRO serves the public interest and is remedial.

B. Cease-and-desist order

Securities Act § 8A and Exchange Act § 21C authorize us to impose a cease-and-desist order on any person who is violating, has violated, or is about to violate any provision of those Acts.[106] In determining whether a cease-and-desist order is appropriate, we consider whether a reasonable likelihood of future violations exists, the seriousness of the violations, the isolated or recurrent nature of the violations, the respondent's state of mind in committing the violations, the respondent's recognition of the wrongful nature of their conduct, and the recency of the violations.[107] Absent evidence to the contrary, a single past violation ordinarily suffices to establish a risk of future violations.[108]

Clifton engaged in egregious and repetitive misconduct. He made numerous material misrepresentations and omissions to prospective investors. Given the seriousness of this misconduct and his failure to appreciate his responsibilities as a securities professional, we find that the record presents sufficient risk that Clifton will commit future violations to warrant our

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[104] *See, e.g., Gary M. Kornman*, Exchange Act Rel. No. 59403, 2009 WL 367635, at *7 (Feb. 13, 2009) (noting that "the importance of honesty for a securities professional is so paramount that we have barred individuals even when the conviction was based on dishonest conduct unrelated to securities transactions or securities business") (citing cases), *aff'd*, 592 F.3d 173 (D.C. Cir. 2010).

[105] *Andrew P. Gonchar*, Exchange Act Rel. No. 60506, 2009 WL 2488067, at *13 (Aug. 14, 2009), *aff'd*, 409 F. App'x 396 (2d Cir. 2010).

[106] 15 U.S.C. §§ 77h-1, 78u-3.

[107] *KPMG Peat Marwick LLP*, Exchange Act Rel. No. 43862, 54 SEC 1135, 2001 WL 47245, at *23 (Jan. 19, 2001), *aff'd*, 289 F.3d 109 (D.C. Cir. 2002). Such a showing is "significantly less than" that required for an injunction. *Id.* at *26.

[108] *Id.* at *24. Clifton does not challenge the imposition of the cease-and-desist order. *See supra* note 13.

imposition of an order requiring him to cease and desist from committing or causing any violations or future violations of Securities Act § 17(a).[109]

C. Civil money penalty

Securities Act § 20(d) and Exchange Act § 21B authorize us to impose a civil money penalty for misconduct, including willfully violating any provision of the federal securities laws or failing reasonably to supervise another person who has committed such violations.[110] In assessing the civil money penalty required in the public interest, we consider: whether the violations involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; harm caused to others; the extent to which any person was unjustly enriched; prior violations; the need for deterrence; and such other matters as justice may require. Securities Act § 20(d) and Exchange Act § 21B specify a three-tier system identifying the maximum amount of a civil money penalty. Clifton's conduct occurred between April 2009 and April 2010. During that time, for each "act or omission" by a natural person, the maximum amount in the first tier was $7,500; in the second tier, $75,000; and in the third tier, $150,000.[111] For a second-tier penalty, the act or omission must have "involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement."[112] For a third-tier penalty, the act or omission must meet those requirements and also must have directly or indirectly resulted in (i) substantial losses, (ii) created a significant risk of substantial losses to other persons, or (iii) resulted in substantial pecuniary gain to the person who committed the act or omission."[113]

The Division asks us to impose one maximum third-tier penalty. Clifton does not dispute that a penalty is warranted but argues that it should only be a second-tier penalty because the December 23, 2009 conference call did not result in any investor losses and because his misconduct did not result in a "substantial" pecuniary gain.[114]

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[109] A cease-and-desist order is not statutorily authorized for a failure to supervise violation. *See Arthur James Huff*, Exchange Act Rel. No. 29017, 50 SEC 524, 1991 WL 296561, at *5 ("[T]he statute . . . clearly distinguishes between violations and supervisory deficiencies. We accordingly conclude that . . . deficient supervision was not a 'violation' within the meaning of Section 15(b)(4)(E).").

[110] 15 U.S.C. §§ 77t(d), 78u-2.

[111] 17 C.F.R. § 201.1004 (setting forth maximum penalty amounts for violations occurring after March 3, 2009). The figures used by the Division and administrative law judge erroneously reflected the adjustment for violations occurring from February 15, 2005 to March 3, 2009. *See* 17 C.F.R. § 201.1003. Since Clifton's misconduct occurred between April 2009 and April 2010, the adjusted maximum penalty amounts in 17 C.F.R. § 201.1004 govern here.

[112] 15 U.S.C. §§ 77t(d), 78u-2.

[113] 15 U.S.C. §§ 77t(d), 78u-2.

[114] As previously stated, Clifton earned an "override" of $18,750 based on roughly $500,000 worth of units sold.

The record is, for the most part, silent with respect to the amount of losses investors actually incurred in the Osage product.[115] And the Division does not argue that Clifton's misconduct resulted in a "substantial" pecuniary gain. We find, however, that a third-tier penalty is appropriate because Clifton's misconduct (as more fully discussed, above) created a significant risk of substantial losses to investors. Through the stale PPM and Clifton's fraudulent misrepresentations and omissions, Clifton and those he supervised sought to raise as much as $1,068,750, and actually raised at least $500,000, in investor funds for the Osage project. Those efforts continued after Clifton conducted the December 23 conference call, after he forwarded a hyperlink to a recording of that call to a sales representative for distribution to prospective investors, and after he instructed two sales representatives to withhold adverse information about the wells from other sales representatives selling LP interests in the project. And even though investors later received a refund of twenty-five percent of their investment after the project was shut down, that refund does not negate the significant risk of substantial losses that Clifton's violations created.

[115] Though twenty-two investors acquired interests in the project, only two testified about their losses. *See supra note* 36. No summary exhibit or other proof was introduced with respect to the losses of the other investors.

Considering the events at issue, we impose a single, maximum third-tier civil money penalty of $150,000. A single penalty at the maximum end of the third tier is necessary to deter Clifton from future misconduct and will have an additional remedial effect of deterring others from engaging in similar misconduct.[116]

An appropriate order will issue.[117]

By the Commission (Chair WHITE and Commissioners WALTER and AGUILAR); Commissioners PAREDES and GALLAGHER, concurring in part and dissenting with respect to the bar from association with municipal advisors and nationally recognized statistical rating organizations.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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[116] We believe that the conduct here could also support a total second-tier penalty of $150,000 based on two violations (the Securities Act § 17(a) and Exchange Act § 15(b) violations) at the maximum second-tier amount of $75,000 each.

Clifton claims that he is financially unable to pay a civil penalty and submits a sworn financial statement in support of this claim. This argument is waived because he did not raise it before the law judge. *See Disraeli,* 2007 WL 4481515, at *19 (holding that respondent waived inability to pay by failing to present evidence to the law judge, but instead presenting it to the Commission for the first time on appeal; further stating that evidence regarding a newly-claimed inability to pay will be admitted only if it comports with the requirements of Rule of Practice 452, *i.e.*, "that such evidence is material and that there were reasonable grounds for failure to adduce such evidence previously"). In any event, under Exchange Act § 21B(c), the ability to pay may be considered, but it is only one factor. Considering it is also discretionary, and where, as here, the conduct is egregious, it may be disregarded. *See, e.g., Gregory O. Trautman,* Exchange Act Rel. No. 61167A, 2009 WL 6761741, at *24 (Dec. 15, 2009).

Clifton also argues that "[h]e has a family including a wife and children," and "[h]e will not be able to take care of his family and pay the hefty penalty assessed over and beyond his removal from the industry." Pet. for Review at 3. How a respondent collaterally suffers as a result of the violation, or from the disciplinary proceeding that followed (*e.g.*, that he lost money, the amount of time he was out of the industry, or the impact the disciplinary proceeding had on his reputation, career, or finances), is not a mitigating factor. *See, e.g., Janet Gurley Katz,* Exchange Act Rel. No. 61449, 2010 WL 358737, at *26 & n.66 (Feb. 1, 2010), *aff'd,* 647 F.3d 1156 (D.C. Cir. 2011); *Ashton Noshir Gowadia,* Exchange Act Rel. No. 40410, 53 SEC 786, 1998 WL 564575, at *4 (Sept. 8, 1998).

[117] 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 ACT OF 1933
Rel. No. 9417 / July 12, 2013

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 69982 / July 12, 2013

Admin. Proc. File No. 3-14266

In the Matter of

JOHNNY CLIFTON
c/o Pace & Pace, LLP
Meadows Building, Suite 940
5646 Milton Street
Dallas, TX 75206

ORDER IMPOSING REMEDIAL SANCTIONS

On the basis of the Commission's Opinion issued this day, it is

ORDERED that Johnny Clifton be barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and it is further

ORDERED that Johnny Clifton cease and desist from committing or causing any violations or future violations of § 17(a) of the Securities Act of 1933; and it is further

ORDERED that Johnny Clifton pay a civil money penalty in the amount of $150,000.

Payment of the civil money penalty shall be: (i) made by U.S. postal money order, certified check, bank cashier's check, or bank money order; (ii) made payable to the Securities and Exchange Commission; (iii) mailed or delivered by hand to the Office of Financial Management, Securities and Exchange Commission, 100 F. Street NE, Mail Stop 6042, Washington, DC 20549; and (iv) submitted under cover letter that identifies the respondent and the file number of this proceeding. A copy of the cover letter and check shall be sent to Toby M. Galloway and D. Dee Raibourn III, Division of Enforcement, U.S. Securities and Exchange Commission, 801 Cherry Street, Suite 1900, Unit 18, Fort Worth, Texas 76102.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 200 and 240

Release No. 34-69979

RIN 3235-AL35

RESCISSION OF SUPERVISED INVESTMENT BANK HOLDING COMPANY RULES

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (the "Commission") is rescinding rules under the Securities Exchange Act of 1934 (the "Exchange Act") that established the Commission's program for supervising investment bank holding companies. The Commission is taking this action pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which eliminated the applicable section effective July 21, 2011. The Commission also is rescinding certain exemptive provisions in its broker-dealer risk assessment rules and delegation of authority rules that pertain to the supervised investment bank holding company program rules that are being rescinded.

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

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director, at (202) 551-5525; Thomas K. McGowan, Deputy Associate Director, at (202) 551-5521; Randall W. Roy, Assistant Director, at (202) 551-5522; Mark M. Attar, Branch Chief, at (202) 551-5889; Carrie A. O'Brien, Special Counsel, at (202) 551-5640, or Rachel B. Yura, Attorney, at (202) 551-5729, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

SUPPLEMENTARY INFORMATION: The Commission is rescinding Exchange Act Rules 17i-1 through 17i-8 and making conforming amendments to Exchange Act Rules 17h-1T and 17h-2T and Rule 30-3 of the Commission's Rules of Organization and Program Management.

I. DISCUSSION

Section 17(i) of the Exchange Act, promulgated under section 231 of the Gramm-Leach-Bliley Act of 1999,[1] authorized the Commission to create a regulatory framework pursuant to which a holding company of a broker-dealer could elect to be supervised by the Commission as a supervised investment bank holding company ("SIBHC").[2] On June 8, 2004, the Commission adopted Exchange Act Rules 17i-1 through 17i-8 to implement the framework for Commission supervision of SIBHCs under section 17(i).[3]

At the time the Commission adopted rules under Exchange Act section 17(i), the Commission amended its risk assessment rules – Exchange Act Rules 17h-1T and 17h-2T – to exempt a broker-dealer that is affiliated with an SIBHC from those rules in part because the SIBHC rules – in particular, Rules 17i-5 and 17i-6 – required that the "SIBHC must make and retain documents substantially similar to those the broker-dealer is required to make and maintain pursuant to Rule 17h-1T" and the "SIBHC would be required to make reports that are substantially similar to those the broker-dealer is required to make pursuant to 17h-2T."[4] The

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1 Pub. L. 106-102, 113 Stat. 1338 (1999).

2 15 U.S.C. 78(q)(i).

3 Supervised Investment Bank Holding Companies, Exchange Act Release No. 49831 (Jun. 8, 2004), 69 FR 34472 (Jun. 21, 2004) (adopting Exchange Act Rules 17i-1 through 17i-8 to implement Exchange Act section 17(i)). See also Supervised Investment Bank Holding Companies, Exchange Act Release No. 48694 (Oct. 24, 2003), 68 FR 62910 (Nov. 6, 2003) (proposing rules to implement Exchange Act section 17(i)).

4 See Supervised Investment Bank Holding Companies, 69 FR at 34480. See also 17 CFR 240.17h-1T(d)(5) and 17h-2T(b)(5). The risk assessment rules, together with Form 17-H, establish a risk assessment recordkeeping and reporting program. Rule 17h-1T, a recordkeeping rule, requires a broker-dealer to maintain information and other records concerning certain affiliated entities of the broker-dealer. Rule

Commission also adopted amendments to Rule 30-3 of its Rules of Organization and Program Management to delegate authority to the Director of the Division of Market Regulation (now the Division of Trading and Markets) to act on certain requests of SIBHCs.[5]

On July 21, 2010, President Obama signed the Dodd-Frank Act into law.[6] Section 617 of Title VI to the Dodd-Frank Act amended the Exchange Act by eliminating section 17(i).[7] The effective date of section 617 is the "transfer date,"[8] which generally is defined in section 311 of the Dodd-Frank Act to mean one year after the date of enactment of the Dodd-Frank Act.[9] As a result, section 17(i) was removed from the Exchange Act effective July 21, 2011.[10]

Because of the effectiveness of section 617 of the Dodd-Frank Act, the Commission is rescinding Exchange Act Rules 17i-1 through 17i-8. The Commission also is amending Exchange Act Rules 17h-1T and 17h-2T to rescind subparagraphs (d)(5) and (b)(5) respectively,

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17h-2T, a reporting rule, requires a broker-dealer to file information regarding its material affiliates on Form 17-H with the Commission.

5 See 17 CFR 200.30-3(a)(77) through (79).

6 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

7 Pub. L. No. 111-203 § 617(a)(1). The Dodd-Frank Act also added section 618, which permits a company that owns at least one registered securities broker or dealer (a "nonbank securities company") and that is required by a foreign regulator or provision of foreign law to be subject to comprehensive consolidated supervision, to register with the Board of Governors of the Federal Reserve System (the "Federal Reserve") as a securities holding company and become subject to supervision and regulation by the Federal Reserve. Pub. L. No. 111-203 § 618. On May 29, 2012, the Federal Reserve adopted a final rule to implement section 618 of the Dodd-Frank Act, which permits securities holding companies to elect to become supervised securities holding companies by registering with the Federal Reserve. See Supervised Securities Holding Company Registration, 77 FR 32881 (Jun. 4, 2012).

8 Pub. L. No. 111-203 § 617(b).

9 Pub. L. No. 111-203 § 311(a).

10 Section 311(b) specifies that the transfer date could be extended to a date no later than 18 months after the date of enactment of the Dodd-Frank Act if the Secretary of the Treasury, after consultation with specified regulators, informed Congress of the extension and published notice of such extension in the Federal Register within 270 days after the enactment of the Dodd-Frank Act. The transfer date was not extended; therefore, the transfer date was July 21, 2011 See, e.g., 76 FR 39246 (Jul. 6, 2011) (identifying July 21, 2011 as the "transfer date" in the context of the Office of Thrift Supervision becoming part of the Office of the Comptroller of the Currency).

which contain the conforming exemptions for broker-dealers affiliated with SIBHCs,[11] and Rule 30-3 subparagraphs (a)(77) through (79) of the Commission's Rules of Organization and Program Management, to remove the delegations of authority that permit the Division Director to act on requests of SIBHCs made pursuant to the SIBHC rules the Commission is rescinding.[12]

The impact of the rescission of the conforming exemptions in the risk assessment rules is that any broker-dealer qualifying for, and relying upon, those exemptions will now have to comply with the risk assessment rules. However, no broker-dealers are affiliated with an SIBHC because, as a result of the elimination of Exchange Act section 17(i) under section 617 of the Dodd-Frank Act, the Commission's SIBHC program is no longer effective, and, accordingly, no broker-dealers can rely on the provisions in the risk assessment rules that exempt a broker-dealer affiliated with an SIBHC from those rules.

II. PROCEDURAL AND OTHER MATTERS

The Administrative Procedure Act ("APA") generally requires an agency to publish notice of a proposed rulemaking in the Federal Register.[13] 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."[14] Further, it does not apply to interpretative rules, general statements of policy, and rules of agency organization, procedures or practice.[15] The APA also generally requires that an agency publish a rule in the Federal Register

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[11] In connection with the Commission's rescission of the exemptions in Rules 17h-1T and 17h-2T for broker-dealers that are affiliated with an SIBHC, the Commission is: (1) removing paragraph (d)(5) of Rule 17h-1T and redesignating paragraph (d)(6) as paragraph (d)(5); and (2) removing paragraph (b)(5) of Rule 17h-2T and redesignating paragraph (b)(6) as paragraph (b)(5).

[12] The Commission is amending Rule 30-3 of the Commission's Rules of Organization and Program Management by removing and reserving paragraphs (a)(77), (a)(78), and (a)(79).

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

[14] Id.

[15] Id.

30 days before the rule becomes effective.[16] This requirement, however, does not apply if the agency finds good cause for making the rule effective sooner.[17]

The Commission finds good cause to have these rule rescissions and rule amendments take effect when they are published in the Federal Register, and that notice and solicitation of comment before the effective date is unnecessary.[18] In particular, as of July 21, 2011, Rules 17i-1 through 17i-8 no longer have any legal effect. Consequently, their continued inclusion in the Code of Federal Regulations might lead to public confusion. Further, as discussed above, as a result of the elimination of Exchange Act section 17(i) under section 617 of the Dodd-Frank Act, no broker-dealers are affiliated with an SIBHC and, therefore, no broker-dealers can rely on the provisions in the risk assessment rules that exempt a broker-dealer affiliated with an SIBHC from those rules. Moreover, because the Dodd-Frank Act eliminated section 17(i), no firms affiliated with a broker-dealer can elect to be supervised by the Commission as an SIBHC. Because no broker-dealers currently, or will in the future, rely on the exemptions in the risk assessment rules available to broker-dealers affiliated with an SIBHC, the Commission finds that notice and solicitation of comment is unnecessary with respect to the rescission of these exemptions. The Commission also finds that notice and solicitation of comment is unnecessary with respect the delegation of authority rules that the Commission is rescinding in this release because the rescinded aspects of those rules pertain to rules under the SIBHC program that no

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

17 Id.

18 This finding also satisfies the requirements of 5 U.S.C. 808(2), allowing the rule amendments to become effective notwithstanding the requirements of 5 U.S.C.801 (if a Federal agency finds that 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"). Because the Commission is not publishing the rule amendments in a notice of proposed rulemaking, no analysis is required under the Regulatory Flexibility Act. See 5 U.S.C. 601(2) (for purposes of Regulatory Flexibility Analysis, the term "rule" means any rule for which the agency publishes a general notice of proposed rulemaking).

longer have legal effect and will no longer exist. Further, the Commission notes that notice and comment is not required with regard to the delegations of authority because they relate solely to Commission organization, procedure, or practice.[19]

Section 23(a)(2) of the Exchange Act requires the Commission to consider the competitive effects of rulemaking under the Exchange Act.[20] Further, section 3(f) of the Exchange Act requires the Commission, when engaging in rulemaking where it 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 will promote efficiency, competition, and capital formation.[21] Rescinding the rules related to the SIBHC program will not create any competitive advantages or disadvantages, or affect efficiency, competition, and capital formation because the Commission is merely rescinding rules that no longer have any legal effect.

III. PAPERWORK REDUCTION ACT

Certain provisions of Rules 17i-1 through 17i-8 contained "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[22] Consequently, the Commission submitted these collections of information to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11.

The titles for the collections of information are: (i) Rule 17i-2 Notice of Intention to be Supervised by the Commission as a Supervised Investment Bank Holding Company; (ii) Rule

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

20 15 U.S.C. 78w(a)(2).

21 15 U.S.C. 78c(f).

22 44 U.S.C. 3501 et seq.

17i-3 Withdrawal from Supervision as a Supervised Investment Bank Holding Company; (iii) Rule 17i-4 Internal Risk Management Control Systems Requirements for Supervised Investment Bank Holding Companies; (iv) Rule 17i-5 Record Creation, Maintenance, and Access Requirements for Supervised Investment Bank Holding Companies; (v) Rule 17i-6 Reporting Requirements for Supervised Investment Bank Holding Companies; and (vi) Rule 17i-8 Notification Requirements for Supervised Investment Bank Holding Companies. OMB approved these collections of information and assigned them OMB Control Nos. 3235-0592, 3235-0593, 3235-0594, 3235-0590, 3235-0588, and 3235-0591, respectively.

As noted above, the rules promulgated under section 17(i) established a framework pursuant to which an investment bank holding company could elect to become supervised by the Commission as an SIBHC, as well as recordkeeping and reporting requirements for SIBHCs. Because the Commission is rescinding this regulatory framework, the Commission has discontinued the OMB collections of information associated with it.

As discussed above, to eliminate duplicative recordkeeping and reporting requirements, broker-dealers affiliated with an SIBHC were exempt from Rules 17h-1T and 17h-2T. Any broker-dealer previously relying on the SIBHC exemptions in Rules 17h-1T and 17h-2T (and thus required to comply with Rules 17i-1 through 17i-8) has, since July 21, 2011, been required to comply with Rules 17h-1T and 17h-2T. One broker-dealer that elected to use the SIBHC rules now is required to comply with Rules 17h-1T and 17h-2T. The Commission has accounted for this increased burden in connection with the recent notice seeking comment on the existing collection of information provided for in Rules 17h-1T and 17h-2T.[23]

[23] See Proposed Collection; Comment Request, 77 FR 31408 (May 25, 2012).

IV. 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

17 CFR Part 200

Administrative practice and procedure; Authority delegations (Government agencies)

17 CFR Part 240

Brokers; Reporting and recordkeeping requirements; Securities

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 200 – ORGANIZATION; CONDUCT AND ETHICS; AND INFORMATION AND REQUESTS

Subpart A – Organization and Program Management

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 200.30-3 is amended by removing and reserving paragraphs (a)(77), (a)(78), and (a)(79).

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

3. The authority citation for Part 240 continues to read, in part, as follows:

   Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 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.; and 18 U.S.C. 1350, 12 U.S.C. 5221(e)(3), and sec. 939A, Pub. L. 111-203, 124 Stat. 1376, (2010), unless otherwise noted.

4. Section 240.17h-1T is amended by:

    a. Removing paragraph (d)(5); and

    b. Redesignating paragraph (d)(6) as paragraph (d)(5).

5. Section 240.17h-2T is amended by:

    a. Removing paragraph (b)(5); and

    b. Redesignating paragraph (b)(6) as paragraph (b)(5).

6. Sections 240.17i-1 through 240.17i-8 are removed, including the heading, "Supervised Investment Bank Holding Company Rules," and the Preliminary Note preceding those sections.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

July 12, 2013

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 69984 / July 12, 2013

INVESTMENT ADVISER ACT OF 1940
Release No. 3629 / July 12, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15377

In the Matter of **STEVEN J. BREWER,** **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 Steven J. Brewer ("Respondent").

II.

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

III.

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

1. From June 2009 through October 2010, Steven J. Brewer was engaged in the business of effecting transactions in securities for the accounts of others by offering and selling promissory notes to investors. During that time, Brewer was associated with a registered broker dealer and with a registered investment adviser.

2. On April 22, 2013, a judgment was entered by consent against Brewer, permanently enjoining him 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 from aiding and abetting future violations of Section 15(c) of the Exchange Act and Sections 206(1) and 206(2) of the Advisers Act, in the civil action entitled *Securities and Exchange Commission v. Steven Brewer, et al.*, Civil Action Number 10-cv-6932-BMM-AK, in the United States District Court for the Northern District of Illinois.

3. The Commission's complaint alleged that, from June 2009 through at least the end of September 2010, Brewer and Adam Erickson ("Erickson"), Brewer Investment Group, LLC ("BIG"), Brewer Financial Services, LLC ("BFS"), a registered broker-dealer, and Brewer Investment Advisors, LLC ("BIA"), a registered investment adviser, participated in fraudulent, unregistered offerings of promissory notes issued by FPA Limited ("FPA"), an Isle of Man company, in the aggregate amount of $5.6 million to at least 74 investors. Through the fraudulent offerings, BIG and Brewer funneled cash to BIG and one of its subsidiaries when the entities were under significant financial distress. The offering materials that Defendants created and used for the offerings of FPA promissory notes ("FPA Notes") failed to disclose that over 90% of the proceeds would be disbursed at Brewer's direction to BIG and then to its wholly-owned subsidiaries. In addition, the offering materials misrepresented the risk of the investment and failed to disclose the precarious financial condition of BIG and its subsidiaries. The complaint further alleged that through the offering materials for the FPA Notes, Defendants also implicitly and explicitly represented to investors that the proceeds of the offerings would be used to procure collateral which would be used to secure the notes. Instead, over 90% of the proceeds were disbursed at Brewer's direction to BIG and then spent, including making payments to one of BIG's subsidiaries, and the promised collateral was never obtained. As a result, representations in the offering materials concerning the use of proceeds and representations concerning the risk of the investment were materially false and misleading. The complaint also alleged that in the offering materials, Defendants did not disclose that BIG was failing to make the required interest payments on the FPA Notes being sold to investors. Nor did Defendants disclose that material information to prospective investors in other communications. These material omissions rendered statements in the offering documents materially misleading. The complaint alleged that Brewer originated the fraudulent offering of the FPA Notes and participated in creating the fraudulent offering documents used to sell the notes. Brewer directed that the notes be sold and directed that the notes be offered to specific investors. Brewer also controlled the bank account into which the proceeds of the offerings were deposited and then disbursed, primarily to BIG. Brewer knew that the representations in the offering documents concerning the use of proceeds and risk were materially

false and misleading. He also knew that material information about the precarious financial condition of BIG and BIG's failure to make required interest payments on the notes was not being disclosed to prospective investors. Nonetheless, Brewer continued to sell the notes and caused others to do so.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Brewer'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 Brewer be, and hereby is barred from association with any broker, dealer, or investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization;

That Respondent Brewer be, and hereby is barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock; and

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. 69994 / July 16, 2013

Admin. Proc. File No. 3-15128

In the Matter of The Hartcourt Companies, Inc., *et al.*	ORDER DISMISSING PROCEEDING WITH RESPECT TO HIV-VAC, INC. (N/K/A GRUPO INTERNATIONAL, INC.)

On December 12, 2012, the Commission instituted administrative proceedings against HIV-VAC, Inc. (n/k/a Grupo International, Inc.) and five other registrants under § 12(j) of the Securities Exchange Act of 1934.[1] The Order Instituting Proceedings alleged that Grupo International violated periodic reporting requirements; it ordered a hearing to determine whether these allegations were true and, if so, whether suspension or revocation of the registration of Grupo International's securities was necessary and appropriate for the protection of investors.

Subsequent to the issuance of the OIP, the Division of Enforcement learned that, on January 11, 2013, Grupo International had filed a Form 15, pursuant to Exchange Act Rule 12g-4(a),[2] to voluntarily terminate the registration of its securities under Exchange Act § 12(g).[3] Under Rule 12g-4(a), an issuer's registration is terminated ninety days after filing Form 15, which in this case was April 11, 2013. The Division filed a motion to dismiss the proceeding against Grupo International, based on the deregistration of its securities. Grupo International has not responded to the Division's motion.

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1 15 U.S.C. § 78l(j). An administrative law judge revoked the registrations of the securities of the other respondents in this proceeding, except for Hellenic Solutions Corp. *See The Hartcourt Companies, Inc., et al.*, Securities Exchange Act Release No. 68686, 2013 SEC LEXIS 185, at *8 (Jan. 18, 2013). The law judge found that Hellenic Solutions Corp. had not yet been served with the OIP. *Id.* at *4.

2 17 C.F.R. § 240.12g-4(a) (certification of termination of registration under § 12(g)).

3 15 U.S.C. § 78l(g).

It is appropriate to grant the Division's motion because the respondent does not now have a class of registered securities and because revocation or suspension of registration is the only remedy available in a proceeding instituted under Exchange Act § 12(j).[4]

Accordingly, IT IS ORDERED that this proceeding be dismissed with respect to HIV-VAC, Inc. (n/k/a Grupo International, Inc.).

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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[4] *See, e.g., Encore Clean Energy, Inc., et al.*, Exchange Act Release No. 68811, 2013 SEC LEXIS 1150, at *2-3 (granting motion to dismiss Exchange Act § 12(j) proceeding against respondent that no longer had a class of securities registered with the Commission).

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 69995 / July 16, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-13757

In the Matter of

JOSEPH I. EMAS

ORDER PERMITTING ATTORNEY TO RESUME APPEARING AND PRACTICING UNDER RULE 102(e)(5) OF THE COMMISSION'S RULES OF PRACTICE

I.

On January 20, 2010 the Commission entered an Order Instituting Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions that, among other things, suspended Joseph I. Emas ("Emas") from appearing or practicing before the Commission as an attorney, with the right to reapply for reinstatement after two years ("Order"). *In the Matter of Joseph I. Emas, Esq.,* Securities Exchange Act. Rel. No. 61386, Admin. Proc. 3-13757 (Jan. 20, 2010). As part of a separate consent judgment to resolve a related civil injunctive action brought by the Commission, Emas was ordered by the United States District Court for the Western District of Pennsylvania to pay disgorgement of $135,782, prejudgment interest of $27,301, and a civil penalty of $15,000.

II.

On or about February 6, 2012, more than two years after he had been suspended by the Commission, Emas filed an application for reinstatement. Emas has paid the $135,782 in disgorgement, the $27,301 in prejudgment interest, and the $15,000 civil penalty. As part of the reinstatement process, Emas has sworn 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)(2) of the Commission's Rules of Practice. Since entry of the Order, no information has come to the attention of the Commission relating to Emas's character, integrity, professional conduct, or qualifications to practice before the Commission that would be a basis for denying his application, or that would be a basis for an adverse action against him pursuant to Rule 102(e) of the Commission's Rules of Practice.

III.

Based on the foregoing, the Commission has determined that, for good cause shown, it is appropriate to reinstate Emas, pursuant to Rule 102(e)(5), to appear or practice before the Commission.

Accordingly, it is HEREBY ORDERED that Joseph I. Emas is reinstated to practice as an attorney before the Commission.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9419 / July 17, 2013

In the Matter of **Seaview Resources Inc.** **Registration No. 333-186344**	**ORDER DENYING WITHDRAWAL OF REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**

1. Seaview Resources Inc. ("Seaview") filed a Form S-1 registration statement with the Commission on January 31, 2013 (the "Registration Statement"). The Registration Statement is still pending. The Registration Statement was filed with respect to 5 million shares of common stock of Seaview.

2. On July 5, 2013 Seaview filed an application to withdraw its Registration Statement under Rule 477 of Regulation C of the Commission's General Rules and Regulations under the Securities Act of 1933 ("Securities Act"), 17 C.F.R. § 230.477.

3. After considering Seaview's application, the Commission has determined that the granting of the withdrawal request is not consistent with the public interest and the protection of investors. Accordingly, it is hereby:

ORDERED that Seaview's application to withdraw its registration statement on Form S-1 filed on January 31, 2013 is denied in accordance with Rule 477.

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. 9420 / July 17, 2013

In the Matter of **Tuba City Gold Corp.** **Registration No. 333-185848**	**ORDER DENYING WITHDRAWAL OF REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**

1. Tuba City Gold Corp. ("Tuba City") filed a Form S-1 registration statement with the Commission on January 2, 2013 (the "Registration Statement"). The Registration Statement is still pending. The Registration Statement was filed with respect to 6 million shares of common stock of Tuba City.

2. On July 5, 2013 Tuba City filed an application to withdraw its Registration Statement under Rule 477 of Regulation C of the Commission's General Rules and Regulations under the Securities Act of 1933 ("Securities Act"), 17 C.F.R. § 230.477.

3. After considering Tuba City's application, the Commission has determined that the granting of the withdrawal request is not consistent with the public interest and the protection of investors. Accordingly, it is hereby:

ORDERED that Tuba City's application to withdraw its registration statement on Form S-1 filed on January 2, 2013 is denied in accordance with Rule 477.

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. 9421 / July 17, 2013

In the Matter of **Yuma Resources Inc.** **Registration No. 333-186345**	**ORDER DENYING WITHDRAWAL OF REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**

1. Yuma Resources Inc. ("Yuma") filed a Form S-1 registration statement with the Commission on January 31, 2013 (the "Registration Statement"). The Registration Statement is still pending. The Registration Statement was filed with respect to 8 million shares of common stock of Yuma.

2. On July 5, 2013 Yuma filed an application to withdraw its Registration Statement under Rule 477 of Regulation C of the Commission's General Rules and Regulations under the Securities Act of 1933 ("Securities Act"), 17 C.F.R. § 230.477.

3. After considering Yuma's application, the Commission has determined that the granting of the withdrawal request is not consistent with the public interest and the protection of investors. Accordingly, it is hereby:

ORDERED that Yuma's application to withdraw its registration statement on Form S-1 filed on January 31, 2013 is denied in accordance with Rule 477.

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. 9422 / July 17, 2013

In the Matter of **Bonanza Resources Corp.** **Registration No. 333-186340**	**ORDER DENYING WITHDRAWAL OF REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**

1. Bonanza Resources Corp. ("Bonanza") filed a Form S-1 registration statement with the Commission on January 31, 2013 (the "Registration Statement"). The Registration Statement is still pending. The Registration Statement was filed with respect to 9 million shares of common stock of Bonanza.

2. On July 5, 2013 Bonanza filed an application to withdraw its Registration Statement under Rule 477 of Regulation C of the Commission's General Rules and Regulations under the Securities Act of 1933 ("Securities Act"), 17 C.F.R. § 230.477.

3. After considering Bonanza's application, the Commission has determined that the granting of the withdrawal request is not consistent with the public interest and the protection of investors. Accordingly, it is hereby:

ORDERED that Bonanza's application to withdraw its registration statement on Form S-1 filed on January 31, 2013 is denied in accordance with Rule 477.

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. 9423 / July 17, 2013

In the Matter of **CBL Resources Inc.** **Registration No. 333-186341**	**ORDER DENYING WITHDRAWAL OF REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**

1. CBL Resources Inc. ("CBL") filed a Form S-1 registration statement with the Commission on January 31, 2013 (the "Registration Statement"). The Registration Statement is still pending. The Registration Statement was filed with respect to 5 million shares of common stock of CBL.

2. On July 5, 2013 CBL filed an application to withdraw its Registration Statement under Rule 477 of Regulation C of the Commission's General Rules and Regulations under the Securities Act of 1933 ("Securities Act"), 17 C.F.R. § 230.477.

3. After considering CBL's application, the Commission has determined that the granting of the withdrawal request is not consistent with the public interest and the protection of investors. Accordingly, it is hereby:

ORDERED that CBL's application to withdraw its registration statement on Form S-1 filed on January 31, 2013 is denied in accordance with Rule 477.

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. 9424 / July 17, 2013

In the Matter of **Chum Mining Group Inc.** **Registration No. 333-185210**	**ORDER DENYING WITHDRAWAL OF REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**

1. Chum Mining Group Inc. ("Chum") filed a Form S-1 registration statement with the Commission on November 30, 2012 (the "Registration Statement"). The Registration Statement is still pending. The Registration Statement was filed with respect to 10 million shares of common stock of Chum.

2. On July 5, 2013 Chum filed an application to withdraw its Registration Statement under Rule 477 of Regulation C of the Commission's General Rules and Regulations under the Securities Act of 1933 ("Securities Act"), 17 C.F.R. § 230.477.

3. After considering Chum's application, the Commission has determined that the granting of the withdrawal request is not consistent with the public interest and the protection of investors. Accordingly, it is hereby:

ORDERED that Chum's application to withdraw its registration statement on Form S-1 filed on November 30, 2012 is denied in accordance with Rule 477.

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. 9425 / July 17, 2013

In the Matter of **Coronation Mining Corp.** **Registration No. 333-186203**	**ORDER DENYING WITHDRAWAL OF REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**

1. Coronation Mining Corp. ("Coronation") filed a Form S-1 registration statement with the Commission on January 25, 2013 (the "Registration Statement"). The Registration Statement is still pending. The Registration Statement was filed with respect to 15 million shares of common stock of Coronation.

2. On July 8, 2013 Coronation filed an application to withdraw its Registration Statement under Rule 477 of Regulation C of the Commission's General Rules and Regulations under the Securities Act of 1933 ("Securities Act"), 17 C.F.R. § 230.477.

3. After considering Coronation's application, the Commission has determined that the granting of the withdrawal request is not consistent with the public interest and the protection of investors. Accordingly, it is hereby:

ORDERED that Coronation's application to withdraw its registration statement on Form S-1 filed on January 25, 2013 is denied in accordance with Rule 477.

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. 9426 / July 17, 2013

In the Matter of **Eclipse Resources Inc.** **Registration No. 333-185227**	**ORDER DENYING WITHDRAWAL OF REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**

1. Eclipse Resources Inc. ("Eclipse") filed a Form S-1 registration statement with the Commission on December 3, 2012 (the "Registration Statement"). The Registration Statement is still pending. The Registration Statement was filed with respect to 9 million shares of common stock of Eclipse.

2. On July 5, 2013 Eclipse filed an application to withdraw its Registration Statement under Rule 477 of Regulation C of the Commission's General Rules and Regulations under the Securities Act of 1933 ("Securities Act"), 17 C.F.R. § 230.477.

3. After considering Eclipse's application, the Commission has determined that the granting of the withdrawal request is not consistent with the public interest and the protection of investors. Accordingly, it is hereby:

ORDERED that Eclipse's application to withdraw its registration statement on Form S-1 filed on December 3, 2012 is denied in accordance with Rule 477.

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. 9427 / July 17, 2013

In the Matter of **Gold Camp Explorations Inc.** **Registration No. 333-185851**	**ORDER DENYING WITHDRAWAL OF REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**

1. Gold Camp Explorations Inc. ("Gold Camp") filed a Form S-1 registration statement with the Commission on January 2, 2013 (the "Registration Statement"). The Registration Statement is still pending. The Registration Statement was filed with respect to 5 million shares of common stock of Gold Camp.

2. On July 5, 2013 Gold Camp filed an application to withdraw its Registration Statement under Rule 477 of Regulation C of the Commission's General Rules and Regulations under the Securities Act of 1933 ("Securities Act"), 17 C.F.R. § 230.477.

3. After considering Gold Camp's application, the Commission has determined that the granting of the withdrawal request is not consistent with the public interest and the protection of investors. Accordingly, it is hereby:

ORDERED that Gold Camp's application to withdraw its registration statement on Form S-1 filed on January 2, 2013 is denied in accordance with Rule 477.

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. 9428 / July 17, 2013

In the Matter of **Goldstream Mining Inc.** **Registration No. 333-183086**	**ORDER DENYING WITHDRAWAL OF REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**

1. Goldstream Mining Inc. ("Goldstream") filed a Form S-1 registration statement with the Commission on August 6, 2012 and filed amendments to the Form S-1 on September 24, 2012 and October 17, 2012 (the "Registration Statement"). The Registration Statement is still pending. The Registration Statement was filed with respect to 5 million shares of common stock of Goldstream.

2. On July 5, 2013 Goldstream filed an application to withdraw its Registration Statement under Rule 477 of Regulation C of the Commission's General Rules and Regulations under the Securities Act of 1933 ("Securities Act"), 17 C.F.R. § 230.477.

3. After considering Goldstream's application, the Commission has determined that the granting of the withdrawal request is not consistent with the public interest and the protection of investors. Accordingly, it is hereby:

ORDERED that Goldstream's application to withdraw its registration statement on Form S-1 filed on August 6, 2012, as amended on September 24, 2012 and October 17, 2012 is denied in accordance with Rule 477.

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. 9429 / July 17, 2013

In the Matter of **Jewel Explorations Inc.** **Registration No. 333-186202**	**ORDER DENYING WITHDRAWAL OF REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**

1. Jewel Explorations Inc. ("Jewel") filed a Form S-1 registration statement with the Commission on January 25, 2013 (the "Registration Statement"). The Registration Statement is still pending. The Registration Statement was filed with respect to 10 million shares of common stock of Jewel.

2. On July 5, 2013 Jewel filed an application to withdraw its Registration Statement under Rule 477 of Regulation C of the Commission's General Rules and Regulations under the Securities Act of 1933 ("Securities Act"), 17 C.F.R. § 230.477.

3. After considering Jewel's application, the Commission has determined that the granting of the withdrawal request is not consistent with the public interest and the protection of investors. Accordingly, it is hereby:

ORDERED that Jewel's application to withdraw its registration statement on Form S-1 filed on January 25, 2013 is denied in accordance with Rule 477.

By the Commission.

Elizabeth M. Murphy
Elizabeth M. Murphy
Secretary

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9430 / July 17, 2013

In the Matter of **Kingman River Resources Inc.** **Registration No. 333-186342**	**ORDER DENYING WITHDRAWAL OF REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**

1. Kingman River Resources Inc. ("Kingman") filed a Form S-1 registration statement with the Commission on January 31, 2013 (the "Registration Statement"). The Registration Statement is still pending. The Registration Statement was filed with respect to 7 million shares of common stock of Kingman.

2. On July 5, 2013 Kingman filed an application to withdraw its Registration Statement under Rule 477 of Regulation C of the Commission's General Rules and Regulations under the Securities Act of 1933 ("Securities Act"), 17 C.F.R. § 230.477.

3. After considering Kingman's application, the Commission has determined that the granting of the withdrawal request is not consistent with the public interest and the protection of investors. Accordingly, it is hereby:

ORDERED that Kingman's application to withdraw its registration statement on Form S-1 filed on January 31, 2013 is denied in accordance with Rule 477.

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. 9431 / July 17, 2013

In the Matter of **Lost Hills Mining Inc.** **Registration No. 333-186343**	**ORDER DENYING WITHDRAWAL OF REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**

1. Lost Hills Mining Inc. ("Lost Hills") filed a Form S-1 registration statement with the Commission on January 31, 2013 (the "Registration Statement"). The Registration Statement is still pending. The Registration Statement was filed with respect to 10 million shares of common stock of Lost Hills.

2. On July 5, 2013 Lost Hills filed an application to withdraw its Registration Statement under Rule 477 of Regulation C of the Commission's General Rules and Regulations under the Securities Act of 1933 ("Securities Act"), 17 C.F.R. § 230.477.

3. After considering Lost Hills' application, the Commission has determined that the granting of the withdrawal request is not consistent with the public interest and the protection of investors. Accordingly, it is hereby:

ORDERED that Lost Hills' application to withdraw its registration statement on Form S-1 filed on January 31, 2013 is denied in accordance with Rule 477.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9432 / July 17, 2013

In the Matter of **Gaspard Mining Inc.** **Registration No. 333-186201**	**ORDER DENYING WITHDRAWAL OF REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**

1. Gaspard Mining Inc. ("Gaspard") filed a Form S-1 registration statement with the Commission on January 25, 2013 (the "Registration Statement"). The Registration Statement is still pending. The Registration Statement was filed with respect to 10 million shares of common stock of Gaspard.

2. On July 5, 2013 Gaspard filed an application to withdraw its Registration Statement under Rule 477 of Regulation C of the Commission's General Rules and Regulations under the Securities Act of 1933 ("Securities Act"), 17 C.F.R. § 230.477.

3. After considering Gaspard's application, the Commission has determined that the granting of the withdrawal request is not consistent with the public interest and the protection of investors. Accordingly, it is hereby:

ORDERED that Gaspards's application to withdraw its registration statement on Form S-1 filed on January 25, 2013 is denied in accordance with Rule 477.

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. 70000 / July 18, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15378

In the Matter of **First Georgia Community Corp.,** **FLO Corp.,** **Florida Community Banks, Inc.,** **In Touch Media Group, Inc., and** **NHS Health 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 the Respondents named in the caption.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. First Georgia Community Corp. ("FGCC") [1] (CIK No. 1024132) is a non-compliant Georgia corporation located in Jackson, Georgia with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). FGCC 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, 2007. As of July 15, 2013, the common stock of FGCC was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

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

2. FLO Corp. ("FLRP") (CIK No. 1399215) is a void Delaware corporation located in Chantilly, Virginia with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). FLRP is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended June 30, 2008, which reported a net loss of $8,717,000 for the prior six months. As of July 15, 2013, the common stock of FLRP was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. Florida Community Banks, Inc. ("FLRB") (CIK No. 1170902) is a dissolved Florida corporation located in Immokalee, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). FLRB 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, 2009, which reported a net loss of $30,627,188 for the prior nine months. As of July 15, 2013, the common stock of FLRB was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. In Touch Media Group, Inc. ("ITOU") (CIK No. 1194842) is a dissolved Florida corporation located in Clearwater, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ITOU 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 a net loss of $5,450,322 for the prior nine months. As of July 15, 2013, the common stock of ITOU was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. NHS Health Solutions, Inc. ("NHSH") (CIK No. 1074507) is a Florida corporation located in Alpharetta, Georgia with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). NHSH 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, 2003, which reported a net loss of $649,664 for the prior nine months. On April 21, 2004, CLSY filed a Chapter 7 petition in the U.S. Bankruptcy Court for the District of Nevada, which was closed on November 3, 2006. On February 28, 2012, NHSH changed its corporate domicile from Nevada to Florida, but failed to report that change to the Commission, as required by Commission rules. As of July 15, 2013, the common stock of NHSH was quoted on OTC Link, had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

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

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

8. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 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 Paredes not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 70003 / July 18, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-12448

In the Matter of **STRONG CAPITAL MANAGEMENT, INC,** **Respondent.**	**ORDER AUTHORIZING THE TRANSFER OF REMAINING FUNDS AND ANY FUTURE FUNDS RECEIVED BY THE FAIR FUND TO THE U.S. TREASURY, DISCHARGING THE FUND ADMINISTRATOR, AND TERMINATING THE FAIR FUND**

On September 29, 2006, the U.S. Securities and Exchange Commission ("Commission") issued an Order Instituting Administrative and Cease-And-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions pursuant to Section 203(e) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 against Strong Capital Management, Inc. ("Order"). Investment Advisers Act Rel. No. 2560 (Sep. 29, 2006). The Commission ordered that Strong Capital Management, Inc. ("SCM") be censured and pay disgorgement in the amount of $1,004,371.50, prejudgment interest in the amount of $181,556.10, and a civil money penalty of $1,000,000. The Order also created a Fair Fund pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended.

On August 3, 2011, the Commission issued an Order Appointing Fund Administrator and Waiving Bond Requirement (Exchange Act Rel. No. 65022 (Aug. 3, 2011)). On August 3, 2011, the Commission also issued a Notice of Proposed Plan of Distribution and Opportunity for Comment (Exchange Act Rel. No. 65023 (Aug. 3, 2011)). No comments were received. On October 3, 2011, the Commission issued an Order Approving Plan of Distribution (Exchange Act Rel. No. 65465 (Oct. 3, 2011)). On March 1, 2012, the Commission issued an Order Directing Disbursement of Fair Fund authorizing the disbursement of $2,310,666.29 that included the original Fair Fund amount plus interest earned by the Fair Fund (Exchange Act Rel. No. 66496 (Mar. 1, 2012)).

More than $1.9 million has been distributed to shareholders in the Strong High-yield Municipal Bond Fund ("HYMBF"). The Fair Fund was allocated *pro rata* to harmed shareholders as follows: 25% to shareholders who owned shares in the HYMBF as of December 31, 2002; 50% to shareholders who owned shares in the HYMBF as of December 31, 2003; and

25% to shareholders who owned shares in the HYMBF as of June 30, 2004. A balance of $386,268.56 remains.

Paragraph 33 of the Plan of Distribution provides that the Fair Fund is eligible for termination after the final accounting by the Fund Administrator has been submitted and approved by the Commission, all taxes and fees have been paid, and all remaining funds have been transferred to the U.S. Treasury. The final accounting, which was submitted to the Commission pursuant to Rule 1105(f) of the Commission's Rules on Fair Fund and Disgorgement Plans, has been approved. All taxes and fees have been paid and the Commission is in possession of the remaining funds.

Accordingly, IT IS ORDERED that:

1. The $386,268.56 balance in the Fair Fund shall be transferred to the U.S. Treasury, and any future funds received by the Fair Fund shall also be transferred to the U.S. Treasury;
2. The Fund Administrator is discharged; and
3. The Fair Fund is terminated.

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. 3630 / July 18, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15380

In the Matter of **JON HARVEY DEAL,** **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 Jon Harvey Deal ("Deal" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, Respondent consents to the Commission's jurisdiction over him and the subject matter of these proceedings and 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. Deal, 55 years old, is a resident of Montgomery, Alabama. From at least November 2007 through at least November 2011, Deal was an associated person of Wilson Price Wealth Management, LLC, an investment adviser registered with the Commission from at least June 2009 through at least April 2012.

2. On August 29, 2012, Deal pled guilty to one count of securities fraud in violation of Title 15, United States Code, Sections 78j(b) and 78ff(a) and Title 17, Code of Federal Regulations, Section 240.10b-5 before the United States District Court for the Middle District of Alabama, in United States v. Jon Harvey Deal, Crim. No. 2:12-CR-155-01-MHT. On January 2, 2013, a judgment in the criminal case was entered against Deal. He was sentenced to a prison term of 38 months followed by two years of supervised release and ordered to pay an assessment fee in the amount of $100.00.

3. The count of the criminal information to which Deal pled guilty alleged, inter alia, that Deal, by the use of means and instrumentalities of interstate commerce, willfully employed a device, scheme, and artifice to defraud in connection with the sale of securities. Deal is further alleged, from on or about October 2008 through on or about October 2011, to have written approximately $440,000 in checks from a client's securities account for his own personal benefit, without the authorization or knowledge of the client.

IV.

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

Accordingly, it is hereby ORDERED pursuant to Section 203(f) of the Advisers Act that Respondent Deal be, and hereby is:

> barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

Any reapplication for association by the 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

July 18, 2013

In the Matter of **First Georgia Community Corp.,** **FLO Corp.,** **Florida Community Banks, Inc.,** **In Touch Media Group, Inc., and** **NHS Health Solutions, Inc.,** **File No. 500-1**	**ORDER OF SUSPENSION OF TRADING**

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of First Georgia Community Corp. because it has not filed any periodic reports since the period ended September 30, 2007.

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

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Florida Community Banks, Inc. because it has not filed any periodic reports since the period ended September 30, 2009.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of In Touch Media Group, Inc. because it has not filed any periodic reports since the period ended September 30, 2006.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of NHS Health Solutions, Inc. because it has not filed any periodic reports since the period ended September 30, 2003.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on July 18, 2013, through 11:59 p.m. EDT on July 31, 2013.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Gallagher not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3634 / July 19, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15382

In the Matter of

STEVEN A. COHEN,

Respondent.

CORRECTED ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO 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 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Steven A. Cohen ("Cohen" or "Respondent").

II.

After an investigation, the Division of Enforcement (the "Division") alleges that:

A. SUMMARY

1. Cohen — the founder and owner of hedge fund investment advisers that bear his initials (S.A.C.) and that until recently managed portfolios of over $15 billion — failed reasonably to supervise two of his senior employees, who engaged in insider trading under his watch.

2. On at least two separate occasions in 2008, two portfolio managers who reported to Cohen obtained material nonpublic information about three different publicly traded companies. Both portfolio managers provided information to Cohen indicating that they may have had access to inside information to support their trading. Based on that information, both portfolio managers engaged in unlawful insider trading.

3. In each case, Cohen received highly suspicious information that should have caused any reasonable hedge fund manager in Cohen's position to take prompt action to determine whether employees under his supervision were engaged in unlawful conduct and to prevent violations of the federal securities laws. Cohen failed to take reasonable steps to investigate and prevent such violations. Instead, faced with red flags of potentially unlawful conduct by employees under his supervision, Cohen allowed his traders to execute the recommended trades and stood by while the portfolio managers traded in the portfolios they managed.

4. Based on these trades, and Cohen's failure reasonably to supervise his portfolio managers who executed the trades, Cohen's hedge funds earned profits and avoided losses totaling more than $275 million.

5. Cohen later praised one of the portfolio managers for his role in one of the trades and rewarded the other with a $9 million bonus for his work.

6. Both portfolio managers have been criminally charged with insider trading. An analyst who reported to one of those portfolio managers has pleaded guilty to criminal insider trading charges.

B. RESPONDENT

7. **Cohen**, age 57, lives in Greenwich, Connecticut and New York, New York. He founded, owns, and controls investment advisers whose names bear his initials, including S.A.C. Capital Advisors, LLC ("SAC"). Before entering the hedge fund business in 1992, Cohen held a Series 3 license while working at Gruntal & Co.

C. RELEVANT ENTITIES AND PERSONS AFFILIATED WITH COHEN

8. **SAC** is an unregistered investment adviser based in Stamford, Connecticut. SAC managed certain affiliated hedge funds until the end of 2008, when another entity that Cohen owned assumed SAC's role.[1]

9. **CR Intrinsic Investors, LLC ("CR Intrinsic")** is an investment adviser based in Stamford, Connecticut. In 2008, it was a wholly-owned subsidiary of SAC. Since January 1, 2009, it has been a wholly-owned subsidiary of SAC LP, a registered investment adviser since February 2012. CR Intrinsic advises hedge funds with approximately $2.8 billion in assets under management.

10. **Sigma Capital Management, LLC ("Sigma Capital")** is an investment adviser based in New York, New York. In 2008, it was a wholly-owned subsidiary of SAC. Since January 1, 2009, it has been a wholly-owned subsidiary of SAC LP, a registered investment adviser since February 2012. Sigma Capital advises hedge funds with approximately $2 billion of assets under management.

11. **Mathew Martoma**, age 39, lives in Boca Raton, Florida. Martoma worked at CR Intrinsic between 2006 and 2010. From at least January 1, 2008 until his departure in 2010, Martoma served as a portfolio manager. In December 2012, the United States Attorney's Office for the Southern District of New York (the "USAO"), filed an indictment against Martoma charging him with two counts of securities fraud and one count of conspiracy to commit securities fraud based on certain of the securities trades alleged here.

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[1] At approximately the end of 2008, SAC's role was assumed by S.A.C. Capital Advisors, L.P. ("SAC LP"), an investment adviser also founded, owned and controlled by Cohen. SAC LP has been registered with the Commission since February 2012. In early 2013, SAC LP had approximately $15 billion in assets under management.

12. **Michael Steinberg**, age 40, lives in New York, New York. Steinberg has worked at Sigma Capital since 1996. In 2008, Steinberg was a portfolio manager responsible for a portfolio of at least $100 million and a team of analysts and traders. On March 29, 2013, the USAO charged Steinberg with securities fraud and conspiracy to commit securities fraud in a criminal proceeding based in part on certain of the securities trades alleged here. Shortly thereafter, Sigma Capital placed Steinberg on paid leave.

13. **Jon Horvath**, age 43, lives in San Francisco, California. From September 2006 to September 2012, Horvath was a research analyst at Sigma Capital and reported to Steinberg. On September 28, 2012, Horvath pleaded guilty to two counts of securities fraud and one count of conspiracy to commit securities fraud.

14. **Hedge Fund Manager A** lives in New York, New York. From approximately 2003 to 2006, Hedge Fund Manager A was an employee of Sigma Capital and worked for Cohen. In 2006, Hedge Fund Manager A left and founded an unregistered investment adviser that SAC funded. Hedge Fund Manager A ran this investment adviser.

15. **Portfolio Manager A** resides in New York, New York. Portfolio Manager A has worked at Sigma Capital since December 2006. In 2008, he managed a portfolio of approximately one billion dollars.

D. THE RELEVANT SECURITIES ISSUERS AND THE INSIDERS

16. **Elan Corporation, plc ("Elan")** is a biotechnology company incorporated in Ireland, with its principal place of business in Dublin, Ireland. Elan's Ordinary Shares trade on the Irish Stock Exchange and the London Stock Exchange. Its American Depositary Receipts ("ADRs") — each representing one Ordinary Share — trade on the New York Stock Exchange under the symbol "ELN." Elan has reported as a foreign issuer since at least 1996.

17. **Wyeth ("Wyeth")** was a pharmaceutical company incorporated in Delaware with its principal place of business in Madison, New Jersey in 2008. Until Wyeth was acquired by Pfizer Inc. in 2009, Wyeth's securities were registered with the Commission pursuant to Section 12(b) of the Exchange Act and its stock traded on the NYSE under the symbol "WYE."

18. **Dell Inc. ("Dell")** is a Delaware corporation headquartered in Round Rock, Texas. Dell develops and sells computers and related products and services. Dell securities are registered with the Commission pursuant to Section 12(b) of the Exchange Act and its stock is traded on the Nasdaq under the symbol "DELL."

19. **Dr. Sidney Gilman**, age 80, lives in Ann Arbor, Michigan and is a former professor at the University of Michigan Medical School. Gilman served as a consultant to Elan and Wyeth. At the same time, he served as a paid consultant for an expert network firm.

20. **The Dell Insider** was an employee in the investor relations department at Dell during the relevant time.

E. OTHER RELEVANT ENTITY AND PERSONS

21. **Sandeep Goyal**, age 40, lives in Princeton, New Jersey. From July 2007 to January 2012, he was an analyst for Neuberger Berman. From 2003 to 2006, Goyal was a manager of

corporate planning at Dell. On November 3, 2011, Goyal pleaded guilty to one count of securities fraud and one count of conspiracy to commit securities fraud.

22. **Diamondback Capital Management LLC** ("Diamondback") was an investment adviser based in Stamford, Connecticut at all relevant times. Diamondback was founded by former employees of SAC LLC. Diamondback registered with the Commission in January 2006 and served as an investment adviser to hedge funds with approximately $4 billion worth of assets under management. On December 6, 2012, Diamondback announced that it would cease investment operations and return the assets it managed to its investors.

23. **Jesse Tortora**, age 35, lives in Pembroke Pines, Florida. From late 2007 until early 2010, Tortora was an analyst at Diamondback. Before that, he worked with Goyal at a prior employer. On May 18, 2011, Tortora pleaded guilty to one count of securities fraud and one count of conspiracy to commit securities fraud.

F. FACTS

1. Cohen's Supervision of Martoma and Steinberg

24. Cohen was the chief executive officer of SAC and owned 100 percent of SAC, which in turn wholly owned Sigma Capital and CR Intrinsic.

25. At all relevant times, Cohen, along with others, directly supervised Martoma and Steinberg.

26. Cohen had the authority to hire and fire Martoma and Steinberg and the authority and ability to affect all aspects of their conduct as portfolio managers.

27. Cohen helped determine Martoma's and Steinberg's compensation, including periodic decisions about whether Martoma and Steinberg deserved discretionary compensation in addition to a percentage of the profits on their trading.

28. Cohen also "tagged" some of the positions in his own portfolio with the name of the portfolio manager who had recommended it. "Tagged" portfolio managers received additional compensation based on profits and losses from these "tagged" positions. When he took a portfolio manager's trading recommendation, Cohen generally determined whether to "tag" that portfolio manager with the position and therefore with more potential compensation.

29. Cohen exercised his authority over Martoma and Steinberg by, among other things, requiring them to update Cohen on their stock trading and to convey to him the reasons for their trades.

2. The Elan and Wyeth Trades

a. Overview

30. In the first half of 2008, Cohen watched Martoma build a massive long position in Elan and Wyeth stock based on the two companies' joint clinical trial of a drug with the potential to treat Alzheimer's disease (the "Drug"). In portfolios for which Cohen had exclusive or shared trading authority, SAC and CR Intrinsic held additional long positions of more than half a billion dollars.

31. Cohen speculated that Martoma might have access to material nonpublic information about the clinical trial. By April 2008, Cohen was aware that Martoma and another CR Intrinsic employee had spoken to a doctor who implied he had access to material, nonpublic information about the clinical trial.

32. Martoma in fact had access to material nonpublic information through another doctor, Gilman, who worked on the clinical trial of the Drug. On July 17 and 18, 2008, Martoma received material, nonpublic information from Gilman, a paid consultant to CR Intrinsic through Gilman's expert network firm, that the clinical trial results were worse than expected.

33. Two days later, on Sunday, July 20, 2008, after months of building up a massive position and being bullish on both Elan and Wyeth, Martoma had a twenty-minute phone conversation with Cohen. Despite receiving red flags that Martoma was unlawfully in possession of material nonpublic information, Cohen failed to take prompt action to determine whether an employee under his supervision was engaged in unlawful conduct and failed to take reasonable steps to prevent violations of the federal securities laws. Instead, starting the next morning, Cohen oversaw the liquidation of his and Martoma's positions in Elan and Wyeth and the accumulation of a short position instead. These trades earned the firm approximately $275 million in illicit profits and avoided losses.

b. Background

34. Before a pharmaceutical company can release a new drug, it must conduct clinical trials to demonstrate the safety and efficacy of the drug.

35. Clinical trials generally proceed in phases. In Phase I, a trial typically tests the drug on a small group of people (generally, 20 to 80 people) to determine its safety, determine a safe dosage range, and identify side-effects. In Phase II, a trial typically tests the drug on a larger group of people (generally, 200 to 300 people) to further evaluate its safety and efficacy. In Phase III, a trial typically tests the drug on large groups of people to more conclusively demonstrate its safety and efficacy and monitor any side-effects.

36. Between 2006 and 2008, Elan and Wyeth jointly conducted a Phase II clinical trial (the "Phase II Trial") for the Drug. The Phase II Trial was designed to assess the Drug's safety and tolerability in mild-to-moderate Alzheimer's disease patients and to explore the Drug's efficacy at a range of doses.

37. On June 17, 2008, Elan and Wyeth released top-line results of the Phase II Trial (the "June 17 Announcement") and announced plans to release detailed final results of the trial on July 29, 2008.

38. The market reacted positively to the June 17 Announcement: on June 18, the stock prices of Elan and Wyeth rose more than 10% and 4%, respectively.

39. Yet just afterwards, investors started looking ahead to the expected release of the detailed results on July 29 (the "July 29 Announcement"). As one analyst put it, the "[p]resentation of more complete data at [a scheduled conference on Alzheimer's disease] at the end of July will be a much anticipated event as investors should gain much greater insight into the drug's safety and efficacy profile as well as whether there may be the possibility for an accelerated registration strategy."

40. The more detailed July 29 Announcement failed to meet the market's expectations. On July 30, Elan's closing stock price plummeted by more than 40% and Wyeth's closing stock price dropped almost 12% from the previous day's close.

c. Gilman's Material Nonpublic Information and Duty of Confidentiality

41. Gilman, a consultant to Elan, had continuing access to material nonpublic information about the Phase II Trial.

42. Gilman served as the chairman of the Phase II Trial's Safety Monitoring Committee ("Safety Committee"), which met regularly between 2006 and 2008 to discuss the health of the trial participants.

43. Gilman also agreed to present, on behalf of Elan and Wyeth, the Phase II Trial results at the International Conference on Alzheimer's Disease (the "Conference"), a medical conference scheduled for July 29, 2008. As a presenter, Gilman received access to the full Phase II Trial results approximately two weeks before the July 29 Announcement.

44. In 2007 and 2008, Elan paid Gilman approximately $79,000 for his consultations on the Drug.

45. Based on his roles in the Phase II Trial and under the terms of his contract with Elan, Gilman owed Elan a duty to hold in strict confidence all information he learned from his participation in the clinical trial and to use such information only for Elan's benefit.

46. The expert network firm for which Gilman moonlighted also trained him on the prohibitions of the federal securities laws. Specifically, the firm repeatedly reminded Gilman not to share nonpublic information with clients and listed the Drug as a topic that Gilman was "not allowed to discuss."

d. Gilman Gives Martoma Material Nonpublic Information on the Drug Trial

47. Gilman first met Martoma through paid consultations arranged by Gilman's expert network firm. Between 2006 and 2009, Gilman earned approximately $108,000 from fifty-nine consultations with portfolio managers and analysts at CR Intrinsic and SAC, including forty-two consultations just with Martoma.

48. SAC's own records show payments from SAC to Gilman through his expert network firm. SAC also had emails between Gilman and Martoma (at Martoma's CR Intrinsic email address) reflecting that Gilman was a consultant for Elan and that Gilman could not discuss the Drug.

49. Over time, Gilman developed a personal relationship with Martoma and considered Martoma a friend and pupil.

50. Beginning in at least 2007, Gilman provided Martoma with material nonpublic information concerning the Phase II Trial. As a member of the Safety Committee, Gilman received periodic updates from Elan concerning nonpublic safety data for the ongoing trial. For example, in advance of each Safety Committee meeting, Elan sent Gilman a PowerPoint presentation that included information about dosages and side-effects experienced by Phase II Trial patients.

51. Starting in at least 2007, Gilman regularly called Martoma just after Safety Committee meetings to share information from the meetings with Martoma. During these calls, Gilman discussed the PowerPoint presentations and provided Martoma with his perspective on the results.

52. Martoma and Gilman coordinated their expert network consultations around scheduled Safety Committee meetings.

53. On at least one occasion prior to July 2008, Gilman emailed Martoma concerning specific — and as yet nonpublic — data from the Phase II Trial. On March 18, 2008, Gilman attended a Safety Committee meeting in which Elan presented PowerPoint slides. Shortly thereafter, Gilman emailed Martoma. Labeling his email "For Your Eyes Only" and "High Priority," Gilman gave Martoma the dropout rate for the Phase II Trial. Gilman took the figures in his email (including certain mathematical errors) directly from Elan's PowerPoint slides.

e. Prior to July 2008, the SAC Funds Held Long Positions in Elan and Wyeth

54. Martoma and Cohen respectively controlled the CR Intrinsic and SAC portfolios that held most of the Elan and Wyeth positions.

55. Throughout 2007 and up to July 2008, the CR Intrinsic and SAC portfolios established substantial long positions in Elan and Wyeth securities. As of June 30, 2008, the CR Intrinsic portfolios owned over \$233 million worth of Elan securities and over \$80 million of Wyeth stock. The combined holdings in Elan and Wyeth securities represented approximately 14% of CR Intrinsic's entire equity position at that time. Similarly, as of June 30, 2008, the SAC portfolios owned over \$293 million of Wyeth stock and over \$95 million of Elan securities — totaling over 4% of SAC's entire equity position at that time. In addition, SAC also held an equity swap position with respect to 12 million shares of Wyeth stock.[2]

56. Between January 1, 2008 and early July 2008, Martoma included Elan and Wyeth as "long ideas" in his weekly portfolio updates to Cohen and others and listed the release of the Phase II Trial results as an "[u]pcoming catalyst."

57. Cohen invested in Elan and Wyeth securities based at least in part on Martoma's advice.

58. Cohen also received input on Elan and Wyeth from Hedge Fund Manager A. In the first half of 2008, Hedge Fund Manager A generally advocated a long position in Wyeth, but not Elan.

59. Martoma and Cohen maintained their bullish positions in Elan and Wyeth despite significant dissent within CR Intrinsic and SAC on the wisdom of a large, unhedged investment in Elan and Wyeth.

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2 An equity swap is a transaction, typically with a broker-dealer, in which a party receives cash flow based on the performance of the underlying equity for a specified period of time in exchange for paying a premium. Generally, a party will sell its equity position and buy the economic interest on the shares it sold via an equity swap in order to free up cash.

f. Cohen Encourages Martoma to Talk to a Doctor About Nonpublic Trial Results

60. In March and April 2008, two analysts at CR Intrinsic (the "Analysts") repeatedly sent emails to Cohen advocating against the Elan and Wyeth positions and suggesting trading strategies to hedge them.

61. Within CR Intrinsic, Martoma claimed to have unique insight into the Phase II Trial. In the words of the Analysts, Martoma claimed to have "black edge" — illicit, nonpublic information.

62. The Analysts grew frustrated with Martoma's claims that he had information about the outcome of the Phase II Trial. They believed it was impossible for anyone, even an insider, to have such information before the trial concluded.

63. The Analysts exchanged a number of emails and instant messages with Cohen about whether Martoma's advice on Elan and Wyeth was sound. On March 28, 2008, one of the Analysts told Cohen in an instant message that he did not think anyone could yet know the Phase II Trial data, because the trial was not over yet. Cohen responded by saying he would follow Martoma's and Hedge Fund Manager A's advice, because "they are closer to it than you." Later in the same message, the Analyst asked Cohen: "[I] don't know if [Hedge Fund Manager A] or mat [Martoma] will answer, but do you think they know something or do they have a very strong feeling." Cohen replied: "[T]ough one . . . i think mat [Martoma] is the closest to it." The Analyst responded: "[T]he question that I would ask is if it[']s possible to know the data yet – i could be wrong, but i don't think it is yet."

64. A few days later, on April 6, 2008, Cohen exchanged instant messages with the other Analyst about the Drug. Cohen remarked that it "seems like mat [Martoma] has a lot of good relationships in this arena."

65. On April 11 and 12, 2008, the Analysts relayed to Cohen their conversation with another doctor, who according to the Analysts, implied that he had seen some confidential Phase II Trial data. Like Gilman, this doctor was a paid consultant to SAC, through an expert networking firm, and simultaneously participated in confidential clinical trials conducted by Elan and Wyeth. The Analysts informed Cohen that this doctor had told one of them that the Drug did not have a statistically significant effect on patients and that the Phase II Trial data were not as good as Elan's public statements might suggest. The Analyst summarized this conversation in an email to Cohen and dismissed Martoma's claim that he had informational "edge" on the Phase II Trial data. The Analyst told Cohen that if Martoma really had "edge," it contradicted the Analyst's conversation with this doctor.

66. During his email exchanges with the Analysts, Cohen displayed no concern about the apparent disclosure of nonpublic information by the doctor to the Analysts or about the Analysts' use of such information to inform their investment decisions on the firm's behalf.

67. Instead, Cohen tried to discover whether the doctor had access to nonpublic information and the weight any such information should be given for investment purposes. Cohen wrote to one of the CR Intrinsic Analysts that it "[s]eems strange that [the doctor] would have seen the [interim] data when other investigators haven't." The Analyst responded, "Some small # of [people] have seen the data, otherwise they would not have been able to design the phase 3s. Was

[the doctor] one of those ppl, I have no idea.... But he said he saw the data before agreeing to be in the study, which isn't totally unreasonable...."

68. Cohen also forwarded the Analyst's email to Martoma to have him follow up with the same doctor. About an hour after receiving Cohen's email, Martoma emailed the doctor to schedule a consultation. A few days later, Martoma reported back to Cohen to tell him he had spoken with the doctor himself and that it was a "[n]on issue." Cohen replied: "How come[?]"

69. Cohen encouraged Martoma to speak with the doctor who Cohen had been told may have seen Phase II Trial results — information that any reasonable hedge fund manager should have known might be material and nonpublic. Cohen also knew, based on his communications with the Analysts, that Martoma possibly had another inside source on the Phase II Trial.

70. Cohen failed to take prompt action to determine whether employees under his supervision were engaged in unlawful conduct and failed to take reasonable steps to prevent violations of the federal securities laws.

71. Cohen's failure to do so was inconsistent with the instructions of SAC's then-applicable Code of Ethics. The Code of Ethics warned that "[e]mployees should also be conscious of the prohibitions of trading on or the misuse of material nonpublic information when communicating with potential sources of market information such as . . . doctors conducting clinical trials . . . . Questions concerning the propriety or advisability of contacting such sources should be discussed with the [Chief Compliance Officer] or the General Counsel prior to doing so." SAC's compliance officers also provided training to employees about the potential for doctors participating in drug trials to have access to material nonpublic information.

g. In July 2008, Gilman Tells Martoma about the Phase II Trial Results

72. After the June 17 Announcement, Martoma maintained his bullish view of Elan. On June 30, 2008, when Elan securities were trading at about $35 per share, Martoma told Cohen that he intended to increase the Elan position and predicted that the stock would rise past $40 per share after the July 29 Announcement.

73. In late June, Gilman learned that he likely would be selected to present the Phase II Trial results at the Conference on July 29. Soon after, Gilman told Martoma. When later designated as the presenter, Gilman arranged to travel to Elan's offices on July 15 and 16, 2008, to obtain the full results of the Phase II Trial.

74. In the weeks leading up to the July 29 Announcement, Gilman had several telephone calls with Martoma. He provided Martoma with material nonpublic information not only on the safety results, but also on the efficacy results for the Phase II Trial.

75. For example, on Friday, July 11, 2008, Gilman participated in a Safety Committee meeting where the safety results for the completed Phase II Trial as a whole were discussed. Two days later, on Sunday, July 13, Gilman spoke with Martoma for more than 1 hour and 40 minutes and provided Martoma with confidential information about the completed Phase II Trial safety results. Towards the end of the call, Martoma and Gilman scheduled another call on July 17, 2008 — the day after Gilman returned from his anticipated two-day meetings with Elan.

76. On July 15, 2008, Gilman traveled to San Francisco in a private plane arranged by Elan to participate in two days of meetings about the Phase II Trial efficacy results. Gilman received the complete efficacy results of the trial and reviewed and commented on a draft PowerPoint presentation that he would use to present the results at the Conference.

77. On July 17, 2008, after Gilman returned to his home in Michigan, an Elan officer sent Gilman an updated Conference PowerPoint presentation in an email labeled "Confidential, Do Not Distribute." The twenty-four page PowerPoint included summaries of the detailed efficacy results and safety results for the Phase II Trial as well as additional commentary on Elan's and Wyeth's interpretation of the data.

78. Later in the afternoon of July 17, 2008, Gilman and Martoma spoke again by phone. During a call that lasted for almost two hours, Gilman provided Martoma with confidential information about the detailed results of the Phase II Trial, including all the information contained in the revised PowerPoint presentation. Shortly afterward, Gilman sent the revised PowerPoint presentation to Martoma and then gave Martoma a password for the encrypted file.

79. On July 18, 2008, Martoma and Gilman spoke again by phone at least three times.

h. Martoma, CR Intrinsic, and SAC Trade Based on the Material Nonpublic Information from Gilman and Cohen Fails Reasonably To Supervise

80. After his July 17 and July 18 communications with Gilman, Martoma reached out to Cohen on the morning of Sunday, July 20, 2008. Martoma told Cohen "[i]t's important" they speak.

81. Later that morning, Cohen and Martoma spoke for nearly 20 minutes. According to Cohen, Martoma said that he was no longer "comfortable" with the Elan investments that CR Intrinsic and SAC held. Despite being informed of Martoma's abrupt change in view on the Elan investments and red flags that Martoma may have unlawfully been in possession of material nonpublic information, Cohen failed to take prompt action to determine whether an employee under his supervision was engaged in unlawful conduct and failed to take reasonable steps to prevent violations of the federal securities laws.

82. Before the market opened on Monday, July 21, 2008, CR Intrinsic and SAC held over 10.5 million Elan securities worth over $365 million and over 7.1 million Wyeth shares worth over $335 million in the portfolios Cohen and Martoma controlled.

83. On July 21, 2008, Cohen's head trader at SAC (the "Head Trader") began selling Elan and Wyeth securities held in those portfolios.

84. Between July 21 and July 29, 2008 (the last trading day before the post-market July 29 Announcement), the CR Intrinsic and SAC portfolios sold over 15 million Elan securities for gross proceeds of more than $500 million. Although the investment advisers' portfolios achieved a zero balance in Elan securities by July 25, 2008, they continued to sell short Elan securities until the July 29 Announcement.[3] By the close of the market on July 29, 2008, the CR Intrinsic and

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3 To "sell short" is to sell a security that one does not own, but rather has arranged to borrow from a third party, with the intention of purchasing (also called "covering") the security at a later date to deliver to the lender. A short seller stands to gain if the price of the security

SAC portfolios had a combined short position of approximately 4.5 million Elan securities. CR Intrinsic's and SAC's trading in Elan made up over 20% of the reported market trading volume in Elan during the seven days before the July 29 Announcement.

85. Between July 21 and July 29, 2008, the CR Intrinsic and SAC portfolios also sold over 10.4 million shares of Wyeth for gross proceeds of more than $460 million, including over 6.1 million Wyeth shares worth more than $270 million on July 29 before the announcement. During the day on July 29, the CR Intrinsic and SAC portfolios briefly had a zero balance in Wyeth stock but then continued to place short sales that day. By the close of the market on July 29, the portfolios had a combined short position of approximately 3.3 million Wyeth shares. CR Intrinsic's and SAC's trading in Elan made up over 11% of the reported market trading volume in Wyeth during the seven days before the July 29 Announcement.

86. CR Intrinsic and SAC also placed options trades in Elan ADRs that bet on the ADRs' share price going down. For example, on July 28 and July 29, the CR Intrinsic and SAC portfolios purchased over $1 million worth of Elan put options with strike prices below the Elan ADR share price on those trading days.[4]

87. Martoma urged Cohen and the Head Trader to sell the Elan securities in the CR Intrinsic and SAC portfolios quickly. For example, on July 22, ten minutes after the Head Trader called Martoma, Martoma sent Cohen an instant message at 1:22:34 p.m., saying, "would do more today if possible[,]" suggesting that Cohen sell more Elan ADRs. At 1:22:50 p.m., Cohen responded, in relevant part, "we are done on 2.3 today[.]" Martoma replied, "my sense is today-thurs are best days so if possible to do more, would do so[.]" After receiving Martoma's message, Cohen sold over 2.2 million more Elan ADRs on July 22.

i. On July 29, Elan and Wyeth Announce Bad News About the Phase II Trial

88. On July 29, 2008, after the close of U.S. securities markets, Gilman presented the results of the Phase II Trial at the Conference, and Elan and Wyeth issued a press release summarizing the results. Although Elan and Wyeth emphasized the positive aspects of the trial, the press release and Gilman's presentation included details not in the June 17 Announcement. The market reacted negatively to the full results.

89. On July 30, 2008, the first trading day after the July 29 Announcement, Elan's share price fell from $33.75 (the closing price on the day of the announcement) to $19.63 (the closing price on the day after the announcement), a decline of approximately 42%. Wyeth's stock price fell from $45.11 (the closing price on the day of the announcement) to $39.74 (the closing price the day after the announcement), a decline of approximately 12%.

90. Cohen's and Martoma's CR Intrinsic and SAC portfolios collectively reaped profits

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drops between the short sale and the purchase because the short seller has sold the security at a price higher than the purchase price.

4 A put option is a financial contract between two parties that gives the buyer the right, but not the obligation, to sell an agreed quantity of stock during a specified time period at a specified price. A buyer of a put option pays a premium to purchase this right and generally stands to gain if the stock price drops.

and avoided losses of approximately $275million based on the trades Martoma and Cohen placed after Martoma received material, nonpublic information from Gilman about the Phase II Trial results and Cohen failed reasonably to supervise Martoma.

j. Cohen Pays Martoma a Big Bonus Before Firing Him Two Years Later

91. At the end of 2008, Martoma received a bonus of over $9.3 million. The bonus included a percentage of the Elan trading profits in the CR Intrinsic portfolios, as well as a share of the Elan profits in certain SAC portfolios.

92. 2008 was a banner year for Martoma. Martoma was never again able to generate such outsized returns.

93. In 2009 and 2010, Martoma did not earn a bonus.

94. In 2010, Cohen and others decided to fire Martoma for poor performance. In a 2010 email suggesting that Martoma be fired, a firm officer said that Martoma had been a "one trick pony with Elan."

3. The Dell Trades

a. Overview

95. In August 2008, as in several previous quarters, Horvath received material nonpublic information about Dell's quarterly financial results before Dell announced them. Horvath received the information from a friend at another hedge fund but knew the ultimate source was a Dell insider.

96. As he had done in prior quarters, Horvath shared the information and the fact that it came from a Dell insider with Steinberg, Horvath's supervisor at Sigma Capital. While in possession of this material nonpublic information, Steinberg unlawfully traded in the portfolio he managed.

97. Two days before Dell was to announce its financial results, Horvath sent Steinberg and Portfolio Manager A an email. He said he had received a gross profit margin range for Dell indirectly from "someone at the company," that Dell's gross margins would fall significantly below what analysts expected, and that Horvath expected Dell's stock price would therefore drop.

98. That email was forwarded to Cohen. Minutes afterward, Cohen began selling his entire $11 million long position in Dell.

99. Despite red flags in the email, Cohen failed to take prompt action to determine whether an employee under his supervision was engaged in unlawful conduct and failed to take reasonable steps to prevent violations of the federal securities laws. Instead, Cohen traded — and stood by knowing Steinberg had traded and might continue to trade — after receiving the email. As a result, SAC's funds profited or avoided losses totaling at least $1.7 million.

b. Background

100. During at least 2008 and 2009, a Dell investor relations employee, the Dell Insider, regularly provided material nonpublic information about Dell's quarterly financial results to Goyal, an analyst at an investment advisory firm and a former colleague of the Dell Insider's at Dell.

101. Goyal and the Dell Insider were friends. While the Dell Insider provided Goyal with inside information about Dell, the Dell Insider sought and received career advice from Goyal in return.

102. The Dell Insider provided specific information on quarterly financial results, such as revenues and gross margins, that Dell had not yet publicly released.[5] Because they are key measures of a company's sales and profitability, revenue and gross margin figures are important to investors.

103. Only a few people within Dell, including certain investor relations employees like the Dell Insider, had access to such confidential financial results before their public release. The Dell Insider's supervisor had informed the Dell Insider and others that this sort of financial information was not to be disseminated prior to its public release.

104. The Dell Insider's provision of this information to Goyal violated the Dell Code of Conduct.

105. Goyal passed the information he received from the Dell Insider to his friend Tortora, an analyst at Diamondback. In exchange, Tortora and his supervisor at Diamondback arranged for Diamondback to make payments totaling over $175,000 to a brokerage account maintained by Goyal's wife. Goyal's wife never provided any goods or services to Diamondback.

106. After receiving the Dell information from Goyal, Tortora passed the information to several other hedge fund analysts — including Horvath — with whom Tortora regularly exchanged information about certain technology companies.

107. Tortora informed Horvath that the information had come from a source within Dell, as was obvious from the specificity of the information. Horvath then passed the information to Steinberg, his supervisor at Sigma Capital, and told Steinberg that the information had come from a Dell employee.

108. Shortly after receiving the information from Horvath, Steinberg executed trades in Dell securities on behalf of hedge funds that Sigma Capital managed.

c. Dell's August 2008 Earnings Announcement

109. In advance of Dell's August 28, 2008 announcement of financial results for its second quarter (May 3, 2008 to August 1, 2008), the Dell Insider provided Goyal with inside information about Dell's revenues and gross profit margin.

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[5] Revenues are the proceeds from a company's sales of its products or services. Gross margins are a company's gross profits — the profit the company earns after deducting the costs of goods sold from the company's revenues. Gross margins are usually expressed as a percentage of revenue.

110. In the weeks leading up to the announcement, as Dell got closer to finalizing its financial results and revised its initial calculations, Goyal received updates from the Dell Insider on the numbers.

111. Goyal then provided the Dell inside information to Tortora, who passed it to Horvath, who then passed it to Steinberg.

112. On the evening of August 4, 2008, the Dell Insider and Goyal spoke on the phone for 40 minutes. The Dell Insider provided Goyal with inside information about Dell's second quarter financial results.

113. Early the next morning, Goyal called Tortora. They spoke for approximately ten minutes. Goyal gave Tortora the inside information Goyal had received from the Dell Insider.

114. A few minutes later, Tortora emailed Horvath and conveyed the inside information he had just received, including Dell's calculation of its revenues and gross margins.

115. In his email, Tortora told Horvath that Dell's then-current calculation of its gross profit margin for the second quarter was 17.5 percent, which was significantly worse than the 18.3-percent figure that analysts expected.

116. On the evening of August 14, the Dell Insider again called Goyal. They spoke for fifty minutes. The Dell Insider told Goyal that Dell's second quarter gross margin was still expected to be lower than analysts were predicting, among other things. The next day, Tortora spoke with Goyal again.

117. On the next trading day, Monday, August 18, Tortora passed the update concerning Dell's disappointing gross margin results to Horvath during a ten-minute call.

118. Three minutes after Horvath's call with Tortora ended, Horvath called Steinberg. They spoke for approximately two minutes. About a minute later, Horvath emailed Steinberg and asked him to "Pls keep the DELL info on the down low. [J]ust mentioning that because JT [Tortora] specifically asked me to be extra sensitive with the info." Steinberg replied, "I will."

119. Steinberg immediately began short-selling Dell stock. The same day, he amassed a short position of over 167,000 shares for a hedge fund that Sigma Capital managed. Over the next few trading days, Steinberg also purchased Dell put options and sold short Dell call options — trades that, like the short sales, would pay off if Dell's stock price declined, as Horvath and Steinberg expected based on the inside information from Tortora.

120. On the evening of August 24, Goyal received another update from the Dell Insider. The next day, Goyal called Tortora and told him that Dell was still planning to announce a worse-than-expected gross margin.

121. Approximately 20 minutes after that call, Tortora sent an email to Horvath indicating that Tortora had done a new "[D]ell check" and that it was the "same as before" and sounded bad for Dell.

d. Cohen Receives the Dell Information and Trades On It

122. On August 25 and 26, Cohen was working at his vacation home on Long Island, where he had a home office set-up virtually identical to the one in his corporate office.

123. On August 25 at 9:30 a.m., Cohen began purchasing shares of Dell in one of the portfolios he controlled at SAC. By 12:01 p.m., he held a long position of 450,000 shares, at a cost of more than $11 million.

124. At 12:31 p.m. that day, Horvath received an automatically-generated email. The email alerted Horvath that Cohen had a long position in Dell, which Horvath knew ran counter to the short position in Steinberg's portfolio. Two minutes later, Horvath forwarded the email to Steinberg and noted that "Steve [Cohen] is long Dell." Steinberg responded that he assumed Cohen took his long position on advice from Portfolio Manager A, who had taken a long position in Dell.

125. Later that day, Steinberg and Horvath exchanged emails. They discussed whether to tell Cohen their view that Dell's stock price would decrease after the earnings announcement based on Dell's disappointing gross margins.

126. At 9:31 a.m. the next day, August 26, Cohen bought 50,000 more shares of Dell, bringing his total long position to 500,000 shares.

127. About three hours later, at 12:37 p.m., Steinberg emailed Horvath and Portfolio Manager A. Steinberg told them that he had talked to Cohen about Dell earlier that day and that Cohen wanted Horvath and Portfolio Manager A, who were on opposite sides of Dell, to compare notes before the markets closed that day. Steinberg added, for Portfolio Manager A's benefit, that he and Horvath thought gross margins were "at risk this [quarter]," among other things, and that he and Horvath expected that the earnings per share would miss analysts' estimates and cause the stock price to drop.

128. At 12:54 p.m., Portfolio Manager A replied that, while he agreed gross margins were "the biggest risk," he estimated gross margins of 18.1% (significantly higher than the figure Horvath had received from Tortora). Portfolio Manager A asked Horvath how he was modeling gross margins.

129. Also at 12:54 p.m., Portfolio Manager A spoke with Cohen on the phone for approximately seven minutes.

130. Just minutes later, at 1:09 p.m., Horvath replied to Portfolio Manager A and copied Steinberg:

> I have a 2nd hand read *from someone at the company* – this is 3rd quarter I have gotten this read from them and it has been very good in the last quarters. They are seeing G[ross] M[argin]s miss by 50-80 [basis points] due to poor mix, op[erating] ex[penses] in-line and a little revenue upside netting out to an [earnings per share] miss. . . . Please keep to yourself as obviously not well known.

(emphasis added).

131. Four minutes later, at 1:13 p.m., Portfolio Manager A forwarded this email to a SAC employee whose duties included forwarding to Cohen trading-related information worthy of Cohen's attention (the "Research Trader").

132. At 1:29 p.m., this employee forwarded Horvath's email to Cohen at two email addresses Cohen maintained at SAC, one designated "Office" and the other designated "Home."

133. From 1:17 p.m. to 1:36 p.m., Cohen spoke on his cell phone to another SAC employee.

134. At 1:37 p.m., the Research Trader called Cohen on his cell phone. The call lasted 48 seconds.

135. At 1:39 p.m., Cohen began selling shares of Dell. By 3:49 p.m., Cohen had sold his entire Dell position.

136. After receiving Horvath's highly suspicious email, which reflected the clear possibility that Steinberg and Horvath were unlawfully in possession of material nonpublic information and that Steinberg had traded or might trade on that information, Cohen failed to take prompt action to determine whether an employee under his supervision was engaged in unlawful conduct and failed to take reasonable steps to prevent violations of the federal securities laws. Instead, Cohen liquidated his Dell shares.

137. Through August 28, Steinberg continued to sell short Dell shares in his Sigma Capital portfolio while in knowing possession of material nonpublic information about Dell.

e. Dell's Stock Price Drops After Its August 28 Earnings Announcement

138. After the markets closed on August 28, Dell announced its second quarter financial results, including a gross margin of 17.2 percent. That figure was substantially worse than the 18.4 percent that analysts had expected.

139. Three hours after Dell's announcement, Cohen emailed Steinberg: "Nice job on Dell."

140. The following day, Dell's share price dropped more than 13 percent, from a closing price of $25.21 on August 28 to a closing price of $21.73 on August 29.

141. Over the next few days, Steinberg closed out his positions and reaped profits of approximately $1 million.

142. By selling shares in his portfolio after receiving Horvath's email, Cohen avoided losses of over $1.7 million.

G. <u>Violations</u>

143. As a result of the conduct described above, Cohen failed reasonably to supervise Martoma and Steinberg with a view to preventing their violations of 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 are true and, in connection therewith, to afford Respondent an opportunity to establish any defenses to such allegations;

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

IV.

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

IT IS FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

If Respondent fails to file the directed answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against him upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served forthwith upon Respondent personally or by certified mail.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 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

July 19, 2013

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

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of RVPlus, Inc. ("RVPL") because of questions regarding: (1) the adequacy of current financial information available about RVPL; (2) the accuracy of RVPL's periodic financial filings, including reported accounts receivable, assets and operations; and (3) assertions by RVPL in press releases to investors. RVPL is a Delaware corporation based in Jersey City, New Jersey and is traded under the symbol "RVPL."

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 July 19, 2013 through 11:59 p.m. EDT, on August 1, 2013.

By the Commission.

Elizabeth M. Murphy
Secretary

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

Commissioner Walter,
Commissioner Paredes
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 70017 / July 22, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15383

In the Matter of **China Intelligent Lighting and Electronics, Inc.** **and** **NIVS IntelliMedia Technology Group, 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 China Intelligent Lighting and Electronics, Inc. ("CIL") and NIVS IntelliMedia Technology Group, Inc. ("NIV" or collectively, "Respondents")

II.

After an investigation, the Division of Enforcement alleges that:

A. CIL (CIK No. 0001421525) is a Delaware corporation with its principal executive offices in Huizhou City, Guangdong Province, China. CIL's common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act. Its securities traded on the NYSE-Amex for approximately nine months, until the exchange halted trading on March 24, 2011. CIL was delisted by NYSE-Amex on October 17, 2011. As of May 15, 2013, CIL stock was quoted at 0.0001 cents per share on OTC Link (formerly "Pink Sheets") operated by OTC Markets Group Inc. ("OTC Link"), had no market makers, and was not eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. NIV (CIK No. 0001403795) is a Delaware corporation with its principal executive offices in Huizhou City, Guangdong Province, China. NIV's common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act. Its securities traded on the NYSE-Amex, until halted by the exchange on March 24, 2011. NIV was delisted by NYSE-Amex on July 29, 2011. As of May 15, 2013, OTC Link quoted NIV stock at 0.0035 cents per share, had three market makers, and was not eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

C. CIL and NIV are delinquent in their periodic filings with the Commission, having repeatedly failed to meet their obligations to file timely periodic reports.

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

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

III.

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

A. Whether the allegations contained in Section II above 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 above.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III above 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 twenty (20) 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 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, 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

July 23, 2013

In the Matter of **Camelot Entertainment Group, Inc.,** **Cavico Corp.,** **Global 8 Environmental Technologies, Inc.,** **GTC Telecom Corp.,** **ICF Corporation, and** **New NRG, Inc.,** **File No. 500-1**	**ORDER OF SUSPENSION OF TRADING**

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

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

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Global 8 Environmental Technologies, Inc. because it has not filed any periodic reports since the period ended June 30, 2009.

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

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of ICF Corporation because it has not filed any periodic reports since the period ended September 30, 2005.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of New NRG, Inc. because it has not filed any periodic reports since the period ended December 31, 2006.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on July 23, 2013, through 11:59 p.m. EDT on August 5, 2013.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 70022 / July 23, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15387

In the Matter of **Camelot Entertainment Group, Inc.,** **Cavico Corp.,** **Global 8 Environmental Technologies, Inc.,** **GTC Telecom Corp.,** **ICF Corporation, and** **New NRG, Inc.** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

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

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Camelot Entertainment Group, Inc. ("CMGR") [1] (CIK No. 1115818) is a delinquent Delaware corporation located in Irvine, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CMGR is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2010, which reported a net loss of $8,026,537 for the prior nine months. As of July 18, 2013, the common stock of CMGR was quoted on OTC Link, had ten market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

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

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2. Cavico Corp. ("CAVO") (CIK No. 1376742) is a delinquent Delaware corporation located in Huntington Beach, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CAVO is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2010, which reported a net loss of $5,354,387 for the prior nine months. On May 16, 2000, CAVO filed a Chapter 11, which was converted to a Chapter 7 on April 3, 2001 petition in the U.S. Bankruptcy Court for the District of New Jersey, which was closed on January 24, 2007. On June 27, 2007, the Commission entered an order pursuant to Exchange Act Section 12(j) revoking the registration of each class of CAVO's securities registered pursuant to Exchange Act Section 12(g). *Laminaire Corp. (n/k/a Cavico Corp.), et al.*, Exchange Act Rel. No. 55968 (June 27, 2007). CAVO filed a new registation statement on Form 10-SB12G on October 23, 2007 and recommenced trading in April 2008. As of July 18, 2013, the common stock of CAVO was quoted on OTC Link, had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. Global 8 Environmental Technologies, Inc. ("GBLE") (CIK No. 1040227) is a defaulted Nevada corporation located in San Diego, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GBLE is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended June 30, 2009, which reported a net loss of $4,313,401 for the prior nine months. As of July 18, 2013, the common stock of GBLE was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. GTC Telecom Corp. ("GTCC") (CIK No. 1081919) is a revoked Nevada corporation located in Costa Mesa, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GTCC is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2007, which reported a net loss of $2,673,990 for the prior nine months. As of July 18, 2013, the common stock of GTCC was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. ICF Corporation ("ICFO") (CIK No. 754568) is a void Delaware corporation located in Concord, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ICFO 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, 2005. As of July 18, 2013, the common stock of ICFO was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

6. New NRG, Inc. ("NNRG") (CIK No. 1043605) is a void Delaware corporation located in Ferndale, Washington with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). NNRG is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the period ended December 31, 2006, which reported a net loss of $4,553,937 for the prior year. As of July 18, 2013, the common stock of NNRG was quoted on OTC Link, had four market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

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

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

9. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 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 Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 70018 / July 23, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15384

In the Matter of **Southern Scottish Inns, Inc.,** **Respondent.**	**ORDER INSTITUTING PROCEEDINGS, MAKING FINDINGS, AND REVOKING REGISTRATION OF SECURITIES PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act"), against Southern Scottish Inns, Inc. ("SSCT" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Proceedings, Making Findings, and Revoking Registration of Securities Pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

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

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

1. SSCT is a Louisiana for-profit corporation with its principal place of business in Tucker, Georgia. It has a class of common stock registered pursuant to Section 12(g) of the Exchange Act that is traded on the Pink Sheets.

2. SSCT has failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder because it has not filed any periodic reports with the Commission since the period ended December 31, 2003.

IV.

Section 12(j) of the Exchange Act provides as follows:

> The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means of instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

In view of the foregoing, the Commission finds that it is necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

Accordingly, it is hereby ORDERED, pursuant to Section 12(j) of the Exchange Act, that registration of each class of Respondent's securities registered pursuant to Section 12 of the Exchange Act be, and hereby is, revoked.

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. 70019 / July 23, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15385

In the Matter of **Securities Transfer, Inc.,** **Respondent.**	**ORDER INSTITUTING PROCEEDINGS, MAKING FINDINGS, AND REVOKING REGISTRATION OF TRANSFER AGENT PURSUANT TO SECTION 17A(c)(3) 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 17A(c)(3) of the Securities Exchange Act of 1934 ("Exchange Act"), against Securities Transfer, Inc. ("STI" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Proceedings, Making Findings, and Revoking Registration of Transfer Agent Pursuant to Section 17A(c)(3) of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

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

1. Securities Transfer, Inc., which is registered with the Commission as a transfer agent under File Number 084-01167, is a Mississippi for-profit corporation with its

[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.

principal place of business in Tucker, Georgia. Securities Transfer registered with the Commission as a transfer agent on November 18, 1983 and is currently the transfer agent for the common and preferred stock of Red Carpet Inns International, Inc. (Securities Transfer's corporate parent) and the common stock of Southern Scottish Inns, Inc. (which holds a controlling interest in Red Carpet Inns International, Inc.).

2. Securities Transfer, Inc., has failed to comply with Exchange Act Section 17A(c)(1) and Rules 17Ac2-1(c) and 17Ac2-2(a) thereunder because it has not filed accurate annual registered transfer agent reports for 2010, 2011, and 2012 and has not filed accurate transfer agent registration amendments regarding its ownership and control.

IV.

Section 17A(c)(3) of the Exchange Act provides as follows:

> The appropriate regulatory agency for a transfer agent, by order, shall deny registration to, censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of such transfer agent, if such appropriate regulatory agency finds, on the record after notice and opportunity for hearing, that such denial, censure, placing of limitations, suspension or revocation is in the public interest and that such transfer agent, whether prior or subsequent to becoming so associated– (A) has committed or omitted any act, or is subject to an order or finding, enumerated in subparagraph (A), (D), (E), (G), or (H) of paragraph (4) of Section 15(b) of this title, ...

In view of the foregoing, the Commission finds that it is necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

Accordingly, it is hereby ORDERED, pursuant to Section 17A(c)(3) of the Exchange Act, that Respondent's registration as a transfer agent 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

SECURITIES EXCHANGE ACT OF 1934
Release No. 70020 / July 23, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15386

In the Matter of **American Wenshen Steel Group, Inc.,** **Case Financial, Inc.,** **Global ePoint, Inc., and** **iMedia 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 the Respondents named in the caption.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. American Wenshen Steel Group, Inc. ("AWSH") [1] (CIK No. 1085104) is a void Delaware corporation located in City of Industry, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). AWSH 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, 2010, which reported a net loss of $186,114 for the prior nine months. As of July 18, 2013, the common stock of AWSH was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

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

2. Case Financial, Inc. ("CSEF") (CIK No. 1096841) is a Delaware corporation located in Carlsbad, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CSEF 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, 2010, which reported a net loss of $621,389 for the prior nine months. As of July 18, 2013, the common stock of CSEF was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. Global ePoint, Inc. ("GEPT") (CIK No. 896195) is a Nevada corporation located in City of Industry, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GEPT 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, 2007, which reported a net loss of $16,258,000 for the prior nine months. As of July 18, 2013, the common stock of GEPT was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. iMedia International, Inc. ("IMED") (CIK No. 1208498) is a delinquent Delaware corporation located in Pasadena, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). IMED 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, 2006, which reported a net loss of $1,237,867 for the prior six months. As of July 18, 2013, the common stock of IMED was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

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

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

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

July 23, 2013

In the Matter of **American Wenshen Steel Group, Inc.,** **Case Financial, Inc.,** **Global ePoint, Inc., and** **iMedia International, Inc.,** **File No. 500-1**	**ORDER OF SUSPENSION OF TRADING**

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

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

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Global ePoint, Inc. because it has not filed any periodic reports since the period ended September 30, 2007.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of iMedia International, Inc. because it has not filed any periodic reports since the period ended June 30, 2006.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on July 23, 2013, through 11:59 p.m. EDT on August 5, 2013.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 70030 / July 23, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15388

In the Matter of Geo Petroleum, Inc., Global Diamond Resources, Inc., Globalsoft Acquisition Group, Inc., and Globus Wireless, 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 Geo Petroleum, Inc., Global Diamond Resources, Inc., Globalsoft Acquisition Group, Inc., and Globus Wireless, Ltd.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Geo Petroleum, Inc. (CIK No. 1016275) is a suspended California corporation located in Yorba Linda, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Geo Petroleum 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 $746,273 for the prior nine months.

2. Global Diamond Resources, Inc. (CIK No. 1003076) is a permanently revoked Nevada corporation located in La Jolla, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Global Diamond 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 $1 million for the prior nine months.

3. Globalsoft Acquisition Group, Inc. (CIK No. 1135297) is a dissolved Nevada corporation located in Los Angeles, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Globalsoft 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 $551 for the prior six months.

4. Globus Wireless, Ltd. (CIK No. 939402) is a permanently revoked Nevada corporation located in Kelowna, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Globus 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, 2002, which reported a net loss of over $1.4 million for the prior twelve months. As of July 11, 2013, the company's stock (symbol "GBWL") was traded on the over-the-counter market.

B. DELINQUENT PERIODIC FILINGS

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

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

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

III.

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

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

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Lynn M. Powalski

By: Lynn M. Powalski
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 70031 / July 23, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15212

In the Matter of **VIRGINIA K. SOURLIS, Esq.,** **Respondent.**	**ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE**

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 Rule 102(e) of the Commission's Rules of Practice against Virginia K. Sourlis, Esq. ("Sourlis").

II.

Sourlis 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 (3) below, which are admitted, Respondent consents to the entry of this Order Making Findings and Imposing Remedial Sanctions Pursuant to Rule 102(e) of the Commission's Rules of Practice ("Order"), as set forth below.

III.

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

78a of 102

1. Sourlis, age 48, is an attorney licensed to practice law in the State of New Jersey and a partner in The Sourlis Law Firm, a law firm with offices in Red Bank, New Jersey.

2. On May 5, 2011, the Commission filed an amended complaint against Sourlis and others in the U.S. District Court for the Southern District of New York ("the Court") that alleged, among other claims, that, on January 11, 2006, Sourlis issued a false legal opinion letter that facilitated the illegal public offering of millions of shares of Greenstone Holdings, Inc. stock (the "Lawsuit"). The amended complaint further alleged that Sourlis thus aided and abetted violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), ("Section 10(b)") and Rule 10b-5 promulgated thereunder, 17 C.F.R. 240.10b-5 ("Rule 10b-5").

3. On November 20, 2012, the Court found that Sourlis aided and abetted violations of Section 10(b) and Rule 10b-5 by issuing her false opinion letter and issued an order granting the Commission partial summary judgment on liability on its claim that Sourlis aided and abetted violations of Section 10(b) and Rule 10b-5. *United States Securities and Exchange Commission v. Greenstone Holdings, Inc., et al.*, 10 civ. 1302 (MGC) (S.D.N.Y. November 20, 2012).

4. On February 19, 2013, the Commission instituted administrative proceedings ("Proceeding") and imposed a temporary suspension pursuant to Rule 102(e)(3)(i)(B) of the Commission's Rules of Practice against Sourlis ("Temporary Suspension Order") based upon the Court's finding that she aided and abetted violations of Section 10(b) and Rule 10b-5.

5. On April 10, 2013, the Commission denied Sourlis's petition to lift the Temporary Suspension and set the matter down for a public hearing.

IV.

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

Accordingly, it is hereby ORDERED pursuant to Rule 102(e) of the Commission's Rules of Practice, effective immediately, that:

A. Sourlis is suspended from appearing or practicing before the Commission as an attorney for 5 years from the February 19, 2013 Temporary Suspension Order.

B. After 5 years from the February 19, 2013 Temporary Suspension Order, Sourlis may request that the Commission consider her application to resume appearing and practicing before the Commission as an attorney. The application should be sent to the attention of the Office of the General Counsel.

C. In support of such an application, Sourlis must provide a certificate of good standing from each state bar where Respondent is a member.

D. In support of such an application, Sourlis must also submit an affidavit truthfully stating, under penalty of perjury:

1. that she has complied with the Order;

2. that she:

    a. is not currently suspended or disbarred as an attorney by a court of the United States (or any agency of the United States) or the bar or court of any state, territory, district, commonwealth, or possession; and

    b. since the entry of the Order, has not been suspended as an attorney for an offense involving moral turpitude by a court of the United States (or any agency of the United States) or the bar or court of any state, territory, district, commonwealth, or possession, except for any suspension concerning the conduct that was the basis for the Order and Lawsuit;

3. that she, since the entry of the Order, has not been convicted of a felony or misdemeanor involving moral turpitude as set forth in Rule 102(e)(2) of the Commission's Rules of Practice; and

4. that she, since the entry of the Order:

    a. has not been found by the Commission or a court of the United States to have committed a violation of the federal securities laws, except for any finding concerning the conduct that was the basis for the Order and Lawsuit;

    b. has not been charged by the Commission or the United States with a violation of the federal securities laws, except for any charge concerning the conduct that was the basis for the Order and Lawsuit;

    c. has not been found by a court of the United States (or any agency of the United States) or any state, territory, district, commonwealth, or possession, or any bar thereof, to have committed an offense involving moral turpitude, except for any finding concerning the conduct that was the basis for the Order and Lawsuit; and

    d. has not been charged by the United States (or any agency of the United States) or any state, territory, district, commonwealth, or possession, or any bar thereof, with having committed an offense involving moral turpitude, except for any charge concerning the conduct that was the basis for the Order and Lawsuit.

E. If Sourlis provides the documentation required in Paragraphs C and D, and the Commission determines that she truthfully attested to each of the items required in her affidavit, she shall by Commission order be permitted to resume appearing and practicing before the Commission as an attorney.[1]

F. If Sourlis is not able to truthfully attest to the statements required in Subparagraphs D(2)(b) or D(4), she shall provide an explanation as to the facts and circumstances pertaining to the matter and the Commission may hold a hearing to determine whether there is good cause to permit her to resume appearing and practicing before the Commission as an attorney.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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[1] If the statutory basis for Sourlis's suspension pursuant to Rule 102(e)(3)(i)(B) is reversed on appeal or otherwise vacated, she may file a motion to vacate her suspension pursuant to the Commission's Rules of Practice.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 70034 / July 24, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15158

In the Matter of **Stewart A. Merkin, Esq.,** **Respondent.**	**ORDER MAKING FINDINGS AND IMPOSING A REMEDIAL SANCTION PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE**

I.

On December 27, 2012, the Securities and Exchange Commission ("Commission") instituted public administrative proceedings pursuant to Rule 102(e) of the Commission's Rules of Practice against Stewart A. Merkin, Esq. ("Merkin" or "Respondent"). Respondent has submitted an Offer of Settlement that the Commission has determined to accept.

II.

Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.4 below, which are admitted, Merkin consents to the entry of this Order Making Findings and Imposing a Remedial Sanction Pursuant to Rule 102(e) of the Commission's Rules of Practice ("Order"), as set forth below.

III.

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

1. Merkin was, at all relevant times, an attorney licensed in Florida, who acted as outside counsel for StratoComm Corporation ("StratoComm") during the Commission's investigation of that company for possible federal securities violations. In that capacity, Merkin communicated with Commission staff, requested and received a copy of the Commission's Formal Order of Investigation, accepted service of subpoenas, forwarded documents to the Commission, and represented StratoComm during six days of investigative testimony. Merkin also represented StratoComm's CEO, and a number of its employees, in connection with the investigation.

2. During the time that the Commission's investigation of StratoComm was ongoing, Merkin prepared and signed four "Attorney Letters" that were submitted to Pink OTC Markets, Inc. (now known as OTC Markets Group Inc.). Those Attorney Letters falsely stated that StratoComm was not under investigation for possible violations of securities laws.

3. On October 3, 2011, the Commission filed a complaint against Merkin in the United States District Court for the Southern District of Florida (the "Court") charging that Merkin had violated Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder, by making false public statements in connection with the purchase or sale of the stock of StratoComm. SEC v. Stewart A. Merkin, Case No. 11-23585-CIV-Graham/Goodman (S.D. Fla.). Specifically, the complaint alleged that on April 8, 2008, June 17, 2010, September 15, 2010, and December 17, 2010, Merkin made false statements in Attorney Letters addressed to Pink OTC Markets, Inc. that appeared on the Pink OTC Markets, Inc. website, to the effect that StratoComm was not under investigation for violations of securities laws, when in fact, as Merkin knew when he prepared and signed those letters, StratoComm was under investigation by the Commission.

4. On October 3, 2012, the Court found that Merkin violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. On that date, the Court issued an order that granted the Commission's motion for summary judgment on the issue of whether Merkin had violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and that contained factual findings establishing that Merkin intentionally violated those provisions.

5. On December 27, 2012, the Commission instituted administrative proceedings and imposed a temporary suspension pursuant to Rule 102(e)(3)(i)(B) of the Commission's Rules of Practice against Merkin based upon the Court's finding that Merkin violated Section 10(b) and Rule 10b-5.

6. On February 25, 2013, the Commission denied Merkin's petition to lift the temporary suspension and set the matter down for a public hearing.

IV.

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

Accordingly, it is hereby ORDERED pursuant to Rule 102(e) of the Commission's Rules of Practice, effective immediately, that:

Merkin is suspended from appearing or practicing before the Commission as an attorney.

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. 33-9433, 34-70040, 39-2491, IC-30629]

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 and related rules to reflect updates to the EDGAR system. The revisions are being made primarily to introduce the new EDGARLink Online submission form type SD (Specialized Disclosure Report) and SD/A; support minor updates to Form 13H. The EDGAR system is scheduled to be upgraded to support this functionality on July 22, 2013.

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 Corporation Finance, for questions concerning submission form type SD and SD/A contact Heather Mackintosh at (202) 551-3600; in the Division of Trading and Markets for questions concerning Form 13H contact Richard Holley; and in the Office of Information Technology, contact Vanessa Anderson 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 Online and the Online Forms/XML website.

The revisions to the Filer Manual reflect changes within Volume II entitled EDGAR Filer Manual, Volume II: "EDGAR Filing," Version 24 (July 2013). The updated manual will be incorporated by reference into the Code of Federal Regulations.

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.[2] Filers may consult the Filer Manual in conjunction with our rules governing mandated electronic filing when preparing documents for electronic submission.[3]

The EDGAR system will be upgraded to Release 13.2 on July 22, 2013 and will introduce the following changes: EDGAR will be updated to introduce submission form types, SD (Specialized Disclosure Report) and SD/A on EDGAR Filing Website for filing disclosure under Exchange Act Sections 13(p) and the related rule regarding the use of conflict minerals. These submission form types will be available on the EDGARLink Online application. Filers may also construct submissions by following the 'EDGARLink Online XML Technical Specification', available on the Commission's public website's "Information for EDGAR Filers" webpage.

Form SD Item 1.02 (Conflict Minerals Report) will require issuers to provide the Conflict Minerals Report as Exhibit 1.02 in ASCII or HTML format. See Final Release No. 34-67716.

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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 May 14, 2013. See Release No. 33-9403 (May 21, 2013) [78 FR 29616].

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

[3] See Release No. 33-9403 (May 21, 2013) [78 FR 29616] in which we implemented EDGAR Release 13.1. For additional history of Filer Manual rules, please see the cites therein.

EDGAR will be updated to allow Form 13H filers to use the 13H-A submission form type to satisfy both their annual and fourth quarter amendment filing requirements. Filers will be able to submit form type 13H-A as their annual (13H-A) and fourth quarter amendment (13H-Q) submissions. Additionally, submission form types 13H, 13H-A and 13H-Q will be updated to increase the maximum number of characters accepted by Item 1(b) to 20,000 characters and increase the number of broker-dealers that can be provided under Item 6 to 2000.

Along with the 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 and the corresponding rule changes relate solely to agency procedures or practice, publication for notice and comment is not required under the Administrative Procedure Act (APA).[4] It follows that the requirements of the Regulatory Flexibility Act[5] do not apply.

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[4] 5 U.S.C. 553(b).

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

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,[6] 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 13.2 is scheduled to become available on July 22, 2013. 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,[7] Sections 3, 12, 13, 14, 15, 23, and 35A of the Securities Exchange Act of 1934,[8] Section 319 of the Trust Indenture Act of 1939,[9] and Sections 8, 30, 31, and 38 of the Investment Company Act of 1940.[10]

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

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[6] 5 U.S.C. 553(d)(3).

[7] 15 U.S.C. 77f, 77g, 77h, 77j, and 77s(a).

[8] 15 U.S.C. 78c, 78l, 78m, 78n, 78o, 78w, and 78ll.

[9] 15 U.S.C. 77sss.

[10] 15 U.S.C. 80a-8, 80a-29, 80a-30, and 80a-37.

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 EDGAR Filer Manual, Volume I: "General Information," Version 15 (May 2013). The requirements for filing on EDGAR are set forth in the updated EDGAR Filer Manual, Volume II: "EDGAR Filing," Version 24 (July 2013). Additional provisions applicable to Form N-SAR filers are set forth in the EDGAR Filer Manual, Volume III: "N-SAR Supplement," Version 2 (August 2011). 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

July 25, 2013

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 200

[Release No. 34-70049]

Delegation of Authority to Director of the Division of Enforcement

Agency: Securities and Exchange Commission.

Action: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is amending its rules to delegate to the Director of the Division of Enforcement the authority to appoint distribution fund administrators in enforcement administrative proceedings from a Commission-approved pool of administrators, and to set the amount of, or waive for good cause shown, the administrator's bond required by Rule 1105(c) of the Commission's rules on Fair Fund and Disgorgement Plans.

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

FOR FURTHER INFORMATION CONTACT: Nancy Chase Burton, 202-551-4425, Office of Distributions, Division of Enforcement, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6553.

SUPPLEMENTAL INFORMATION: In administrative proceedings instituted by the Commission to enforce the federal securities laws, the Commission, in the exercise of its discretion, seeks to distribute amounts collected as disgorgement, prejudgment interest, and penalties to investor victims. The federal securities laws authorize the Commission in administrative proceedings to establish disgorgement and other funds to accomplish this goal. *See, e.g.*, Section 308(a) of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7261; Sections 21B(e) and 21C(e) of the Securities Exchange Act ("Exchange Act"), 15 U.S.C. 78u-2(e) and 78u-3(e).

According to the Commission's regulations, the "Commission or [a] hearing officer shall have discretion to appoint any person, including a Commission employee, as administrator of a plan of disgorgement or a Fair Fund plan and to delegate to that person responsibility for administering the plan." Rule 1105(a), 17 CFR 201.1105(a). To improve the efficiency of the Commission's distribution processes, and to centralize certain distribution-related functions within the Division of Enforcement, the Commission is formally delegating to the Director of the Division of Enforcement the authority to appoint certain persons as plan administrators if the person to be appointed is included in the Commission's approved pool of qualified administrators.[1] The Commission is also delegating to the Director, when the Director appoints an administrator pursuant to this delegation, the authority to set the amount of, or waive for good cause shown, the administrator's bond required by Rule 1105(c), 17 CFR 201.1105(c), of the Commission's rules on Fair Fund and Disgorgement Plans.

If the Division Director deems it appropriate, a recommendation to appoint an administrator from the qualified pool or to set the amount of, or waive for good cause shown, any administrator's bond may be submitted to the Commission for review.

[1] On July 15, 2013, the Commission approved a pool of nine firms from which future fund administrators will be appointed to administer the distribution of disgorgement or fair funds. Each administrator in the pool will be evaluated annually by the Office of Distributions and, if performance is deemed in compliance with the requirements for selection, will be continued in the pool for another year, up to a total of five years, at which time a selection process for a new pool will take place. Beginning six months after approval of the delegation and every six months thereafter, the Office of Distributions must provide the Commission with a memorandum discussing the implementation of the delegation and issues relevant to the Commission's evaluation of the distribution processes. In particular, each memorandum must include (i) a list of all distributions assigned to pool participants at that time; (ii) the stage of each such distribution; and (iii) the Office of Distributions' evaluation of each administrator responsible for the distributions. Each memorandum must also discuss, as data becomes available, the following: (i) whether the delegation has resulted in lower cost of distributions; (ii) whether the delegation has resulted in a greater percentage of funds from the distribution funds being returned to harmed investors; and (iii) whether the delegation has resulted in more timely and efficient distributions. The Office of Distributions must follow these procedures in connection with the delegation authority.

Administrative Law Matters:

The Commission finds, in accordance with 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, the provisions of the APA regarding notice of rulemaking, opportunity for public comment, and publication of the amendment prior to its effective date are not applicable. 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. Further, because this amendment imposes no new burdens on private persons, the Commission does not believe that the amendment will have any anti-competitive effects for purposes of Section 23(a)(2) of the Exchange Act, 15 U.S.C. 78w(a)(2). Finally, this amendment does not contain any collection of information requirements as defined by the Paperwork Reduction Act of 1980, as amended. Accordingly, the amendment is effective [insert date of Federal Register publication].

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, 7202, and 7211 *et seq.*, unless otherwise noted.

* * * * *

2. Section 200.30-4 is amended by adding paragraph (a)(17) to read as follows:

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

* * * * *

(a) * * *

(17) With respect to disgorgement and Fair Fund plans established in administrative proceedings instituted by the Commission pursuant to the federal securities laws, to appoint a person as a plan administrator, if that person is included in the Commission's approved pool of administrators, and, for an administrator appointed pursuant to this delegation, to set the amount of or waive for good cause shown, the administrator's bond required by § 201.1105(c) of this chapter.

* * * * *

By the Commission

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: July 26, 2013

Commissioner Paredes
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 70042 / July 26, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15389

In the Matter of **Duoyuan Printing, Inc.** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

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

II.

After an investigation, the Division of Enforcement alleges that:

A. <u>RESPONDENT</u>

Duoyuan Printing, Inc. was a Wyoming corporation[1] headquartered in Beijing, the People's Republic of China. It manufactures and sells offset printing equipment, and all of its operations are carried out in China. At all relevant times, Duoyuan Printing's common stock has been registered pursuant to Section 12(g) of the Exchange Act. Duoyuan Printing is required to file periodic reports with the Commission, including an annual report on Form 10-K and quarterly reports on Form 10-Q under Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder. On September 6, 2010, Duoyuan Printing dismissed its external auditor Deloitte Touche Tohmatsu CPA Limited after it identified serious financial and accounting irregularities, and so far has not retained a new auditor. Duoyuan Printing is delinquent in its periodic filings with the Commission, having not filed

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[1] Duoyuan Printing was administratively dissolved in October 2010, and its registered agent resigned in March 2012.

any periodic reports since it filed a Form 10-Q for the period ended March 31, 2010. The company's stock was traded on the New York Stock Exchange under the symbol "DYP" from November 2009 to April 4, 2011, when NYSE halted the trading. Subsequently, the NYSE delisted the stock and filed a Form 25 with the Commission on October 6, 2011 after finding that the stock was no longer suitable for continued listing and trading. The stock is currently quoted on the OTC market (ticker symbol "DYNP.PK").

B. RESPONDENT'S DELINQUENT FILINGS

1. Duoyuan Printing is delinquent in its periodic filings with the Commission for over two years, having failed to file Forms 10-K for the years ended June 30, 2010, 2011 and 2012 and Forms 10-Q for quarters ended September 30, 2010, December 31, 2010, March 31, 2011, September 30, 2011, December 31, 2011, March 31, 2012, September 30, 2012, December 31, 2012, and March 31, 2013.

2. 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. Exchange Act Rules 13a-1 and 13a-13 require issuers to file annual and quarterly reports.

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

III.

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

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

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

IV.

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

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

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

This Order shall be served forthwith upon Respondent personally or as 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

Commissioner Paredes not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
July 26, 2013

In the Matter of **Duoyuan Printing, Inc.,** **File No. 500-1**	**ORDER OF SUSPENSION OF TRADING**

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Duoyuan Printing, Inc., because Duoyuan Printing, Inc. has not filed any periodic reports for any reporting period subsequent to March 31, 2010.

The Commission is of the opinion that the public interest and the protection of the investors require a suspension of trading in securities of Duoyuan Printing, Inc.

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in Duoyuan Printing, Inc. is suspended for the period from 9:30 a.m. EDT, July 26, 2013, through 11:59 p.m. EDT, on August 8, 2013.

By the Commission.

Elizabeth M. Murphy
Elizabeth M. Murphy
Secretary

Commissioner Paredes not participating

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Release No. 70046 / July 26, 2013

Admin. Proc. File No. 3-15080

In the Matter of the Application of

ACAP FINANCIAL, INC. and GARY HUME
c/o Anthony W. Djinis
Pickard and Djinis LLP
1990 M Street, NW, Suite 660
Washington, DC 20036

For Review of Disciplinary Action Taken by

FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION—REVIEW OF DISCIPLINARY PROCEEDING

Unregistered Sale of Securities

Conduct Inconsistent with Just and Equitable Principles of Trade

Failure to Establish Written Supervisory Procedures

Failure to Supervise

Member firm of registered securities association engaged in unregistered sale of securities in violation of Securities Act and association's rules. Member firm and its compliance officer failed to reasonably supervise firm's registered representative engaging in unregistered sale of securities. Member firm and compliance officer also failed to maintain adequate written supervisory procedures. *Held*, association's findings of violation and sanctions imposed *sustained.*

APPEARANCES:

Anthony W. Djinis and *Paul J. Bazil*, of Pickard and Djinis LLP, for *ACAP Financial, Inc.* and *Gary Hume*.

Alan Lawhead, *Carla Carloni*, and *Jennifer Brooks*, for *Financial Industry Regulatory Authority, Inc.*

Appeal filed: October 25, 2012
Last brief received: March 5, 2013

I.

ACAP Financial, Inc., a FINRA[1] member firm, and Gary Hume, currently and during the relevant period, its compliance officer and head trader,[2] seek review of a FINRA disciplinary action.[3] FINRA found that ACAP violated Section 5 of the Securities Act of 1933 and NASD Conduct Rule 2110[4] through sales of Greyfield Capital securities on an unregistered basis without an applicable exemption from registration.[5] FINRA also found that ACAP and Hume violated NASD Conduct Rules 3010[6] and 2110 by failing to take steps to ensure that the registered representative who made the Greyfield trades at issue ascertained the information necessary to determine whether the Greyfield securities could be sold in compliance with the Securities Act and also by failing to establish and maintain written procedures regarding transactions in restricted securities or the receipt of stock certificates.[7]

FINRA fined ACAP $50,000 for its unregistered sales of securities in violation of the Securities Act.[8] For its supervisory violations, FINRA fined ACAP an additional $50,000 and required it to revise its procedures and retain an independent consultant to review and approve them.[9] FINRA further suspended ACAP from receiving and liquidating penny stocks for which no registration statement is in effect until it implemented appropriate procedures approved by the

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1 We apply the conduct rules of NASD, FINRA's predecessor, that were in place at the time of the misconduct.

2 Hume has been associated with ACAP since 1991.

3 *Dep't of Enf. v. ACAP Fin., Inc.*, Complaint No. 2007008239001, 2012 FINRA Discip. LEXIS 55 (NAC Sept. 26, 2012).

4 NASD Conduct Rule 2110, now FINRA Rule 2010, requires members to "observe high standards of commercial honor and just and equitable principles of trade" in the conduct of their business.

5 *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *11.

6 Among other things, NASD Conduct Rule 3010 requires members to "establish and maintain a system to supervise the activities of" registered representatives and other associated persons "that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules" and to "establish, maintain, and enforce written procedures to supervise the types of business in which it engages" and the activities of registered representatives and other associated persons "that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable Rules of NASD." *See* NASD Conduct Rule 3010(a) & (b)(1). Because Hume had responsibility for creating and maintaining ACAP's supervisory and compliance procedures, Rule 3010 applies to him. *See* NASD Rule 0115(a) ("Persons associated with a member shall have the same duties and obligations as a member under these Rules.").

7 *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *12-13.

8 *Id.* at *21.

9 *Id.* at *25.

consultant.[10] For his supervisory violations, FINRA fined Hume $25,000, suspended him for six months in all capacities, and required him to requalify before acting in any capacity requiring qualification.[11] ACAP and Hume now challenge those sanctions but not FINRA's underlying findings of misconduct, to which they stipulated. We base our findings on an independent review of the record.

II.

A. Background

ACAP Financial, Inc. is a FINRA member firm based in Salt Lake City, Utah and has been a member of FINRA and its predecessor, NASD, since 1978. Gary Hume has been in the securities industry since 1988 and has been employed by ACAP since 1991. At the time of the events at issue, Hume held Series 7, 24, and 63 licenses. In 2005, Hume was ACAP's compliance officer and head trader and maintained supervisory responsibilities over all but one of the registered representatives in ACAP's home office.[12]

Since at least 1990,[13] the majority of ACAP's business has been in lower-priced Bulletin Board and Pink Sheet securities.[14] Most of ACAP's business is liquidating stock. Such transactions in lower-priced securities present a risk of abuse because, among other things, information about issuers of such securities "can be extremely difficult to find, making them more vulnerable to investment fraud schemes."[15]

In light of these considerations, we have cautioned broker-dealers to be alert to the possibility of an illegal, unregistered distribution of lower-priced stock,[16] and attentive to the possibility that customers or related persons might attempt to mislead them regarding the legality

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10 *Id.*

11 *Id.* at *26.

12 The single representative whom Hume did not supervise primarily worked with ACAP's owner on private placements and was supervised by ACAP's owner.

13 ACAP Br. at 2.

14 In 2005, "[t]he 'Pink Sheets' [wa]s a quotation service for over-the-counter securities operated by Pink Sheets LLC." *Gateway Int'l Holdings, Inc.*, Exchange Act Release No. 53907, 2006 SEC LEXIS 1288, at *4 n.5 (May 31, 2006). OTC Markets Group Inc. is the successor to Pink Sheets LLC and now operates the OTCPink marketplace on the OTC Link electronic quotation system. *See OTC Link LLC*, http://www.sec.gov/answers/pink.htm (last visited July 2, 2013); *OTC Markets Overview*, http://www.otcmarkets.com/about/overview (last visited July 2, 2013).

15 *Microcap Stock: A Guide for Investors*, http://www.sec.gov/investor/pubs/microcapstock.htm (last visited July 2, 2013); *see also id.* (stating that "[w]hile all investments involve risk, microcap stocks are among the most risky"); *OTC Link LLC* (explaining that the fact that many OTC Link quoted issuers "do not file periodic reports or audited financial statements with the SEC" makes it "very difficult for investors to find current, reliable information about those companies" and observing that they can be "among the most risky investments").

16 *Distribution by Broker-Dealers of Unregistered Securities*, Securities Act Release No. 4445, 27 Fed. Reg. 1251, 1251 (Feb. 2, 1962) ("*1962 Securities Act Release*") ("[A] dealer who offers to sell, or is asked to sell a substantial amount of securities must take whatever steps are necessary to be sure that this is a transaction not involving an issuer, person in a control relationship with an issuer or an underwriter.").

of a sale.[17] For this reason, it is essential for broker-dealers and their associated persons, in determining whether a sale of securities is exempt from registration under the Securities Act, to make "routine inquiries" of customers,[18] as well as conduct independent inquiries as a matter of course regarding the securities that those customers seek to sell,[19] to detect any warning signs indicating the possibility of an unlawful distribution. While the amount of inquiry necessarily varies with the circumstances of a particular case, the need for vigilance is "particularly acute" where "substantial amounts of a previously little-known security appear in the trading markets within a fairly short period of time and without the benefit of registration under the Securities Act of 1933."[20] Other "red flags" may include customers liquidating stock shortly after deposit,[21] the stock being thinly traded,[22] or the issuer being newly formed or recently experiencing a change in control.[23]

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[17] *Sales of Unregistered Securities by Broker-Dealers*, Securities Act Release No. 5168, 1971 SEC LEXIS 19, at *7 (July 7, 1971) ("*1971 Securities Act Release*") ("[I]nformation received from little-known companies or their officials, transfer agent or counsel must be treated with great caution as these are the very parties that may be seeking to deceive the firm."), quoted in *Midas Sec., LLC*, Exchange Act Release No. 66200, 2012 SEC LEXIS 199, at *41 n.56 (Jan. 20, 2012); *see also Benjamin Werner*, Exchange Act Release No. 8579, 44 SEC 886, 1972 SEC LEXIS 743, at *4 n.4 (Apr. 24, 1972) (citing *1971 Securities Act Release* with approval).

[18] These inquiries include (1) if a customer has direct or indirect connections with any publicly owned company or the issuer, (2) if the customer's financial condition is consistent with the value of the securities to be sold, (3) if the customer acquired the securities on the open market, (4) if the customer is the true beneficial owner of the securities, (5) if the customer has non-public information about the issuer, and (6) if the customer is currently selling or attempting to sell the same securities through other brokerage houses. *1971 Securities Act Release*, 1971 SEC LEXIS 19, at *5-6.

[19] This basic information should include, at a minimum, the issuer's "address, business activities, principals, products, assets, financial condition and number of shares of stock outstanding." *Id.* at *6.

[20] *1962 Securities Act Release*, 27 Fed. Reg. at 1251; *see also James L. Owsley*, Exchange Act Release No. 32491, 51 SEC 524, 1993 SEC LEXIS 1525, at *13 (June 18, 1993) ("[T]he enormous volume of trades emanating from a few accounts should have alerted Nelson to the likelihood that unlawful distributions were taking place."); *Gilbert F. Tuffli, Jr.*, Exchange Act Release No. 12534, 46 SEC 401, 1976 SEC LEXIS 1467, at *18 (June 10, 1976) ("[I]nquiry is essential whenever a salesman is presented with a large block of an obscure stock.").

[21] *Jacob Wonsover*, Exchange Act Release No. 41123, 54 SEC 1, 1999 SEC LEXIS 430, at *25 n.25 (Mar. 1, 1999) ("A distribution within a relatively short period after acquisition is evidence of an original intent to distribute."), *petition denied*, 205 F.3d 408 (D.C. Cir. 2000); *see also Robert G. Leigh*, Exchange Act Release No. 27667, 50 SEC 189, 1990 SEC LEXIS 153, at *9 (Feb. 1, 1990) (finding that because customer "immediately sold" shares following deposit, customer was "deemed to have acquired them with a view to distribution").

[22] *Charles F. Kirby*, Exchange Act Release No. 47149, 56 SEC 44, 2003 WL 71681, at *5 (Jan. 9, 2003) (finding that trader failed to make appropriate inquiry into "stock's true status" when, among other things, company traded "only sporadically"), *petition denied sub nom., Geiger v. SEC*, 363 F.3d 481 (D.C. Cir. 2004); *Butcher & Singer Inc.*, Exchange Act Release No. 23990, 48 SEC 640, 1987 SEC LEXIS 2813, at *3, *7 (Jan. 13, 1987) (reciting that stock was an "obscure penny stock for which prices had not been quoted in the pink sheets for about two months" and finding that trader failed to make required inquiry under the circumstances), *aff'd*, 833 F.2d 303 (3d Cir. 1987) (table).

[23] *Midas Sec.*, 2012 SEC LEXIS 199, at *34 (finding the fact that issuer was a "newly formed company that had been trading for less than two weeks" constituted a red flag); *Kirby*, 2003 WL 71681, at *5 (noting fact that "there was little or no information available regarding the Company's business since [its] change in control" as support for finding that trader failed to make necessary inquiry).

B. ACAP's procedures regarding transactions in restricted securities and the receipt of stock certificates without restrictive legends were minimal.

Notwithstanding the extent of its penny stock business, ACAP did not have any written procedures regarding transactions in restricted securities[24] or the receipt of stock certificates without restrictive legends,[25] and there was nothing in ACAP's written procedures manual regarding the determination of whether stock could legally be traded.[26] When presented with a stock certificate without a restrictive legend, ACAP and Hume would make no effort to determine whether a Securities Act registration statement was in effect as to the offer and sale of the stock or an exemption from registration applied. No one at ACAP would undertake any effort to determine how the customer obtained the stock, how long the customer had held it, what the customer paid for the stock, or whether the customer was an officer, director, control person, or otherwise an affiliate of the issuer.[27] Nor would Hume undertake any other due diligence to obtain information about the issuer or its securities. In his investigative testimony, Hume could not recall ever raising a question as to whether stock could be sold in compliance with the registration requirements of the Securities Act. Indeed, Hume admitted that, under ACAP's procedures, he had no way of knowing whether shares deposited by a customer and represented by stock certificates that did not bear restrictive legends could legally be sold.

ACAP relied on Jim Walker, an employee of ACAP's clearing firm, Alpine Securities, to make such a determination. Although an employee of Alpine, Walker maintained offices on site at ACAP in 2005. Hume testified that he would check with Walker "to make sure it was OK" to sell securities the first time ACAP would sell a particular stock and that, depending on the volume of stock certificates received, Hume might talk with Walker multiple times a day or as

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24 Rule 144(a)(3) of the Securities Act defines the term "restricted securities" to include "[s]ecurities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering." 17 C.F.R. § 230.144(a)(3); *see also* FINRA Regulatory Notice 09-05 (citing Rule 144(a)(3) definition of restricted securities).

25 A restrictive legend is "a statement placed on restricted stock notifying the holder that the stock may not be resold without registration." *Kirby*, 2003 WL 71681, at *2.

26 Instead, ACAP's written procedures generally provided that Hume, as the firm's compliance officer, would review and approve penny stock transactions, investigating and documenting all "suspicious activity." These procedures did not provide specific guidance. Hume conceded that he conducted any penny stock review of other traders' transactions only after those trades were executed and that he never disapproved a trade. Because most of ACAP's business was liquidating stock, Hume did not consider sales to be suspicious activity. Rather, Hume looked for large numbers of purchases in a particular security, as well as sales followed by purchases, under circumstances in which he could not discern a reason for the trades.

27 ACAP and Hume assert that "whenever a customer placed a sell order, Hume would review customer new account forms to see whether the customer disclosed that he (or she) was an officer, director, greater than 10% shareholder or otherwise [a] control [person] of a public company . . . ." ACAP Br. at 3. But the record does not support this assertion. Hume testified that when he reviewed a new account application, he reviewed the answer to the control person question in the application. Although he testified that he had reviewed new account forms in connection with some trades in the past, Hume could not specify how often that had occurred or whether he had ever done so without prompting from ACAP's clearing firm. In any event, these forms were updated only if clients moved or notified the broker of changes to their information. Hume also testified that at times he had asked brokers whether there was a relationship between clients. There is no testimony that it was ACAP's and Hume's regular practice to do this before trades.

seldom as once a week. Hume's general understanding was that, after Walker had received stock certificates from ACAP or its customer, he would send them to the Depository Trust Company ("DTC")[28] to determine if they could be offered and sold consistent with the registration requirements of the Securities Act. Hume did not know if DTC did any research into the history of the ownership of the stock. Rather, Hume believed that DTC's "main goal" was to have the stock placed in the name of its nominee, Cede & Co.[29] As Hume explained, ACAP's view was that the only limitation on the ability to sell stock represented by a certificate without a restrictive legend was to wait until Alpine sent it to DTC. Other than as discussed above, the record contains no evidence that Walker or anyone else at Alpine conducted any type of inquiry to determine whether shares represented by stock certificates lacking restrictive legends could legally be offered and sold absent registration or that ACAP provided Alpine with the type of information necessary to make this determination.

C. ACAP executed unregistered sales of Greyfield securities.

On May 3, 2005, a certificate for 25 million shares of Greyfield Capital was deposited into an account that Gold Technologies, LLC, a Texas entity owned by Mervin George Fiessel, maintained at ACAP. On the same day, an ACAP account maintained by a business associate of Fiessel received 20 million shares of Greyfield stock. Both accounts had been opened in 2003 by Vincent Michael McGuire, a registered representative at ACAP supervised by Hume.[30]

On July 6, 2005, Gold Technologies deposited 10 million additional shares. All 55 million deposited shares had been issued on April 28, 2005, i.e., less than a week before the initial deposits, and together they made up approximately 11% of the total issued and outstanding shares of Greyfield. No Securities Act registration statement was in effect for the offer and sale of any Greyfield securities, and none of these stock certificates carried a restrictive legend.

At the time of the deposits and ACAP's subsequent sales, Greyfield was a little-known development-stage company that was quoted in the Pink Sheets. Greyfield had begun trading in the over-the-counter market on May 24, 2002, at an initial price of $1.40 per share. In the nearly three years before May 6, 2005, Greyfield stock had traded only four times with a total volume of 1,530 shares.[31] Other than the initial trade, each trade was at $.01 per share. Just prior to ACAP's customers' Greyfield trades, the market for Greyfield securities suddenly became active.

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28 DTC "was created by the securities industry to improve efficiencies and reduce risk in the clearance and settlement of securities transactions" and is the largest securities depository in the world. *Investor Bulletin: DTC Chills and Freezes*, SEC Office of Investor Education and Advocacy (May 2012), http://www.sec.gov/investor/alerts/dtcfreezes.pdf (last visited July 2, 2013).

29 FINRA 000291 (Investigative Test. of Gary Hume ("Hume Test.") at 45:19-23).

30 The record does not contain evidence of improper activity linked to the accounts before the events underlying this proceeding.

31 While the parties stipulated that 1,330 shares were traded, historical trading data from Google Finance reflects that 1,530 Greyfield shares traded prior to May 6, 2005. *See* http://www.google.com/finance/historical?cid=825226&startdate=Jan+1%2C+2002&enddate=May+6%2C+2005&num=30&ei=tcQwUcCXDYyy0AG_eQ (listing of GRYF trades between January 1, 2002 and May 6, 2005) (last visited July 2, 2013). This 200 share discrepancy is (continued...)

On May 6, 2005, Greyfield issued a press release touting its business prospects.[32] According to the press release, Greyfield had acquired Autorama, which it described as a "highly profitable, fast growing premium automobile dealership" with "explosive growth" that was "quickly becoming the largest automobile dealership in western Canada" although it had only a single location.[33] The press release's focus on Autorama's activities was consistent with the fact that Greyfield itself had no business operations as of April 2005. From May through July 2005, Greyfield released a number of additional press releases touting its business prospects.

On May 9, 2005, Gold Technologies sold 423,684 of the Greyfield shares in its ACAP account. Thereafter, between June 17 and June 30, 2005, Fiessel's associate sold 20 million shares of Greyfield from his ACAP account. Between July 8 and July 26, 2005, Gold Technologies sold an additional 7.3 million shares of Greyfield. McGuire acted as the registered representative for each of these sales. The average daily trading volume in Greyfield shares from May 6 through July 26, 2005 was approximately 1,580,000 shares, i.e., over 1,000 times the entire volume of Greyfield shares that had been publicly traded over its nearly three-year trading history before May 6, 2005.

This pattern of trading raised substantial red flags. Nonetheless, ACAP and Hume failed to take adequate steps to ensure that McGuire ascertained (1) whether the offer and sale of the Greyfield securities were the subject of a Securities Act registration statement, (2) how and from whom ACAP's customers obtained their shares, (3) whether and when those shares were paid for, and (4) whether the sales of the Greyfield shares were exempt from registration under the Securities Act. Moreover, supervisory personnel at ACAP undertook no efforts to determine whether the Greyfield shares were eligible for sale without registration, other than relying on the fact that the stock certificates did not bear a restrictive legend and whatever efforts ACAP's clearing firm made to determine whether the shares could be traded consistent with the registration requirements of the Securities Act.

On July 27, 2005, we suspended trading of Greyfield securities for ten days, finding that there were questions regarding Greyfield's corporate domicile, the identity of its officers and directors, whether its shares were validly issued, and the accuracy of information in its press releases.[34] In all, prior to the suspension and under Hume's watch, ACAP had sold more than

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(...continued)
immaterial and our findings herein are not affected by it. *Cf.* Rule of Practice 323, 17 C.F.R. § 201.323 (authorizing Commission to take official notice of certain "material fact[s]").

32 The parties stipulated to the May 6, 2005 press release date. Business Wire appears to have distributed the press release on the following business day, May 9, 2005. *See Greyfield Completes Reverse Merger With Autorama: Acquires 100% Ownership of Highly Profitable, Fast Growing, Premium Automobile Dealership in Canada*, Westlaw 5/9/05 Bus. Wire 11:30:00. This minor difference is immaterial to our analysis.

33 FINRA 000066 (Stipulations of Facts and Violations ("Stipulations") ¶ 18). When Greyfield subsequently announced the opening of a second dealership, it claimed to be "aggressively expanding its network of dealerships throughout Canada." *Id.*

34 *See* http://www.sec.gov/litigation/suspensions/34-52127.pdf (press release announcing action); http://www.sec.gov/litigation/suspensions/34-52127-o.pdf (order halting trading).

27 million shares of Greyfield stock from its customers' accounts into the public markets for proceeds of approximately $46,000 without registration or an applicable exemption.

D. ACAP's sales of Greyfield securities were part of a broader illegal distribution.

The sales of Greyfield shares that ACAP's customers made from their ACAP accounts were part of a broader unregistered distribution of hundreds of millions of Greyfield shares that began in late April 2005. That month or earlier, Fiessel and two colleagues took control of Greyfield by providing false documents to its transfer agent. Using a signature stamp he had obtained from a former president of Greyfield, Fiessel generated letters appointing two of his colleagues as its controlling officers and directors. Also in April 2005, Greyfield authorized the issuance of 600 million new shares. Although 466 million of these shares were issued to Gold Technologies, Fiessel caused the transfer agent to break the shares up into groups and to send them to various entities and individuals, including his business associate. Neither Fiessel nor Gold Technologies ever paid for the Greyfield shares, despite Gold Technologies's entering into an April 20, 2005 agreement with Greyfield that stated that $120,000 was being paid with the execution of the agreement.

In the first two weeks of trading, the Greyfield stock price rose from $.04 per share to $0.05 per share but subsequently fell substantially. By the first week of June 2005, Greyfield traded at less than $0.01 per share, i.e., a greater than 80% decline from its peak price, and subsequently never rose above $0.01.

In November 2006, the SEC and the British Columbia Securities Commission announced settlements with Fiessel and one of his colleagues for market manipulation and the violation of Section 5 of the Securities Act in connection with sales of Greyfield securities.[35] The defendants agreed to injunctions, officer-and-director bars, penny stock bars, and financial sanctions of more than $180,000 in the Commission's case and additional sanctions in the BCSC action.

E. FINRA initiated proceedings against McGuire, ACAP, and Hume.

On June 7, 2010, FINRA's Department of Enforcement filed a two-count Complaint against McGuire,[36] ACAP, and Hume. On October 27, 2010, ACAP and Hume entered into Stipulations of Facts and Violations with FINRA. ACAP and Hume admitted that ACAP had made unregistered sales of Greyfield securities in violation of Section 5 of the Securities Act and that this conduct violated NASD Conduct Rule 2110. They also admitted that they each had violated NASD Conduct Rules 3010 and 2110 "[b]y failing reasonably to supervise McGuire in

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35 *SEC v. Mervin George Fiessel and Robert Michael Doherty, Civil Action No. 1:06-CV-1260 (E.D. Va., Nov. 8, 2006)*, Lit. Release No. 19902, 2006 SEC LEXIS 2570, at *2 (Nov. 8, 2006); *Cross-border stock scheme ends with two B.C. men ordered out of capital market*, British Columbia Securities Commission, http://www.bcsc.bc.ca/release.aspx?id=4724 (Nov. 8, 2006) (last visited July 2, 2013).

36 On November 24, 2010, FINRA accepted an offer of settlement by McGuire in which he admitted making unregistered sales of Greyfield securities in violation of the Securities Act and NASD Conduct Rule 2110. McGuire was suspended from association with any FINRA member firm in any capacity for forty-five calendar days and fined $15,000. The findings contained in the order of settlement were not binding on ACAP or Hume and we do not rely on them.

connection with the [unregistered] sale of [Greyfield] securities, and by failing to establish, maintain and enforce written procedures reasonably designed to achieve compliance with applicable securities laws and regulations."[37] The parties also agreed to limit the proceeding before the FINRA Hearing Panel to a determination, based on a paper record, of appropriate sanctions in light of the stipulated facts and violations.

The Hearing Panel issued a decision on May 3, 2011 in which it found that the record supported the stipulated misconduct and ordered a combination of monetary and other sanctions.[38] The Hearing Panel fined ACAP $25,000 for its unregistered sales of securities and, with respect to its supervisory failures, fined ACAP an additional $50,000, required it to revise its written procedures to ensure that they were reasonably designed to comply with the requirements of Securities Act Section 5, and required it to retain an independent consultant to review and approve the firm's revised procedures. The Hearing Panel also "suspended [ACAP] from the activity of receiving [] penny stocks" for which no Securities Act registration statement was in effect as to the offer and sale of the stock "including those [stocks] represented by unlegended stock certificates, and liquidating those positions, until it has implemented its revised procedures after approval by the independent consultant."[39] The Hearing Panel fined Hume $10,000, suspended him from associating with any FINRA member firm in all principal capacities for one year, and required him to re-qualify by examination as a principal before re-entering the securities industry in any principal capacity.

The review subcommittee of FINRA's National Adjudicatory Council (the "NAC") subsequently called the case for review solely as to the sanctions issued. On September 26, 2012, the NAC affirmed the Hearing Panel's findings of misconduct but modified the sanctions.[40] The NAC fined ACAP $50,000 for the Section 5 and Rule 2110 violations, thereby increasing the $25,000 fine previously ordered by the Hearing Panel.[41] Consistent with the Hearing Panel's prior determination, the NAC also fined ACAP an additional $50,000 for its supervisory failures, required it to revise its relevant procedures and retain an independent consultant to review and approve them, and suspended ACAP from receiving and liquidating penny stocks for which no registration statement is in effect until it implemented the approved procedures.[42] The NAC also fined Hume $25,000 for his supervisory failings, thereby increasing the $10,000 fine previously ordered by the Hearing Panel, and suspended him in all capacities for six months, in contrast to the Hearing Panel's decision to suspend him for one year in all principal capacities.[43] The NAC also required Hume to requalify before acting in any capacity requiring qualification.[44] On

[37] FINRA 000069 (Stipulations ¶ 32).

[38] *Dep't of Enf. v. ACAP Fin. Inc.*, Complaint No. 2007008239001, 2011 FINRA Discip. LEXIS 32, at *4 (OHO May 3, 2011).

[39] *Id.* at *28.

[40] *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *11, *13, *19, *23.

[41] *Id.* at *13, *21.

[42] *Id.* at *25, *29.

[43] *Id.* at *26-27, *29.

[44] *Id.*

October 25, 2012, ACAP and Hume timely filed an application for review of the NAC's decision, in which they challenged these sanctions and the NAC's determination that their misconduct was egregious.

III.

A. ACAP violated NASD Rule 2110 through the unregistered sale of Greyfield securities in contravention of Securities Act Section 5.

In the FINRA proceeding, ACAP conceded that it engaged in unregistered sales of Greyfield securities in violation of Securities Act Section 5 and, in so doing, violated NASD Conduct Rule 2110.[45] We find that the record amply supports ACAP's concessions and accordingly affirm FINRA's finding of violation.

Securities Act Sections 5(a) and (c) prohibit any person from offering or selling securities in interstate commerce unless a registration statement is filed or in effect with the Commission or an exemption from registration is available.[46] The Securities Act was designed "to protect investors by promoting full disclosure of information thought necessary to informed investment decisions."[47] "The registration requirements are the heart of" the Securities Act.[48]

A *prima facie* case for a violation of Section 5 requires a showing that "(1) the defendant directly or indirectly sold or offered to sell securities; (2) through the use of interstate transportation or communication and the mails; (3) when no registration statement was in effect."[49] There is no requirement to show scienter,[50] i.e., an "intent to deceive, manipulate, or defraud."[51] Once a prima facie case is established, the burden shifts to the person seeking an exemption from registration to establish the availability of the exemption.[52]

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45 *See Midas Sec.*, 2012 SEC LEXIS 199, at *46 n.63 ("A violation of Securities Act Section 5 also violates NASD Rule 2110." (citing *Sorrell v. SEC*, 679 F.2d 1323, 1326 (9th Cir. 1982))); *Kunz v. SEC*, 64 F. App'x 659, 663-64, 668 (10th Cir. 2003) (noting SEC conclusion that respondent violated Conduct Rule 2110 by failing to comply with Securities Act registration requirements and affirming that determination).

46 15 U.S.C. § 77e(a) & (c); *see also Wonsover*, 1999 SEC LEXIS 430, at *15.

47 *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953).

48 *Pinter v. Dahl*, 486 U.S. 622, 638 (1988); *Kirby*, 2003 WL 71681, at *11; *see also Leigh*, 1990 SEC LEXIS 153, at *16 ("The registration provisions are a keystone of securities regulation and set forth basic requirements for the protection of public investors.").

49 *SEC v. Calvo*, 378 F.3d 1211, 1214 (11th Cir. 2004); *accord Lively v. Hirshfeld*, 440 F.2d 631, 631 (10th Cir. 1971).

50 *Calvo*, 378 F.3d at 1215 (collecting authority).

51 *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 & n.12 (1976). Scienter can also be shown through recklessness. *David Disner*, Exchange Act Release No. 38234, 52 SEC 1217, 1997 SEC LEXIS 258, at *15 (Feb. 4, 1997) (internal citation omitted); *see also Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 n.3 (2007) (noting that "[e]very Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly").

52 *SEC v. Cavanagh*, 445 F.3d 105, 111 n.13 (2d Cir. 2006) (citing *SEC v. Ralston Purina.*, 346 U.S. at 126); *Andrews v. Blue*, 489 F.2d 367, 374 (10th Cir. 1973); *see also Apex Fin. Corp.*, Exchange Act Release No. 16749,

(continued...)

ACAP stipulated to facts establishing the existence of each of the elements required to make out a prima facie case of a Section 5 violation with respect to the Greyfield transactions at issue. First, ACAP and Hume conceded that between May 9 and July 26, 2005, ACAP sold more than 27 million shares of Greyfield stock into the public markets from its customers' accounts. Second, Greyfield stock traded in the over-the-counter market and was quoted on the Pink Sheets. ACAP obtained market maker quotes for each of its customers' sales of Greyfield stock. Third, no Securities Act registration statement was in effect with respect to the offer and sale of the Greyfield stock at the time of the sales. In addition, ACAP conceded that no exemption from registration was available, and the record also fully supports this concession.[53] Accordingly, we affirm FINRA's findings that ACAP violated Securities Act Section 5 and NASD Conduct Rule 2110.

B. ACAP and Hume violated NASD Conduct Rule 3010(a) by failing to reasonably supervise McGuire in connection with the unregistered sale of Greyfield securities and by failing to establish, maintain, and enforce written supervisory procedures reasonably designed to achieve compliance with Securities Act Section 5.

ACAP and Hume also stipulated that they violated NASD Conduct Rules 3010 and 2110 by failing to (1) reasonably supervise McGuire in connection with the unregistered sale of the Greyfield securities without an applicable exemption and (2) establish, maintain, and enforce written procedures reasonably designed to achieve compliance with Securities Act Section 5. We find the record fully supports ACAP and Hume's concessions and affirm FINRA's findings that they violated NASD Conduct Rules 3010 and 2110.[54]

First, NASD Conduct Rule 3010(a) requires members to "establish and maintain" a system of supervision that is "reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules."[55] In addition to an adequate

(...continued)
47 SEC 265, 1980 SEC LEXIS 1663, at *2 (Apr. 16, 1980) ("It is well settled that the burden of establishing the availability of an exemption from registration rests upon those who claim it.") (collecting cases).

53 ACAP did not argue that the "broker's exemption" under Securities Act Section 4(a)(4), formerly Section 4(4), exempted its sales of Greyfield securities. *See* 15 U.S.C. § 77d(a)(4). As we explained in *Midas Securities*, the broker's exemption "is designed to exempt ordinary brokerage transactions and is not available if the broker knows or has reasonable grounds to believe that the selling customer's part of the transaction is not exempt from Section 5 of the Securities Act." *Midas Sec.*, 2012 SEC LEXIS 199, at *30 (internal citation omitted). Brokers thus have a "duty of inquiry" regarding facts surrounding a proposed sale. *Id.* (internal citation omitted). "A broker cannot rely on the Section 4[(a)](4) exemption when his customer is an 'underwriter,' defined as 'any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security . . . .'" *Id.* at *35 (citing 15 U.S.C. § 77b(a)(11)). For these purposes, "an 'issuer' includes 'any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.'" *Id.* Had ACAP and Hume conducted a reasonable inquiry discharging their duty, they would have perceived the high likelihood that their customers were underwriters and the proposed sales were part of an illegal distribution.

54 A violation of NASD Conduct Rule 3010 also violates NASD Conduct Rule 2110. *John B. Busacca, III*, Exchange Act Release No. 63312, 2010 SEC LEXIS 3787, at *48 & n.56 (Nov. 12, 2010), *petition denied*, 449 F. App'x 886 (11th Cir. 2011).

55 NASD Conduct Rule 3010(a).

supervisory system, "[t]he duty of supervision includes the responsibility to investigate 'red flags' that suggest that misconduct may be occurring and to act upon the results of such investigation."[56] "[R]ed flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review."[57]

ACAP and Hume fell far short of this standard. Appellants conceded before FINRA that neither Hume, who was ACAP's compliance officer and supervised McGuire, nor ACAP itself took adequate measures to ensure that McGuire did not engage in the unregistered sale of securities in violation of Securities Act Section 5. Specifically, Hume and ACAP failed to take adequate steps to ensure that the registered representative ascertained whether the offer and sale of the shares were registered under the Securities Act, how and from whom the customers obtained their shares, whether and when the shares were paid for, and whether the transactions were exempt from registration. Supervisory personnel at ACAP undertook no efforts to determine whether the Greyfield shares were eligible for sale without registration, either when the stock was deposited or sold, other than relying on the absence of a restrictive legend on the stock certificates deposited at ACAP and the efforts of its clearing firm.

Second, under NASD Conduct Rule 3010(b), a member must "establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities" of associated persons.[58] These procedures must be "reasonably designed to achieve compliance with applicable securities laws and regulations" and applicable NASD rules.[59] We have emphasized that "all registered broker-dealers should establish minimum standard procedures to prevent and detect violations of the federal securities laws and to ensure that the firm meets its continuing responsibility to know both its customers and the securities being sold."[60] Hume and ACAP conceded that ACAP had no written or formal procedures regarding transactions in restricted securities or the receipt of unlegended stock certificates. There was nothing in the firm's written procedures manual regarding the determination of whether stock could be sold consistent with the registration requirements of the Securities Act. Accordingly, we also affirm FINRA's findings that ACAP and Hume violated NASD Rules of Conduct 3010(b) and 2110 by failing to establish, maintain, and enforce appropriate written procedures.

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56 *Michael T. Studer*, Exchange Act Release No. 50543A, 57 SEC 1011, 2004 WL 2735433, at *6 (Nov. 30, 2004), *petition denied*, 260 F. App'x 342 (2d Cir. 2008).

57 *Busacca*, 2010 SEC LEXIS 3787, at *35 (citation omitted); *see also George J. Kolar*, Exchange Act Release No. 46127, 55 SEC 1009, 2002 WL 1393652, at *4 (June 26, 2002) ("Decisive action is necessary whenever supervisors are made aware of suspicious circumstances, particularly those that have an obvious potential for violations.").

58 NASD Conduct Rule 3010(b).

59 *Id.*

60 *Midas Sec.*, 2012 SEC LEXIS 199, at *48 (*quoting 1971 Securities Act Release*, 1971 SEC LEXIS 19, at *4).

IV.

Under Exchange Act Section 19(e)(2), we sustain FINRA sanctions unless we find that, giving due regard to the public interest and the protection of investors, the sanctions are excessive, oppressive, or impose an unnecessary or inappropriate burden on competition.[61] ACAP and Hume request that we find the sanctions imposed by FINRA excessive and reduce them. Alternatively, they ask us to vacate the sanctions and remand this case to the NAC for further consideration of the evidentiary record.[62]

In assessing the appropriate sanctions to impose on ACAP and Hume, FINRA looked to its Sanction Guidelines. FINRA promulgated the Guidelines to achieve greater consistency, uniformity, and fairness in its sanctions.[63] Although the Guidelines do not bind us, they serve as a benchmark for our review under Exchange Act Section 19(e)(2).[64] We analyze the sanctions ordered for each of the two violations separately below.

A. The sanctions imposed for ACAP's unregistered sale of securities are not excessive or oppressive based on the record and FINRA's Sanction Guidelines.

For ACAP's unregistered sales of Greyfield stock without an applicable exemption, FINRA fined ACAP $50,000,[65] increasing the $25,000 fine issued by the Hearing Panel.[66] FINRA determined that four guideline-specific considerations were relevant to ACAP's misconduct and that each weighed in favor of an increased fine.[67] Applying these considerations, the NAC found significant that, in the face of multiple red flags,[68] ACAP made no attempt to determine if a registration statement was in effect for the offer and sale of the Greyfield securities or an exemption from registration applied, but rather "exclusively relied upon the lack of a restrictive legend and clearance of the stock by the clearing firm."[69] The NAC also cited as significant "the severe danger to investors" from the 27 million shares of Greyfield stock that

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[61] 15 U.S.C. § 78s(e)(2). Exchange Act Section 19(e)(2) permits us to cancel, reduce, or remit a FINRA sanction but does not authorize us to increase the sanction. *Id.*; *see also Gregory W. Gray*, Exchange Act Release No. 60361, 2009 SEC LEXIS 2554, at *39 n.41 (July 22, 2009) (noting that the Exchange Act does not authorize us to increase SRO disciplinary sanction). Neither ACAP nor Hume claims, nor does the record show, that FINRA's action imposed an unnecessary or inappropriate burden on competition.

[62] ACAP Br. at 26.

[63] *Richard A. Neaton*, Exchange Act Release No. 65598, 2011 SEC LEXIS 3719, at *39 n. 38 (Oct. 20, 2011).

[64] *Jason A. Craig*, Exchange Act Release No. 59137, 2008 SEC LEXIS 2844, at *18 n.27 (Dec. 22, 2008).

[65] *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *2. Because ACAP was the lone non-settling respondent with respect to the first count, the NAC imposed sanctions solely on ACAP under this count.

[66] The NAC was authorized to increase the sanctions that the Hearing Panel imposed. *Harry Friedman*, Exchange Act Release No. 64486, 2011 SEC LEXIS 1699, at *25 (May 13, 2011) ("We have repeatedly held that the NAC reviews the Hearing Panel's decision *de novo* and has broad discretion to modify the Hearing Panel's decisions and sanctions.").

[67] *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *13-14.

[68] *Id.* at *19-20.

[69] *Id.* at *14-15.

ACAP sold into the public marketplace without registration or an applicable exemption.[70] The NAC found that ACAP "intentionally ignored the legality of the Greyfield trades," which supported treating ACAP's misconduct as egregious,[71] and concluded that ACAP's actions evinced a "deliberate disregard of its gate-keeping responsibilities pursuant to Securities Act Section 5," which merited the increased fine.[72]

For unregistered sales of securities without an applicable exemption, FINRA's Sanction Guidelines recommend a fine of $2,500 to $50,000.[73] In egregious cases, the Guidelines call for consideration of a higher fine and suspension of the firm with respect to any or all activities or functions for up to 30 business days or until procedural deficiencies are remedied.[74] In addition, FINRA has identified the following considerations as relevant to the determination of sanctions for an unregistered sale of securities where no exemption was available: (1) whether the respondent attempted to comply with an exemption from registration; (2) whether the respondent had implemented reasonable procedures to ensure that it did not participate in an unregistered distribution; (3) whether the respondent disregarded "red flags" suggesting the presence of an unregistered distribution; and (4) the share volume and dollar amount of transactions involved.[75] We review these factors below.[76]

First, the record contains no evidence, and ACAP does not assert, that it ever attempted to determine if a registration statement was in effect for the offer and sale of the Greyfield shares or if an exemption from registration was available. Instead, ACAP points to record evidence that shows that its practice was to execute stock sales if a certificate did not contain a restrictive legend and ACAP's clearing firm determined that the shares "could be sold into the market."[77] Consistent with its admission that it "failed to determine . . . whether there was an applicable exemption to registration in the circumstances present here,"[78] ACAP could not reasonably follow such a practice and maintain that it attempted to comply with the conditions of the Section 4(a)(4) exemption from registration. Over fifty years ago, we explained that, while the standard of diligence for a broker is flexible, it requires "searching inquiry" when "a dealer is offered a substantial block of a little-known security" under circumstances that suggest that an illegal

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70 *Id.* at *18.

71 *Id.* at *19.

72 *Id.* at *21.

73 FINRA Sanction Guidelines (2011) at 24, http://www.finra.org/web/groups/industry/@ip/@enf/@sg/documents/industry/p011038.pdf (last visited July 2, 2013).

74 *Id.* The Guidelines also set out other considerations applicable to the determination of appropriate sanctions for individuals in egregious cases of unregistered sales of securities, which are inapplicable here.

75 *Id.*

76 The Guidelines also call for consideration of "whether the respondent sold securities before the effective date of the registration statement for the shares at issue." FINRA Sanction Guidelines at 24. We agree with the NAC that this factor did not apply to ACAP's sales of Greyfield stock because no registration statement was ever in effect for the offer and sale of its securities. *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *14 n.12.

77 ACAP Br. at 8-9.

78 FINRA 000068 (Stipulations ¶ 25).

distribution might be underway.[79] And we have repeatedly explained that where, as here, there are indicia of an illegal distribution, a broker cannot claim that its sales of a security were exempt from registration simply because the stock certificates lack a restrictive legend[80] or a clearing firm or transfer agent raises no objections to the sales.[81] Because ACAP exclusively relied on precisely these half measures, it failed to take any reasonable steps to comply with an applicable exemption from registration.[82] As the NAC aptly observed,[83] ACAP's practices were particularly egregious given that the majority of its business involved the liquidation of lower priced securities in the over-the-counter markets.[84]

Second, ACAP failed to implement reasonable procedures to ensure that it did not participate in an unlawful securities distribution. We long ago identified the pressing need for broker-dealers to establish appropriate minimum standard procedures[85] and specified non-

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79 *1962 Securities Act Release*, 27 Fed. Reg. at 1251 (explaining that duty is triggered when persons offering the little-known stock in question "appear reluctant to disclose exactly where the securities came from, or where the surrounding circumstances raise a question as to whether or not the ostensible sellers may be merely intermediaries for controlling persons or statutory underwriters"); *id.* (noting that "it must be assumed that these securities emanate from the issuer or from persons controlling the issuer" unless some other source is known).

80 *See, e.g., John A. Carley*, Exchange Act Release No. 57246, 2008 SEC LEXIS 222, at *48 n.55 (Jan. 31, 2008) (The absence of a restrictive legend on stock certificates does not "warrant the conclusion" that stock may be traded consistent with the registration requirements of the Securities Act. (citing *Gilbert F. Tuffli, Jr.*, Exchange Act Release No. 12534, 46 SEC 401, 1976 SEC LEXIS 1467, at *19 (June 10, 1976))), *petition denied in relevant part sub nom., Zacharias v. SEC*, 569 F.3d 458 (D.C. Cir. 2009); *Transactions in the Securities of Laser Arms Corp. by Certain Broker-Dealers*, Exchange Act Release No. 28878, 50 SEC 489, 1991 SEC LEXIS 257, at *39 (Feb. 14, 1991) (Exchange Act 21(a) report) ("[A] broker-dealer may not rely upon the absence of restrictive legends on the stock certificates when the circumstances surrounding the transaction indicate the need for a thorough investigation." (citing *Quinn & Co. v. SEC*, 452 F.2d 943, 947 (10th Cir. 1971))); *Stone Summers & Co.*, Exchange Act Release No. 9839, 45 SEC 105, 1972 SEC LEXIS 835, at *11-12 (Nov. 3, 1972) (The absence of a restrictive legend does not "relieve a broker-dealer from his duty as a professional in the securities business to make reasonable inquiry to assure himself that he is not participating in an illegal sale of unregistered securities.").

81 *Midas Sec.*, 2012 SEC LEXIS 199, at *41 ("[I]t is well established that the clearance of sales by a transfer agent and clearing firm does not relieve a broker of its obligation to investigate."); *Kirby*, 2003 WL 71681, at *5 n.34 ("[W]e have held that a securities professional cannot rely on the determination of a transfer agent that stock is free trading.") (internal citations omitted); *see also Wonsover v. SEC*, 205 F.3d 408, 415 (D.C. Cir. 2000) ("Precedent will not suffer [broker's] argument that he justifiably relied on the clearance of sales by [his firm's restrictive stock department], the transfer agent and counsel." (*citing, e.g., Stead v. SEC*, 444 F.2d 713, 716 (10th Cir. 1971) ("[C]alling the transfer agent is obviously not a sufficient inquiry."))).

82 *See A.G. Becker Paribas,* Exchange Act Release No. 2139, 48 SEC 118, 1985 SEC LEXIS 2139, at *8 (Feb. 19, 1985) ("If a broker relies on others to make the inquiry called for in any particular circumstances, it does so at its peril.") (settled proceeding cited in *Wonsover*, 20 F.3d at 415-16 and *Midas Sec.*, 2012 SEC LEXIS 199, at *41 n.56).

83 *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *23.

84 *See 1971 Securities Act Release*, 1971 SEC LEXIS 19, at *1 ("The potential harm to the public [from an unlawful distribution] is particularly acute when securities of a little-known issuer . . . are sold to the public on the over-the-counter market."); *see also Laser Arms Corp.*, 1991 SEC LEXIS 257, at *42 ("[B]rokers and dealers often are pivotal to the success of fraudulent and manipulative schemes involving penny stocks.").

85 *See supra* note 60 and associated text; *see also Midas Sec.*, 2012 SEC LEXIS 199, at *50-51 (discussing need to provide meaningful guidance in written supervisory procedures to detect and avoid illegal distributions).

exclusive lists of routine inquiries regarding customers and issuers that firms should make.[86] These inquiries were not required under ACAP's procedures, and ACAP failed to conduct the requisite inquiry with respect to the sales of Greyfield shares.

Third, the NAC found that, in executing the Greyfield trades, ACAP "ignored several red flags" suggesting those sales were part of an unregistered distribution.[87] The NAC properly identified the following red flags: (1) Greyfield was an unknown, development-stage company that had recently undergone a change in control;[88] (2) more than 10% of the outstanding Greyfield stock was deposited into ACAP accounts beginning less than a week after those shares were issued;[89] and (3) ACAP's customers began liquidating their shares soon after depositing them,[90] and at the same time that Greyfield was issuing press releases promoting its business prospects.[91] It was also a red flag that the 45 million shares initially deposited in ACAP's customers' accounts represented nearly 30,000 times the total volume of Greyfield stock that traded over the approximately three previous years. Moreover, it was a matter of public record that no Securities Act registration statement was in effect for the offer and sale of Greyfield's securities.[92] ACAP should have discovered or taken note of these facts and expeditiously conducted an investigation to determine whether the sales of Greyfield shares were part of an illegal distribution. But due to its lack of inquiry, ACAP failed to discover that Fiessel's company, Gold Technologies, had obtained its shares directly from Greyfield for no consideration and that, soon thereafter, Gold Technologies had transferred a portion of those shares to Fiessel's business associate. The record, including Hume's on-the-record testimony,[93] supports the NAC's conclusion that ACAP "turned a blind eye and conducted no inquiry into the

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[86] *See supra* notes 18 & 19 and associated text.

[87] *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *19.

[88] *See Kirby*, 2003 WL 71681, at *5 (finding that respondent failed to make appropriate investigation of "little-known company with limited assets" that had traded only sporadically and experienced a change of control).

[89] *See Laser Arms Corp.*, 1991 SEC LEXIS 257, at *43 (emphasizing that "a broker-dealer that is asked to sell a large block of a relatively unknown stock must conduct an appropriate inquiry regarding the need for registration and must be alert to any unusual circumstances that may exist or which may come to light").

[90] *See Midas Sec.*, 2012 SEC LEXIS 199, at *33 (finding that broker "was required to conduct a searching inquiry to assure itself that . . . proposed sales were exempt from the registration requirements and not part of an unlawful distribution" when client "deposited a large block of recently issued shares of a little-known stock into his account and directed [broker] to sell the shares shortly thereafter without a registration statement in effect").

[91] *Cf. Id.*, 2012 SEC LEXIS 199, at *15, *35 (finding that client's "known stock promotion activities should have raised additional concerns that his sales were part of an unlawful distribution" and noting that "spam campaign coincided with several upbeat press releases").

[92] Issuers must file Securities Act registration statements on the Commission's publicly accessible EDGAR system, which is searchable over the Internet. *See* http://www.sec.gov/edgar/searchedgar/companysearch.html.

[93] As the NAC accurately observed, "Hume testified in a 2008 on-the-record interview with [FINRA] Enforcement that ACAP took no action to investigate whether a stock [could legally be] trad[ed] when a customer deposited a stock certificate that bore no restrictive legend." *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *20.

circumstances surrounding the Greyfield activity."[94] ACAP's inaction in the face of obvious red flags underscores the egregiousness of its violation.

Finally, the NAC appropriately found that the 27 million Greyfield shares ACAP sold into the public marketplace without registration or an available exemption posed a "severe danger" to investors and that these sales were an aggravating factor in the determination of sanctions.[95] The NAC found that the proceeds from the sale of these shares were "not insignificant" and that the dollar amount of the sales and commissions that ACAP earned in no way mitigated the severity of its misconduct.[96] We agree and also reject ACAP's argument that the relevant monetary sanction should be determined as a function of the amount of the commissions it received from the illegal sales of securities.[97] Such an approach would unduly limit incentives to comply with the Securities Act's registration requirements, where, as here, tens of millions of shares of penny stocks were sold to the public without registration or an applicable exemption and would place excessive reliance on a single factor in the determination of sanctions.

In sum, all four relevant considerations identified by FINRA's Sanction Guidelines weigh in favor of finding that ACAP's unregistered sales of Greyfield securities in violation of the Securities Act were egregious. While the Guidelines authorize a fine of up to $50,000 for unregistered sales of securities where no exemption is available, they recommend consideration of higher fines, where, as here, the violation was egregious. Because we agree with the NAC that ACAP's conduct was egregious, we find that the $50,000 fine was neither excessive nor oppressive.[98]

B. The sanctions imposed for ACAP's and Hume's failures to supervise are not excessive or oppressive based on the record and FINRA's Sanction Guidelines.

For ACAP's supervisory failings, FINRA imposed an additional $50,000 fine, required the firm to revise its procedures and retain an independent consultant acceptable to FINRA to review and approve the procedures, and suspended ACAP from receiving and liquidating penny stocks for which no Securities Act registration statement is in effect until the revised procedures

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94 *Id.* We address in detail in Section IV.C.1. below ACAP's contention that the NAC erred by making this determination.

95 *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *18.

96 *Id.* at *18 n.14.

97 *See* ACAP Br. at 17-18 (arguing that the fines imposed by the Hearing Panel are "disproportionate to the size of the underlying transaction and are excessive" because FINRA purportedly "typically assesses fines proportionate to . . . the commission received by the sales agent"). Although the Sanction Guidelines provide that a fine may be increased by the amount of the personal benefit to the violator, they do not mandate that the base amount of the fine be determined based on that benefit. *See* FINRA Sanction Guidelines at 24 n.1 ("Adjudicators may increase the recommended fine amount by *adding* the amount of a respondent's financial benefit.") (emphasis added); *id.* at 103 n.2 (same).

98 In finding that the sanctions were not excessive or oppressive, we have considered ACAP's contrary arguments. We separately address those arguments in Section IV.C. below but rely on that analysis here.

are approved by the consultant and implemented.[99] FINRA also fined Hume $25,000, suspended him in all capacities for six months, and required him to requalify before acting in any capacity requiring qualification.[100] FINRA explained that ACAP's and Hume's supervisory violations were egregious in that they ignored red flags, conducted no inquiry, and abdicated their gate-keeping role to ACAP's clearing firm, thereby permitting the illegal sales of Greyfield shares to occur through their misconduct.[101] FINRA also found that the firm's failure to employ any supervisory procedures was particularly egregious given that ACAP's business principally involved brokering transactions in lower-priced Bulletin Board and Pink Sheets securities, and it considered the large volume of Greyfield shares sold to the public to be aggravating.[102]

FINRA's Sanction Guidelines set out sanctions recommendations for both failure to supervise and failure to maintain adequate written supervisory procedures. The Guidelines recommend a fine of $5,000 to $50,000 for a failure to supervise and call for consideration of independent, rather than joint-and-several monetary sanctions for the firm and individual.[103] In egregious cases, the Guidelines call for consideration of the following additional sanctions: (1) suspending the responsible individual in any or all capacities for up to two years or barring the responsible individual; (2) limiting activities of the branch office or department for a longer period or suspending the firm with respect to any or all activities or functions for up to 30 business days; and (3) where there were systemic supervision failures, suspending the firm with respect to any or all activities or functions for up to two years or expelling the firm.[104]

The Guidelines recognize the following principal considerations in determining sanctions for a failure to supervise: (1) whether the respondent ignored "red flag" warnings that should have resulted in additional supervisory scrutiny and whether individuals responsible for underlying misconduct attempted to conceal misconduct from respondent; (2) the nature, extent, size, and character of the underlying misconduct; and (3) the quality and degree of the supervisor's implementation of the firm's supervisory procedures and controls.[105]

Each of those considerations supports FINRA's egregiousness finding. First, as explained above, ACAP and Hume ignored multiple red flags that should have caused additional

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99 *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *25. ACAP does not challenge the non-monetary sanctions for its supervisory failings.

100 *Id.* at *26.

101 *Id.* at *23.

102 *Id.* at *23-24.

103 FINRA Sanction Guidelines at 103. The Guidelines also call on the adjudicator to consider suspending the responsible individual in all supervisory capacities for up to 30 business days, and to consider limiting activities of an appropriate branch office or department for up to 30 business days. *Id.*

104 *Id.*

105 *Id.*

supervisory scrutiny.[106] The NAC properly treated this as an aggravating factor supporting its finding of egregious conduct.[107]

Second, the nature, extent, size, and character of the underlying misconduct, i.e., the illegal sales of securities in violation of Securities Act Section 5, also support treating ACAP and Hume's supervisory violations as egregious. The NAC properly treated the millions of shares of Greyfield stock sold without registration or an available exemption as an aggravating factor because these sales of a little-known penny stock were precisely the sort of transactions for which particular attention is required.[108] ACAP and Hume's assertions that ACAP made only limited profit, and that they were not involved in or knowledgeable regarding the underlying fraudulent scheme, do not mitigate the seriousness of their misconduct and evidence a troubling indifference to the danger it posed to investors.

Third, the quality and degree of Hume's implementation of the firm's supervisory procedures and controls were poor. The NAC accurately observed that ACAP and Hume "fail[ed] to employ any supervisory procedures" and "engaged in no due diligence and abdicated all responsib[ility] to [ACAP's] clearing firm," all of which it properly found to be aggravating.[109] Although ACAP and Hume go to great lengths to explain their practices when receiving securities that bore no restrictive legend,[110] the evidence they highlight merely confirms that they habitually relied on the lack of a restrictive legend on stock certificates and their clearing firm to determine whether a stock could be sold on an unregistered basis. Indeed, when asked directly to identify the efforts ACAP would take to determine if securities that bore no restrictive legend could legally be sold without registration, Hume admitted that there were "[n]one really" and explained that Applicants instead relied on their clearing firm.[111] There was thus no system in place to prevent illegal distributions of the sort effected by Fiessel.

FINRA's Sanction Guidelines also recommend a fine of $1,000 to $25,000 for failure to maintain adequate written supervisory procedures.[112] In egregious cases, the Guidelines call for consideration of suspending the responsible individual in any or all capacities for up to one year and of suspending the firm with respect to any or all relevant activities or functions for up to 30 business days and thereafter until the supervisory procedures are amended to conform to rule requirements.[113]

The Guidelines identify the following principal considerations as applicable to determining the appropriate sanctions for deficient written supervisory procedures: (1) whether

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106 *See* discussion of third factor in Section IV.A. above.

107 *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *23.

108 *See supra* note 84 and associated text.

109 *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *23.

110 *See, e.g.*, ACAP Br. at 2-3, 8-9.

111 FINRA 000290 (Hume Test. at 44:15-24).

112 FINRA Sanction Guidelines at 104.

113 *Id.*

deficiencies allowed violative conduct to occur or to escape detection and (2) whether the deficiencies made it difficult to determine the individual or individuals responsible for specific areas of supervision or compliance.[114]

These considerations also support treating ACAP and Hume's supervisory failings as egregious. First, the failure to maintain written procedures allowed violative conduct to occur in the form of unregistered sales of tens of millions of Greyfield shares without an available exemption. Second, because there were no written procedures, the deficiencies in the written supervisory procedures made it difficult to determine the individual or individuals responsible for specific areas of supervision or compliance. No one at ACAP conducted the necessary inquiry; ACAP relied solely on its clearing firm.

Each of the applicable considerations identified by FINRA's Sanction Guidelines thus weighs in favor of FINRA's finding that ACAP's and Hume's supervisory failures were egregious. The fines FINRA imposed on ACAP and Hume are within the range recommended by the Guidelines for even non-egregious failures to supervise. ACAP does not challenge the requirement that it revise its procedures with the approval of an independent consultant or its suspension from certain trading until revised procedures have been implemented, and we find that these measures are also consistent with the Guidelines.[115] We therefore determine that these sanctions were neither excessive nor oppressive and sustain them.[116]

C. ACAP and Hume's arguments that the sanctions are excessive lack merit.

ACAP and Hume present three principal arguments in support of their assertion that the sanctions imposed by FINRA were excessive: (1) that the NAC ignored critical evidence because it was not contained in the parties' stipulations; (2) that a number of alleged mitigating factors required lesser sanctions,[117] and (3) that Hume's six-month all-capacities suspension was excessive. We reject each of these arguments for the reasons explained below.

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114 *Id.*

115 *See* FINRA Sanction Guidelines at 3 (authorizing adjudicators to craft appropriate sanctions, including those that "require a respondent firm to retain a qualified independent consultant to design and/or implement procedures for improved future compliance with regulatory requirements" or "suspend or bar a respondent firm from engaging in a particular line of business"); *see also id.* at 103 (authorizing "suspension of the firm with respect to any or all activities or functions (of up to two years) or expulsion of the firm" in "a case against a member firm involving systemic supervision failures").

116 We separately address Hume's challenge to his all-capacities suspension in Section IV.C.3. below. In determining that the other sanctions issued for supervisory misconduct were not excessive or oppressive, we have considered ACAP and Hume's other arguments discussed in Section IV.C. below.

117 In making the first two arguments, ACAP and Hume generally do not distinguish between arguments applicable to ACAP, Hume, or each of them, or differentiate between the two separate violations for which FINRA ordered sanctions. Where appropriate, we make such distinctions in our analysis below.

1. The NAC's decision is consistent with the entirety of the record.

ACAP and Hume argue that the NAC ignored undisputed evidence contradicting[118] the NAC's determinations that ACAP "intentionally ignored the legality" of the sales of Greyfield shares at issue, acted in "deliberate disregard of its gate-keeping responsibilities pursuant to Securities Act Section 5," and "turned a blind eye" to the legality of the sales.[119] ACAP and Hume contend that these findings "give the false and misleading impression that ACAP entered into a deliberate, thoughtful/planned course of action to ensure that [Greyfield] securities" were sold to the public without registration or an available exemption and that other NAC statements "give the false and misleading impression that ACAP and Hume were complicit with the [Greyfield] fraud scheme conspirators."[120] ACAP and Hume also assert that the NAC "completely ignored" evidence showing that it engaged in efforts to determine whether shares could legally be sold prior to sale[121] and imply that they permitted the sales of Greyfield shares to go forward only because they were deceived by Fiessel, the Greyfield scheme's "mastermind."[122] Finally, ACAP and Hume assert that the NAC's identification of red flags relied on factual errors and therefore that its findings that they engaged in egregious conduct are incorrect.[123]

Contrary to ACAP and Hume's contentions, the NAC did not determine that they were complicit in Fiessel's underlying scheme to seize control of Greyfield and distribute newly issued shares of the company without registration or exemption. Instead, the NAC based its sanctions on ACAP and Hume's inaction in the face of obvious red flags and their lack of any reasonable system to ensure the sales ACAP executed complied with Securities Act Section 5.[124] When charged with a duty of inquiry, a broker may not defend his conduct by pleading ignorance of facts he may have discovered if he had made required inquiries.[125] ACAP's relationship with its customers uniquely positioned it "to ask relevant questions, acquire material information, or disclose [its] findings" regarding the existence of an illegal distribution.[126] Although the facts in their possession or readily available to them triggered a duty of inquiry, ACAP and Hume chose

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118 ACAP Br. at 1; *see also id.* at 7-8.

119 *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *19, *21, *20.

120 ACAP Br. at 8, 11-12.

121 *Id.* at 7.

122 *Id.* at 11.

123 *Id.* at 11-12.

124 *See generally ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *13-27.

125 *See Owsley*, 1993 SEC LEXIS 1525, at *12-13 (rejecting representative's claim that he "did not know [the illegal distribution] was occurring" because the circumstances presented "the classic pattern of an unlawful distribution" and sustaining NASD findings of Securities Act Section 5 violations); *see also SEC v. Mono-Kearsarge Consolidated Mining Co.*, 167 F. Supp. 248, 259 (D. Utah 1958) ("[A dealer] cannot close his eyes to obvious signals which if reasonably heeded would convince him of, or lead him to, the facts and thereafter succeed on the claim that no express notice of those facts was served upon him."), cited in *1971 Securities Act Release*, 1971 SEC LEXIS 19, at *3 n.2; *cf. Hanly v. SEC*, 415 F.2d 589, 596 (2d Cir. 1969) (holding that salesman "cannot deliberately ignore that which he has a duty to know").

126 *Kane v. SEC*, 842 F.2d 194, 198 (8th Cir. 1988).

instead to rely on the absence of a restrictive legend on stock certificates and ACAP's clearing firm to determine whether the Greyfield stock could legally be sold without registration. Because we long ago rejected that practice,[127] ACAP and Hume's detailed explanation in their briefs of exactly how they relied on these measures, based on evidence they contend the NAC ignored, is irrelevant; this evidence does not establish that ACAP and Hume conducted any inquiry into the Greyfield transactions.[128] The entirety of Hume's investigative testimony and the parties' stipulations clearly demonstrated that ACAP and Hume failed to maintain and apply appropriate practices. On this record, the NAC's finding that ACAP "intentionally ignored the legality" of the sales of Greyfield shares merely reflects that applicants intentionally abdicated their duty to ascertain the legality of the sales prior to permitting ACAP to execute them.

We also reject ACAP and Hume's suggestion that their actions were not egregious because Fiessel concealed his scheme from them. ACAP and Hume assert that the NAC erred by finding that Fiessel "and his associates deposited more than 10 percent of the outstanding Greyfield stock into ACAP accounts within weeks of the Greyfield shares being issued"[129] because ACAP's customers purportedly never held 10% or more of Greyfield's outstanding stock in their ACAP accounts at any one time. Based on this contention, ACAP and Hume imply that they did not discover the illegal distribution of Greyfield shares because their customers "staggered" their deposits of Greyfield shares and the sales of these shares to avoid detection.[130]

ACAP and Hume incorrectly suggest that the NAC's findings relied on a determination that ACAP's customers held more than 10% of Greyfield's issued and outstanding shares in their accounts at any one moment in time. ACAP's customers deposited approximately 11% of Greyfield's total issued and outstanding stock over slightly more than two months, over 80% of which was deposited on a single day less than a week after the shares were issued. That the initial deposits made up approximately 9%, rather than more than 10% of all issued and outstanding Greyfield stock is of no moment;[131] those deposits still presented "the classic warning signs of an obscure issuer, a thinly traded security, and the deposit of stock certificates in a large volume of shares" that demanded that ACAP and Hume conduct a searching inquiry.[132] Days after the initial deposit, Gold Technologies then began to sell its Greyfield shares, as Hume generally expected ACAP's customers to do. ACAP and Hume were not relieved of their duty of inquiry simply because ACAP's customers did not sell all of their Greyfield stock at one time.

ACAP and Hume also argue that the NAC erred by referring to Fiessel in its recitation of red flags because Fiessel was not the account holder on either of the customer accounts. There was no error. Broker-dealers must be on the alert to deposits that might have been made on

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127 *See supra* notes 80 & 81.

128 *See, e.g., supra* notes 26 & 27; *see also generally* Section II.B.

129 *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *19.

130 ACAP Br. at 12.

131 ACAP and Hume stipulated that the 55 million total Greyfield shares their customers deposited between May 3 and July 6, 2005 constituted approximately 11% of Greyfield's float. The 45 million shares deposited on May 3, 2005 thus constituted approximately 9% of Greyfield's stock.

132 *Midas Sec.*, 2012 SEC LEXIS 199, at *51.

behalf of an issuer or its control persons.[133] Thus, the fact that the Greyfield securities were deposited into the accounts of Fiessel's company[134] and business associate, rather than his own personal account, does not excuse ACAP and Hume's failure to conduct any inquiry consistent with their obligations.[135]

ACAP and Hume also assert that there is "no evidence in the record that ACAP or Hume knew that [ACAP's customers'] accounts were related in any way."[136] Tellingly, neither ACAP nor Hume asserts that they attempted to determine whether there was a connection between the two accounts. They should have. On the same day, ACAP's customers both deposited tens of millions of Greyfield shares that had been issued only six days earlier. It was thus obvious that at least the possibility of a connection between Gold Technologies's and Fiessel's business associate's accounts needed to be investigated. Any suggestion that ACAP and Hume were deceived by Feissel or his associate is disproven by the fact that they failed to obtain any information from their customers through which they could have been misled.[137]

2. FINRA properly considered and rejected ACAP and Hume's arguments regarding alleged mitigating factors.

ACAP and Hume also erroneously assert that the sanctions are excessive because FINRA failed to accord weight to certain alleged mitigating factors. First, ACAP and Hume contend that FINRA should have considered their stipulations to be a mitigating factor meriting a reduction in the sanctions against them.[138] FINRA's Sanction Guidelines call for consideration of whether a respondent "accepted responsibility for and acknowledged the misconduct" at issue "prior to detection and intervention."[139] Because ACAP and Hume did not stipulate to their misconduct until after FINRA had instituted a disciplinary proceeding against them, their stipulations came too late to warrant consideration under the Guidelines.

Nonetheless, ACAP and Hume cite three FINRA decisions for the proposition that FINRA has considered an admission of misconduct to be a mitigating factor even when it

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133 *Id.* at *31-32 (explaining that "ostensible sellers may be merely intermediaries for controlling persons or statutory underwriters" (quoting *1962 Securities Act Release*, 27 Fed. Reg. at 1251)).

134 Fiessel was the owner of Gold Technologies.

135 We reject ACAP's suggestion that its conduct is mitigated because it purportedly could not have discovered Fiessel's wrongdoing before the Commission did so. *See Apex Fin.*, 1980 SEC LEXIS 1663, at *5 ("We have repeatedly held that a broker-dealer cannot shift its responsibility for compliance with applicable requirements to regulatory authorities.").

136 ACAP Br. at 4, 12.

137 We also cannot accept ACAP and Hume's argument that their conduct was not egregious because each of the red flags present in *Department of Enforcement v. Patrick F. Harte, Jr.*, Proceeding No. 2006003672401, 2009 FINRA Discip. LEXIS 32 (OHO Aug. 31, 2009) was not present here. ACAP Br. at 9-11. The relevant question is whether a respondent ignored red flags, not whether the red flags at issue are identical to those in a prior case.

138 ACAP Br. at 15.

139 FINRA Sanction Guidelines at 6. Although the Guidelines contemplate that an individual might acknowledge responsibility to an employer before the firm's detection of misconduct, there is no evidence in the record that Hume acknowledged the misconduct to his employer or that ACAP independently discovered it.

occurred after an investigation was initiated.[140] These decisions provide no support for a reduction in sanctions. Each decision determined that the respondent demonstrated a genuine showing of remorse and, in any event, imposed significant sanctions.[141] In contrast, ACAP and Hume, while admitting their misconduct, have attempted to minimize its significance. For example, ACAP and Hume argued below (but not before us) that their failure to conduct any due inquiry with respect to the sale of the Greyfield shares did not merit significant sanctions because it purportedly was consistent with standard industry practice[142] and also argued that FINRA's action was based on only recently asserted obligations.[143] Before us, ACAP and Hume unconvincingly cast themselves as victims of the underlying fraud, rather than acknowledge the gravity of their misconduct. Under these circumstances, we do not find that ACAP and Hume's acknowledgement of their violations before FINRA—over five years after their misconduct—should mitigate their sanctions.[144]

Second, ACAP and Hume also assert that FINRA should have attached mitigative weight to the fact that ACAP revised its procedures in 2008 by instituting the use of a "large block" questionnaire created by ACAP's clearing firm to obtain relevant information from customers.[145] FINRA's Sanction Guidelines call for consideration of whether a respondent "voluntarily employed subsequent corrective measures, *prior to detection or intervention* . . . to revise general

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140 ACAP Br. at 15.

141 *See Dep't of Enf. v. Kelly*, Complaint No. E9A2004048801, 2008 FINRA Discip. LEXIS 48, at *32, *33 n.34, *34 (NAC Dec. 16, 2008) (finding respondent "consistently expressed remorse" and according "some mitigative value in Kelly's frank admission to the Hearing Panel" but determining that "sanctions at the highest end of the recommended ranges" were "necessary and proportional" and imposing a two-year suspension and greater than $100,000 fine); *Dep't of Enf. v. Leopold*, Complaint No. 2007011489301, 2012 FINRA Discip. LEXIS 2, at *21, *23-24 (NAC Feb. 24, 2012) (recognizing that respondent was "genuinely remorseful" but fining him $25,000 and suspending him for one year); *Dep't of Market Reg. v. Drake*, Proceeding No. 20060053785-02, 2012 FINRA Discip. LEXIS 48, at *4, *23-24 (OHO May 3, 2012) (finding that, although Drake was "sincerely remorseful," this did not "demonstrate that he would be able to fulfill a supervisory role effectively in the future" and barring him from association with any FINRA member firm in a supervisory capacity).

142 Our long-standing, unambiguous precedent precludes that argument. *Midas Sec.*, 2012 SEC LEXIS 199, at *45 (rejecting argument that industry standard authorized reliance on transfer agent because "applicable standard of care was clear"); *see also Monetta Fin. Servs., Inc. v. SEC*, 390 F.3d 952, 956 (7th Cir. 2004) (finding that "the mere presence of an industry practice is insufficient to overcome the conclusion" that investment advisor violated statutory duties); *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 274 (3d Cir. 1998) (noting that "[e]ven a universal industry practice may still be fraudulent"). The NAC also properly rejected ACAP and Hume's argument because they presented no evidence of an industry practice. *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *15-16; *see also Midas Sec.*, 2012 SEC LEXIS 199, at *44-45 (rejecting factual assertion that reliance on transfer agent was "widely, if not universally, the practice in the brokerage industry").

143 ACAP and Hume also have abandoned this argument before us. In any event, it has no merit. *See Midas Sec.*, 2012 SEC LEXIS 199, at *45 n.62 (rejecting argument that brokers "lacked sufficient notice of their requirements under the Securities Act" to conduct a reasonable inquiry to prevent unregistered distributions of securities without an available exemption based on prior Commission and NASD guidance).

144 *See Mark F. Mizenko*, Exchange Act Release No. 52600, 58 SEC 846, 2005 SEC LEXIS 2655, at *17 (Oct. 13, 2005) (according "little weight" to broker's admission of misconduct "because it came only after he was confronted by his employer with his wrongdoing").

145 ACAP Br. at 15.

and/or specific procedures to avoid recurrence of misconduct."[146] ACAP and Hume do not dispute the NAC's finding that "ACAP took no remedial measures before Enforcement commenced its investigation of the Firm,"[147] nor can they. Hume testified that ACAP had begun using a questionnaire in connection with the deposit of large blocks of stock to determine if the stock was eligible for resale without registration only "in the last week or two" prior to his investigative testimony and that ACAP had not put in place a requirement dictating when the questionnaire was to be used. Accordingly, FINRA's Sanction Guidelines afford no mitigative weight to ACAP's remedial measures.[148]

Nonetheless, ACAP and Hume argue that these belated measures should be granted mitigative weight because they implemented them before FINRA filed its complaint. ACAP and Hume rely on a FINRA hearing panel decision, *Department of Enforcement v. Ranni.*[149] In that case, the supervisory failure predated the respondent's tenure by years and was discovered after the respondent had been on the job for a matter of months, at which time he began to take action.[150] The hearing panel found that the fact that Ranni made "some revisions to the [written supervisory procedures] when he recognized problems" after the commencement of an investigation, along with other factors, supported treating his failure to supervise as serious but not egregious.[151] In contrast, when the misconduct cited here occurred in 2005, Hume had worked at ACAP since 1991 and served as compliance officer since 2002. ACAP and Hume first began to create necessary procedures in 2008, over three years after the unregistered sale of Greyfield securities in violation of the Securities Act.[152] We find that any modicum of mitigative weight that we might reasonably afford to this "trace evidence" of remedial measures,[153] and ACAP and Hume's stipulations of violations, is outweighed by the egregiousness of their misconduct and other factors discussed herein.

Third, ACAP argues that the NAC should have reduced the sanctions against the firm due to ACAP's alleged inability to pay the monetary sanctions.[154] Under the Guidelines, "[a]djudicators are required to consider a respondent's bona fide inability to pay when imposing a

[146] FINRA Sanction Guidelines at 6 (emphasis added).

[147] *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *24-25.

[148] FINRA Sanction Guidelines at 6; *see also Dennis Todd Lloyd Gordon*, Exchange Act Release No. 57655, 2008 SEC LEXIS 819, at *68 (Apr. 11, 2008) ("Remedial action taken after the initiation of an examination has little mitigative value.").

[149] Proceeding No. 20080117243, 2012 FINRA Discip. LEXIS 6 (OHO Mar. 9, 2012).

[150] *Id.* at *44.

[151] *Id.* at *44-45.

[152] Also in contrast to *Ranni*, there is no evidence that ACAP and Hume changed their *written* supervisory procedures in 2008. Instead, Hume testified that ACAP began to use a large block questionnaire but had not put in place a requirement for when the questionnaire was to be used.

[153] *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *24.

[154] Before the NAC, Hume argued that the sanctions against him should be reduced based on his financial circumstances. The NAC rejected Hume's argument because Hume failed to raise it before the Hearing Panel and there was no evidence in the record that he could not pay the sanction assessed. *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *28 n.26. We agree with the NAC that Hume's (now abandoned) argument lacks merit.

fine or ordering restitution."[155] "The burden is on the respondent to raise the issue of inability to pay and to provide evidence thereof."[156] The Guidelines also provide that "[a]djudicators should require respondents who raise the issue of inability to pay to document their financial status through the use of standard documents that FINRA staff can provide[]."[157] Further, under the Guidelines, "[a]lthough Adjudicators must consider a respondent's bona fide inability to pay when the issue is raised by a respondent, monetary sanctions imposed on member firms need not be related to or limited by the firm's required minimum net capital."[158]

We agree with the NAC that ACAP failed to establish an inability to pay the monetary sanctions.[159] ACAP argues that because, at year end 2009, its net loss was $143,133 and its excess net capital was approximately $90,000, the $100,000 total fines would have the "practical effect of shuttering" ACAP and thus are "improper and excessive."[160] But there is no evidence before us of ACAP's current financial circumstances. Because ACAP did not seek to supplement the record,[161] it has not met its burden to show that it currently cannot pay the monetary sanction. Moreover, even if ACAP had submitted current information regarding its finances in the form that it previously submitted below, that would not be sufficient to establish the firm cannot pay the sanctions.[162] ACAP has not demonstrated that it could not obtain financing, employ other sources of funds to discharge the monetary liability, or agree to an appropriate installment payment plan or other alternate payment option with FINRA.[163]

Citing several FINRA and NASD decisions, ACAP and Hume also argue that the sanctions were excessive because they were not commensurate with the sales commissions

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155 FINRA Sanction Guidelines at 5.

156 *Id.*; *see also* Order Denying Mot. for Recon., *Joseph J. Vastano, Jr.*, Exchange Act Release No. 50691, 2004 SEC LEXIS 2775, at *3 (Nov. 18, 2004) ("[A] respondent carries the burden of demonstrating an inability to pay."); *Robert Tretiak*, Exchange Act Release No. 47534, 56 SEC 209, 2003 WL 1339182, at *5 (Mar. 19, 2003) (noting that NASD was "entitled to make a searching inquiry" into allegations of inability to pay).

157 FINRA Sanction Guidelines at 5.

158 *Id.*

159 *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *27-28.

160 ACAP Br. at 16-17.

161 *See* Rule of Practice 452, 17 C.F.R. § 201.452.

162 Contrary to ACAP's suggestion, *Department of Enforcement v. Berry-Shino Securities*, Proceeding No. C3A030001, 2003 NASD Discip. LEXIS 61 (Hearing Panel Dec. 10, 2003), does not establish that a fine is *per se* excessive if it exceeds a firm's available net capital. In that case, the Hearing Panel declined to grant a disgorgement remedy where the "extraordinary circumstances" at issue involved the firm's "good faith involvement in collecting commissions that, although allowable under European laws, were unfair and excessive under NASD rules." *Id.* at *39. Based on these "unique" facts not present here, the hearing panel also found that the $250,000 disgorgement sought would be punitive given the firm's less than $100,000 net capital. *Id.* at *39-40.

163 *See ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *28 n.28 (citing FINRA Sanction Guidelines at 11 regarding alternative payment plans); *Robert L. Den Herder*, Exchange Act Release No. 39297, 53 SEC 329, 1997 SEC LEXIS 2293, at *10 n.11 (Nov. 5, 1997) (noting that, although respondent had failed to establish his inability to pay, "NASD makes available an installment plan which would permit [him] to pay over time").

ACAP received.[164] We are satisfied that FINRA appropriately analyzed and applied the Guidelines to the facts to reach a reasoned basis for the sanctions imposed.[165] The egregiousness of the supervisory failures, the large volume of shares illegally sold, and the other factors discussed herein, as well as the need for general and specific deterrence, provide ample support for the monetary sanction. Moreover, ACAP and Hume fail to cite recent cases in which we sustained FINRA fines for unregistered sales of securities and associated supervisory failures that exceeded the commissions earned from those sales.[166] In any event, we have consistently held that "the appropriateness of the sanctions imposed depends on the facts and circumstances of the particular case and cannot be determined precisely by comparison with action taken in other cases."[167]

3. FINRA's six-month all-capacities suspension of Hume protects investors from future harm.

Finally, Hume argues that his six-month all-capacities suspension with a requalification requirement[168] is excessive because his misconduct occurred solely in a supervisory capacity. According to Hume's argument, FINRA "has recognized that when the misconduct at issue is a failure to supervise, barring or suspending a registered representative in all capacities has limited remedial value" and thus limiting Hume's suspension to a supervisory capacity would be more appropriately tailored to his misconduct.[169]

Hume's argument does not recognize that FINRA's Sanction Guidelines applicable to supervisory failures expressly authorize an all-capacities suspension or bar for egregious conduct[170] and that FINRA has ordered sanctions consistent with this guidance in the past.[171]

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164 ACAP Br. at 17-18 (citing FINRA Sanction Guidelines, Principal Consideration No. 18 (providing for consideration of "the number, size and character of the transactions at issue")). In their briefing, ACAP and Hume concentrate on the size of their commissions and ignore the large number of shares sold in unregistered transactions and the egregious character of those sales.

165 *See supra* note 97 & associated text.

166 *See Midas Sec.*, 2012 SEC LEXIS 199, at *1, *4, *17 (sustaining fines of $80,000 to firm and $50,000 to its president where sales generated approximately $2,200 in commissions); *see also World Trade Fin. Corp.*, Exchange Act Release No. 66114, 2012 SEC LEXIS 56, at *1, *4, *15 (Jan. 6, 2012) (sustaining fines that exceeded commissions), *appeal docketed*, 12-70681 (9th Cir. Mar. 2, 2012).

167 *Scott Epstein*, Exchange Act Release No. 59328, 2009 SEC LEXIS 217, at *74 (Jan. 30, 2009), *petition denied*, 416 F. App'x 142 (3d Cir. 2010); *cf. Butz v. Glover Livestock Commission Co.*, 411 U.S. 182, 187 (1973) ("The employment of a sanction within the authority of an administrative agency is . . . not rendered invalid in a particular case because it is more severe than sanctions imposed in other cases.").

168 FINRA's Sanction Guidelines provide that a requalification requirement may be imposed where, as here, "a respondent's actions have demonstrated a lack of knowledge or familiarity with the rules and laws governing the securities industry." FINRA Sanction Guidelines at 5. Hume does not challenge the requalification requirement and we believe it is fitting under the circumstances.

169 ACAP Br. at 18-19.

170 FINRA Sanction Guidelines at 103, 104.

171 *See, e.g., Dennis S. Kaminski*, Exchange Act Release 65347, 2011 SEC LEXIS 3225, at *45 (Sept. 16, 2011) (sustaining FINRA's imposition of an 18-month all-capacities suspension and requalification requirement); *William J. Murphy*, Exchange Act Release No. 69923, 2013 SEC LEXIS 1933, at *112 & n.155 (July 2, 2013) (sustaining

(continued...)

FINRA accurately found that Hume was "centrally responsible for the rule violations at issue here" and that he abdicated his responsibility to others and displayed a disturbing lack of understanding and ignorance of FINRA rules.[172] Indeed, Hume's supervisory misconduct goes to the heart of the obligations of a securities professional.[173] Although Hume was charged with establishing written procedures for ensuring the legality of the sales of securities and ensuring that registered representatives adhered to them, proper procedure would require representatives to make many of the same inquiries that Hume chose not to require or make when stock certificates did not bear restrictive legends.[174] Moreover, given the nature of ACAP's business model, which relies heavily on the liquidation of penny stocks, the associated risk is all the more concerning given Hume's continued employment with ACAP.[175] Accordingly, we sustain the all-capacities suspension.[176]

(...continued)
all-capacities bar imposed for egregious conduct and noting that "[b]ecause proper supervision serves such an important role in protecting investors, egregious violations of supervisory rules often warrant the most severe sanctions"); *cf. Dep't of Enf. v. Pellegrino*, No. C3B050012, 2008 FINRA Discip. LEXIS 10, at *70 n.57 (NAC Jan. 4, 2008) (explaining that FINRA's "imposition of a principal bar in this proceeding does not mean . . . that broader sanctions, such as a bar or suspension in all capacities, would not be warranted in other cases involving supervisory failures" and noting that "[t]he appropriate sanctions depend on the facts and circumstances of each case").

172 *ACAP Fin.*, 2012 FINRA Discip. LEXIS 55, at *27.

173 *See supra* note 48 and associated text; *cf. Carley*, 2008 SEC LEXIS 222, at *93 (imposing bar on association with broker or dealers where individuals' "failure to conduct a searching inquiry into the origin" of OTC Bulletin Board stock at issue "despite numerous indications that it was part of an unregistered distribution, evince[d] a disregard for regulatory requirements that call[ed] into serious question their ability to function as securities professionals").

174 *See World Trade Fin.*, 2012 SEC LEXIS 56, at *28, *42 (noting that "duty of inquiry extends to both the broker and the registered representative executing the transactions" and sustaining FINRA finding that registered representative violated Securities Act Section 5 through unregistered sales of thinly traded penny stock (citing *Leigh*, 1990 SEC LEXIS 153, at *11)).

175 For this reason, the present case is distinguishable from the hearing panel decision in *Stonegate*, cited by ACAP and Hume, in which there was "no indication" that the respondent posed any threat in a non-supervisory capacity. *Stonegate*, 2008 FINRA Discip. LEXIS 26, at *37. Similarly, in *Drake*, the sanction focused on preventing harm to the public from poor supervision. *Drake*, 2012 FINRA Discip. LEXIS 48, at *24. Here, the risk is not limited to Hume's supervisory capacity. *General Securities Corp. v. SEC*, 583 F.2d 1108 (9th Cir. 1978), is also unhelpful to Hume. There, the Ninth Circuit noted our conclusion that the sanction imposed on the individual petitioner "was appropriately tailored to fit his failings as a manager and supervisor" where "[h]is ability to continue as a salesman in the securities field was not impaired." 583 F.2d at 1110. That decision also rejected the petitioners' challenge to sanctions based on the fact that they were purportedly out of line with those imposed in other cases, i.e., the essence of ACAP and Hume's argument here. *Id.*

176 Our decision in *Ronald Pellegrino*, Exchange Act Release No. 59125, 2008 SEC LEXIS 2843 (Dec. 19, 2008), does not aid Hume's cause. In *Pellegrino*, we sustained NASD's imposition of a supervisory bar to remedy Pellegrino's supervisory misconduct, finding that NASD "appropriately tailored" the bar to remedy and deter his misconduct when it determined not to bar him in all capacities. *Id.* at *71. In taking that action, NASD relied in part on a finding that Pellegrino's "early and prompt firing" of certain representatives to address serious concerns was mitigating. 2008 FINRA Discip. LEXIS 10, at *79; *see also* 2008 SEC LEXIS 2843, at *70 n.71 (same). A different calculus applies here where Hume was suspended for six months, rather than barred, and where the underlying facts and circumstances differ as well.

Finally, we cannot say that the six-month suspension is unduly long. For egregious supervisory violations, the Guidelines recommend consideration of a suspension of up to two years or a bar in appropriate circumstances.[177] A six-month suspension, while not insignificant, falls on the lower end of this spectrum.

* * * * *

Based on the foregoing, we find that the sanctions FINRA imposed on ACAP and Hume were neither excessive nor oppressive. Because "violations of the antifraud and other provisions of the securities laws frequently depend for their consummation on the activities of broker-dealers who fail to make diligent inquiry," it is essential that broker-dealers and their associated persons discharge their duties.[178] ACAP and Hume's failure to discharge their duties as securities professionals caused 27 million shares of an unknown stock to be sold to investors without registration under the Securities Act when no exemption from registration was available, depriving investors of the protections afforded by the registration and disclosure requirements of the Securities Act. Their failure to adopt or implement any reasonable protections was shocking and demonstrated a lack of knowledge of their responsibilities and the laws and regulations governing the securities profession, particularly in light of the fact that the majority of ACAP's business is the liquidation of low-priced stock. Under these circumstances, we conclude that FINRA's sanctions are justified under its Sanction Guidelines, result from a thoughtful weighing of the relevant facts, and are appropriately remedial because they will serve as a reminder that ACAP and Hume must comply with fundamental regulatory requirements and deter others from engaging in similar misconduct.[179]

Accordingly, we sustain these sanctions.

An appropriate order will issue.[180]

By the Commission (Chair WHITE and Commissioners WALTER, AGUILAR, and GALLAGHER); Commissioner PAREDES not participating

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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177 FINRA Sanction Guidelines at 103.

178 *Laser Arms Corp.*, 1991 SEC LEXIS 257, at *42 n.35 (internal citation and ellipsis omitted), quoted in *Midas Sec.*, 2012 SEC LEXIS 199, at *72-73; *accord Apex Fin.*, 1980 SEC LEXIS 1603, at *9-10 ("We have stressed the responsibility of broker-dealers to prevent their firms from being used as conduits for illegal distributions, such use having frequently been a major factor in the success of such unlawful activity.").

179 *See McCarthy v. SEC*, 406 F.3d 179, 189 (2d Cir. 2005) ("[G]eneral deterrence is not, by itself, sufficient justification for expulsion or suspension . . . [but] may be considered as part of the overall remedial inquiry.").

180 We have considered all the arguments advanced by the parties. We reject or sustain them to the extent that they are inconsistent or in accord with the views expressed herein.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 70046 / July 26, 2013

Admin. Proc. File No. 3-15080

In the Matter of the Application of

ACAP FINANCIAL, INC. and GARY HUME
c/o Anthony W. Djinis
Pickard and Djinis LLP
1990 M Street, NW, Suite 660
Washington, DC 20036

For Review of Disciplinary Action Taken by

FINRA

ORDER SUSTAINING DISCIPLINARY ACTION TAKEN BY FINRA

On the basis of the Commission's opinion issued this day, it is

ORDERED that the disciplinary action, and the sanctions imposed, by FINRA on ACAP Financial, Inc. and Gary Hume be, and they hereby are, sustained.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-70050; File No. 10-209)

In the Matter of the Application of Topaz Exchange, LLC for Registration as a National Securities Exchange

Findings, Opinion, and Order of the Commission

July 26, 2013

I. Introduction

On July 3, 2012, Topaz Exchange, LLC ("Topaz Exchange" or "Exchange") submitted to the Securities and Exchange Commission ("Commission") an Application for Registration as a National Securities Exchange ("Form 1 Application")[1] under Section 6 of the Securities Exchange Act of 1934 ("Act").[2] On December 19, 2012, Topaz Exchange submitted Amendment No. 1 to its Form 1 Application.[3] On December 31, 2012, Topaz Exchange submitted Amendment No. 2 to its Form 1 Application.[4] Notice of the Form 1 Application, as

1 On March 1, 2013, the Commission issued an order granting Topaz Exchange exemptive relief, subject to certain conditions, in connection with the filing of its Form 1 Application. See Securities Exchange Act Release No. 69011, 78 FR 14844 (March 7, 2013). Because Topaz Exchange's Form 1 Application was incomplete without the exemptive relief, the date of filing of such application is March 1, 2013. Id.

2 15 U.S.C. 78f.

3 Amendment No. 1, among other things, includes changes to the Limited Liability Company Agreement of Topaz Exchange, LLC ("Topaz Exchange LLC Agreement") and the Constitution of Topaz Exchange, LLC ("Topaz Exchange Constitution") concerning board composition and size, the initial director election process, and the use of regulatory funds. Amendment No. 1 also includes revisions to proposed rules of Topaz Exchange to remove rules relating to complex orders; to respond to comments on the Form 1 application from Commission staff; and to reflect recent changes to comparable rules of International Securities Exchange, LLC ("ISE"). Amendment No. 1 further provides additional descriptions in the Form 1 Application regarding proposed allocation procedures, auction mechanisms, execution of qualified contingent crosses, and the interim and initial director election processes, and removes references to complex orders.

4 Amendment No. 2, among other things, provides updated information regarding the board of directors of ISE and the Corporate Governance Committee of ISE and includes

modified by Amendment Nos. 1 and 2, was published for comment in the Federal Register on March 7, 2013.[5] The Commission received four comment letters regarding the Form 1 Application.[6] Topaz Exchange submitted a detailed response to comments on July 11, 2013.[7] On July 11, 2013, Topaz Exchange submitted Amendment No. 3 to the Form 1 Application.[8]

II. Discussion

Under Sections 6(b) and 19(a) of the Act,[9] the Commission shall by order grant an application for registration as a national securities exchange if the Commission finds, among other things, that the proposed exchange is so organized and has the capacity to carry out the

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information regarding Longitude S.A., a newly incorporated affiliate of Topaz Exchange, which information includes the Articles of Incorporation and financial information for Longitude S.A. Finally, Amendment No. 2 provides an updated organizational chart that reflects the affiliates of Topaz Exchange.

5 See Securities Exchange Act Release No. 69012 (March 1, 2013), 78 FR 14847 ("Notice").

6 See Letter from Angelo Evangelou, Associate General Counsel, Chicago Board Options Exchange, Incorporated, to Elizabeth M. Murphy, Secretary, Commission, dated April 23, 2013 ("CBOE Letter"); Letter from Jeffrey S. Davis, Vice President and Deputy General Counsel, NASDAQ OMX Group, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated April 25, 2013 ("NASDAQ Letter"); Letter from Janet McGinness, EVP and Corporate Secretary, NYSE Euronext, General Counsel, NYSE Markets, to Elizabeth M. Murphy, Secretary, Commission, dated May 10, 2013 ("NYSE Euronext Letter I"); and Letter from Janet McGinness, EVP and Corporate Secretary, NYSE Euronext, General Counsel, NYSE Markets, to Elizabeth M. Murphy, Secretary, Commission, dated June 20, 2013 ("NYSE Euronext Letter II").

7 See Letter from Michael Simon, General Counsel and Secretary, Topaz Exchange, to Elizabeth M. Murphy, Secretary, Commission, dated July 10, 2013 ("Topaz Exchange Response Letter").

8 Amendment No. 3, among other things, includes changes to proposed Topaz Exchange rules to respond to concerns raised by the commenters and to reflect changes to comparable ISE rules since the filing of Amendment No. 1. The changes are discussed below in Section II.D. Amendment No. 3 also provides further descriptions or updates information in the Form 1 Application. The changes proposed in Amendment No. 3 are not substantive, are consistent with the existing rules of other registered national securities exchanges, or are responsive to the concerns of the commenters and do not raise any new or novel regulatory issues.

9 15 U.S.C. 78f(b) and 15 U.S.C. 78s(a), respectively.

purposes of the Act and can comply, and can enforce compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulations thereunder, and the rules of the exchange.

As discussed in greater detail below, the Commission finds that Topaz Exchange's application for exchange registration meets the requirements of the Act and the rules and regulations thereunder. Further, the Commission finds that the proposed rules of Topaz Exchange are consistent with Section 6 of the Act in that, among other things, they assure a fair representation of the exchange's members in the 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, or with a broker or dealer;[10] and that they are designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, and remove impediments to and perfect the mechanisms of a free and open market and a national market system and, in general, protect investors and the public interest and are not designed to permit unfair discrimination between customers, issuers, or broker-dealers.[11] Finally, the Commission finds that Topaz Exchange's proposed rules do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.[12]

A. Overview of Ownership of Topaz Exchange

Topaz Exchange is structured as a Delaware limited liability company ("LLC"), and is a wholly-owned subsidiary of International Securities Exchange Holdings, Inc. ("ISE

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10 See 15 U.S.C. 78f(b)(3).

11 See 15 U.S.C. 78f(b)(5).

12 See 15 U.S.C. 78f(b)(8).

Holdings").[13] In December 2007, ISE Holdings became a direct, wholly-owned subsidiary of various German companies and Swiss companies[14] through an intermediary holding company, U.S. Exchange Holdings, Inc. ("U.S. Exchange Holdings").[15] U.S. Exchange Holdings is wholly-owned by a German stock corporation, Eurex Frankfurt AG ("Eurex Frankfurt"). Eurex Frankfurt is a wholly-owned subsidiary of a Swiss stock corporation, Eurex Zurich AG ("Eurex Zurich"), which, in turn, was in 2007 jointly owned by Deutsche Börse and SWX Swiss Exchange AG ("SWX")[16] ("Eurex Acquisition"). In 2012, SWX transferred its interest in Eurex Zurich to a Swiss subsidiary of Deutsche Börse ("Deutsche Börse Acquisition"), such that Eurex Zurich is now jointly owned by Deutsche Börse (together with Eurex Frankfurt, the "German companies") and EGD (together with Eurex Zurich, the "Swiss companies," and the Swiss companies and the German companies are referred to collectively as the "Non-U.S. Upstream Owners," and collectively with U.S. Exchange Holdings, the "Upstream Owners"). As Deutsche

13 Following any Commission grant of registration to Topaz Exchange, ISE Holdings will be: (1) the sole holding company of two registered national securities exchanges, ISE and Topaz Exchange; and (2) the holder of a 31.54% ownership interest of a holding company, DE Holdings, that in turn owns two registered national securities exchanges, EDGX Exchange, Inc. ("EDGX") and EDGA Exchange, Inc. ("EDGA"). See Exhibit C to Topaz Exchange Form 1 Application, Section R ("Organizational Chart of Affiliates of Deutsche Börse AG").

14 See Organizational Chart of Affiliates of Deutsche Börse, Exhibit C. Section R. to Topaz Exchange Form 1 Application.

15 See Securities Exchange Act Release No. 56955 (December 13, 2007), 72 FR 71979 (December 19, 2007) (File No. SR-ISE-2007-101) (order approving a transaction in which ISE Holdings became a wholly-owned indirect subsidiary of Eurex Frankfurt) ("Eurex Acquisition Order").

16 At the time, SWX was owned by SWX Group AG (later became part of SIX Group AG), which in turn was owned by Verein SWX Swiss Exchange. In 2008, SWX changed its name to SIX. In 2012, SIX transferred its interest to Eurex Global Derivatives AG ("EGD"). See Securities Exchange Act Release No. 66834 (April 19, 2012), 77 FR 24752 (April 25, 2012) (File Nos. SR-EDGA-2012-08; SR-EDGX-2012-07; and SR-ISE-2012-21) (order approving a transaction in which Eurex Frankfurt became a wholly-owned indirect subsidiary of Deutsche Börse) ("Deutsche Börse Acquisition Order").

Börse holds a 100% direct ownership interest in EGD, it therefore holds a 100% indirect ownership interest in Eurex Zurich.

B. Governance of Topaz Exchange

1. Topaz Exchange Board of Directors

The board of directors of Topaz Exchange ("Topaz Exchange Board" or "Board") will be its governing body and will possess all of the powers necessary for the management of its business and affairs, including governance of Topaz Exchange as a self-regulatory organization ("SRO").[17] Topaz Exchange will be governed by a board of directors comprised of no fewer than 8, but no more than 16, directors.[18] Specifically:

- At least 50% of Topaz Exchange Board must be comprised of Non-Industry Directors;[19]
- At least one of the Non-Industry Directors must be a Public Director;[20]
- Topaz Exchange Board will include the President/Chief Executive Officer as a director;[21] and

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17 See Topaz Exchange Constitution, Article III, Section 3.1.

18 See Topaz Exchange Constitution, Article III, Section 3.2(a).

19 See Topaz Exchange Constitution, Article III, Section 3.2(b)(ii). In no event shall the number of Non-Industry Directors constitute less than the number of Industry Directors. ISE Holdings, Inc. may, in its sole discretion, elect one additional director who shall meet the requirements of Non-Industry Directors, except that such person was employed by Topaz Exchange at any time during the three-year period prior to his or her initial election. See Topaz Exchange Constitution, Article III, Section 3.2(b)(iv). This provision is similar to a provision in ISE's Constitution and has been used in the past to place a former president/chief executive officer of ISE on its board of directors ("ISE Board").

20 See Topaz Exchange Constitution, Article III, Section 3.2(b)(ii).

21 See Topaz Exchange Constitution, Article III, Section 3.2(b)(iii).

- At least 30% of Topaz Exchange Board must be officers, directors or partners of Topaz Exchange members, and must be elected by a plurality of holders of Exchange Rights ("Industry Directors"), of which at least one must be elected by a plurality of holders of Primary Market Maker ("PMM") Exchange Rights, one must be elected by a plurality of holders of Competitive Market Maker ("CMM") Exchange Rights, and one must be elected by a plurality of holders of Electronic Access Member ("EAM") Exchange Rights, provided that the number of each type of Industry Director shall always be equal to one another.[22]

As part of the process to elect members of the Board, the Nominating Committee will nominate the proposed Industry Directors and the Corporate Governance Committee[23] or ISE Holdings will nominate the proposed Non-Industry Directors.[24] A petition process will allow Topaz Exchange members to nominate alternative candidates for consideration as Industry Directors.[25] At the first annual meeting and at each annual meeting thereafter, ISE Holdings will

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22 See Topaz Exchange Constitution, Article III, Section 3.2(b)(i).

23 See infra Section II.B.2. for a description of Topaz Exchange's Nominating Committee and Corporate Governance Committee.

24 See, e.g., Topaz Exchange Constitution, Article III, Section 3.10(a)-(b). ISE Holdings, as the Sole LLC Member of Topaz Exchange, is permitted to petition the Corporate Governance Committee to propose alternative Non-Industry Directors and Public Directors. See Topaz Exchange Constitution, Article III, Section 3.10(b)(ii).

25 See, e.g., Topaz Exchange Constitution, Article III, Section 3.10(a)(ii). Specifically, as proposed in Amendment No. 1, in addition to the Industry Director nominees named by the Nominating Committee, persons eligible to serve as such may be nominated for election to the Topaz Exchange Board by a petition, signed by the holders of not less than five percent (5%) of the outstanding Exchange Rights of the series entitled to elect such person if there are more than eighty (80) Exchange Rights in the series entitled to vote, ten percent (10%) of the outstanding rights of such series entitled to elect such person if there are between eighty (80) and forty (40) Exchange Rights in the series entitled to vote, and twenty-five percent (25%) of the outstanding Exchange Rights of such series entitled to elect such person if there are less than forty (40) Exchange Rights in the series entitled to vote. For purposes of determining whether a person has been nominated for

elect all of the members of the Topaz Exchange Board (except the Industry Directors which are elected by Topaz Exchange members[26]), but it will be required to do so in compliance with the compositional requirements for the Board outlined in the Topaz Exchange Constitution.

The Commission believes that the requirement in the Topaz Exchange Constitution that at least 30% of the directors be Industry Directors and the means by which they will be chosen by Topaz Exchange members[27] provide for the fair representation of members in the selection of directors and the administration of Topaz Exchange and therefore is consistent with Section 6(b)(3) of the Act.[28] Section 6(b)(3) of the Act requires that "the rules of the exchange assure a fair representation of its members in the 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." As the Commission previously has noted, this statutory requirement helps to ensure that members have a voice in the exchange's use of self-regulatory authority, and that the exchange is administered in a way that is equitable to all those persons who trade on its market or through its facilities.[29] In addition, with respect to

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election by petition by the requisite percentage, no Topaz Exchange member, alone or together with its affiliates, may account for more than 50% of the signatures of the holders of outstanding Exchange Rights of the series entitled to elect such person, and any such signatures by such Exchange Members, alone or together with its affiliates, in excess of such 50% limitation shall be disregarded. Id. This process is identical to the process in place at ISE. See ISE Constitution, Article III, Section 3.10(a)(ii).

26 See Topaz Exchange Constitution, Article III, Sections 3.2(b)(i) and (c).

27 Id.

28 15 U.S.C. 78f(b)(3).

29 See, e.g., Securities Exchange Act Release Nos. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (File No. 10-131) (order granting the exchange registration of Nasdaq Stock Market, Inc.) ("Nasdaq Order"); and 58375 (August 18, 2008), 73 FR 49498 (August 21, 2008) (File No. 10-182) (order granting the exchange registration of BATS Exchange, Inc.) ("BATS Order"). See also Securities Exchange Act Release No. 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006) (File No. SR-NYSE-2005-77) ("NYSE/Archipelago Merger Approval Order").

the requirement that the number of Non-Industry Directors, including at least one Public Director, will at all times be at least 50% of the Board, the Commission believes that the proposed composition of the Topaz Exchange Board satisfies the requirements of Section 6(b)(3) of the Act.[30]

Interim Board

After Topaz Exchange is granted registration by the Commission, but prior to commencing operations, ISE Holdings, as the sole shareholder of Topaz Exchange,[31] will appoint an interim board of directors for Topaz Exchange that will serve only until the first annual meeting ("Interim Topaz Exchange Board"). The Interim Topaz Exchange Board will include the same individuals as the then-serving ISE Board and will consist of 15 directors: the President/Chief Executive Officer Director;[32] 6 Industry Directors; and 8 Non-Industry Directors.[33] Topaz Exchange represents that it anticipates that there will be a significant overlap between its membership and the membership of ISE.[34] Topaz Exchange further represents that it does not expect to receive a meaningful number of applications for membership from non-ISE

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30 15 U.S.C. 78f(b)(3). See also Securities Exchange Act Release No. 68341, p.8, (December 3, 2012), 77 FR 73065, 73067 (December 7, 2012) (File No. 10-207) (order granting the registration of Miami International Securities Exchange, LLC) ("MIAX Order") and Regulation of Exchanges and Alternative Trading Systems, Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) ("Regulation ATS Release").

31 See infra Section II.C.1. for a discussion of the ownership of Topaz Exchange.

32 See Exhibit J to Topaz Exchange Form 1 Application.

33 See Exhibit J to Topaz Exchange Form 1 Application. See also Amendment No. 3.

34 See Exhibit L to Topaz Exchange Form 1 Application. Based on discussions with ISE members, Topaz Exchange represented that it currently expects that Topaz Exchange's membership will consist substantially of current ISE members, including, but not limited to, those ISE members that have representatives serving as industry directors on the ISE Board. See Exhibit J to Topaz Exchange Form 1 Application.

members during the tenure of the Interim Topaz Exchange Board.[35] Thus, the 6 interim Industry Directors to be appointed to the Topaz Exchange Board likely will have been elected by Topaz Exchange members in their capacity as ISE members.[36]

These interim Industry Directors will serve until the first initial Topaz Exchange Board is elected pursuant to the full nomination, petition, and voting process set forth in the Topaz Exchange Constitution and described above.[37] Topaz Exchange will complete such process as promptly as possible and within 90 days after its application for registration as a national securities exchange is granted by the Commission.[38]

The Commission believes that the process for electing the interim Topaz Exchange Board, as proposed, is consistent with the requirements of the Act, including that the rules of the exchange assure fair representation of the exchange's members in the selection of its directors and administration of its affairs.[39] The Interim Topaz Exchange Board will be filled by current ISE Board members (which currently include Industry Directors who were elected by current ISE members) until the first annual meeting of Topaz Exchange. As noted above, Topaz

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35 See Exhibit J to Topaz Exchange Form 1 Application.

36 See id.

37 See Topaz Exchange Constitution, Article III, Sections 3.2(c) and 3.10; see also Exhibit J to Topaz Exchange Form 1 Application.

38 See Exhibit J to Topaz Exchange Form 1 Application.

39 See 15 U.S.C. 78f(b)(3). Topaz Exchange's proposed timeline for the interim Topaz Exchange Board process comports with the interim board process recently approved by the Commission for the Boston Options Exchange ("BOX") and Miami International Securities Exchange, LLC ("MIAX"). BOX, which previously operated as a facility of NASDAQ OMX BX, Inc., recently was granted registration as a national securities exchange. See Securities Exchange Act Release No. 66871 (April 27, 2012), 77 FR 26323 (May 3, 2012) (File No. 10-206) ("BOX Order"). NASDAQ OMX BX recently received approval for a new options market. See Securities Exchange Act Release No. 67256 (June 26, 2012), 77 FR 39277 (July 2, 2012) (File No. SR-BX-2012-030) ("BX Order"). MIAX recently was granted registration as a national securities exchange. See MIAX Order, supra note 30.

Exchange represents that it anticipates that there will be significant overlap between the initial members of Topaz Exchange and the current members of ISE.[40] Topaz Exchange further represents that it will complete the full nomination, petition, and voting process as set forth in the Topaz Exchange Constitution,[41] as promptly as possible and within 90 days of when Topaz Exchange's application for registration as a national securities exchange is granted.[42] As noted above, as part of this process, members of Topaz Exchange will be able to petition for alternative candidates to be considered for Industry Director positions.[43] This process will provide persons who are approved as members of Topaz Exchange after the effective date of this Order with the opportunity to participate in the selection of the Industry Directors within 90 days of when Topaz Exchange's application for registration as a national securities exchange is granted.

The Commission believes that the Interim Topaz Exchange Board process is designed to provide member representation sufficient to allow Topaz Exchange to commence operations for an interim period prior to going through the process to elect a new Board pursuant to the full nomination, petition, and voting process set forth in the Topaz Exchange Constitution.

2. Exchange Committees

Topaz Exchange will have a number of Board committees,[44] including an Executive Committee (consisting of six directors, including three Non-Industry Directors),[45] a Finance and Audit Committee (consisting of between three and five directors, all of whom must be Non-

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40 Topaz Exchange will have a streamlined waive-in process for existing ISE members to apply for membership on Topaz Exchange. See Topaz Exchange Rule 302(a).

41 See, e.g., Topaz Exchange Constitution, Article III, Section 3.10(a)-(b).

42 See Topaz Exchange Constitution, Article III, Sections 3.2(c) and 3.10.

43 See Topaz Exchange Constitution, Article III, Section 3.10(a)(ii).

44 See Topaz Exchange Constitution, Article V, Section 5.1(a).

45 See Topaz Exchange Constitution, Article V, Section 5.2.

Industry Directors),[46] a Compensation Committee (consisting of between three and five directors, all of whom must be Non-Industry Directors),[47] and a Corporate Governance Committee (consisting of at least three directors, all of whom must be Non-Industry Directors),[48] and such other additional committees as may be approved by the Topaz Exchange Board.[49]

Topaz Exchange also will have a Nominating Committee, which will be a committee of Topaz Exchange and not a committee of the Board.[50] The Nominating Committee will be composed of three industry representatives, and will be responsible for nominating candidates for Industry Director positions.[51] As noted above, there will be a petition process by which members of Topaz Exchange can nominate their own nominees for the Industry Director positions.[52] These nomination processes are consistent with processes that the Commission has approved for other exchanges.[53]

The Commission believes that Topaz Exchange's proposed committees, which are similar to committees maintained by other exchanges,[54] are designed to help enable Topaz Exchange to carry out its responsibilities under the Act and are consistent with the Act, including

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46 See Topaz Exchange Constitution, Article V, Section 5.5.

47 See Topaz Exchange Constitution, Article V, Section 5.6.

48 See Topaz Exchange Constitution, Article V, Section 5.4.

49 See Topaz Exchange Constitution, Article V, Section 5.1(a).

50 See Topaz Exchange Constitution, Article V, Section 5.3.

51 See id. The Interim Topaz Exchange Board shall appoint the initial members of the Nominating Committee in accordance with the qualifications prescribed in Section 5.3 of the Topaz Exchange Constitution.

52 See Topaz Exchange Constitution, Article III, Section 3.10(a)(ii). See also supra note 25 and accompanying text.

53 See, e.g., ISE Constitution, Articles III and V, Sections 3.10 and 5.3; MIAX By-laws Articles II and V, Sections 2.4 and 5.3.

54 See, e.g., MIAX Order, supra note 30, and BOX Order, supra note 39.

Section 6(b)(1), which requires, in part, an exchange to be so organized and have the capacity to carry out the purposes of the Act.[55]

C. Regulation of Topaz Exchange

When Topaz Exchange commences operations as a national securities exchange, Topaz Exchange will have all the attendant regulatory obligations under the Act. In particular, Topaz Exchange will be responsible for the operation and regulation of its trading system and the regulation of its members. Certain provisions in the Topaz Exchange and ISE Holdings governance documents are designed to facilitate the ability of Topaz Exchange and the Commission to fulfill their regulatory and oversight obligations under the Act. The discussion below summarizes some of these key provisions.

1. Ownership Structure: Ownership and Voting Limitations

As noted above in Section II.A, Topaz Exchange will be structured as a Delaware LLC and will be a wholly-owned subsidiary of ISE Holdings[56] following any Commission grant of registration to Topaz Exchange as a national securities exchange.[57] ISE Holdings is owned by German companies and Swiss companies through an intermediary holding company, U.S. Exchange Holdings.[58] ISE Holdings' governing documents impose limits on any direct or

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55 15 U.S.C. 78f(b)(1).

56 The Topaz Exchange LLC Agreement provides that ISE Holdings may not assign its interest in Topaz Exchange unless such assignment is subject to prior approval by the Commission pursuant to the rule filing procedure under Section 19 of the Act. See Topaz Exchange LLC Agreement, Section 7.1 (Assignments; Additional LLC Members).

57 See supra note 13 and accompanying text.

58 See supra note 14 and accompanying text.

indirect change in control of ISE Holdings, which are to be enforced through the creation of a statutory trust.[59]

First, ISE Holdings' governing documents prohibit any Topaz Exchange member (alone or together with its Related Persons[60]) from owning more than 20% of any class of Voting Shares of ISE Holdings.[61] A second limit prohibits any other person (alone or together with its related persons) from owning more than 40% of any class of Voting Shares of ISE Holdings.[62] A third limit prohibits any person (alone or together with its Related Persons) from voting or causing the voting of shares representing more than 20% of the voting power of the then outstanding Voting Shares of ISE Holdings.[63] As described more fully below, if a person exceeds an ISE Holdings' ownership or voting limit, a majority of the capital stock of ISE Holdings that has the right by its terms to vote in the election of the ISE Holdings board of directors ("ISE Holdings Board") or on other matters (other than matters affecting the rights, preferences or privileges of the capital stock) automatically will be transferred to a Delaware statutory trust ("Trust").[64]

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59 See Article FOURTH, Section III.(c) of the Amended and Restated Certificate of Incorporation of International Securities Exchange Holdings, Inc. ("ISE Holdings Certificate"). See infra notes 72-74 and 110-114 and accompanying text for a discussion of the statutory trust.

60 See ISE Holdings Certificate, Article FOURTH, Section III for the definition of "Related Persons."

61 See id. for the definition of "Voting Shares."

62 See ISE Holdings Certificate, Article FOURTH, Section III.(a)(i).

63 See ISE Holdings Certificate, Article FOURTH, Section III.(b). See also Second Amended and Restated Bylaws of ISE Holdings ("ISE Holdings Bylaws"), Article XI, Section 11.1(b).

64 See ISE Holdings Certificate, Article FOURTH, Section III.(c). See also infra notes 72-75 and accompanying text for a discussion of the Trust and the related Trust Agreement.

Consistent with the governance structure of other exchanges, ISE Holdings' Board may waive the 40% ownership limitation and the 20% voting restriction for persons other than Topaz Exchange members, subject to certain specified conditions,[65] but such waiver will not be effective unless approved by the Commission.[66]

The Topaz Exchange LLC Agreement and Topaz Exchange Constitution do not include change of control provisions that are similar to those in the ISE Holdings Certificate and ISE Holdings Bylaws. However, the Topaz Exchange LLC Agreement and the Topaz Exchange Constitution explicitly provide that ISE Holdings is the Sole LLC Member of Topaz

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65 The ISE Holdings Certificate allows the ISE Holdings Board to waive the ISE Holdings ownership and voting limits pursuant to an amendment to the ISE Holdings Bylaws, provided that the ISE Holdings Board makes certain determinations. See ISE Holdings Certificate, Article FOURTH, Sections III.(a)(i)(A), III.(a)(i)(B) and III.(b)(i). Article XI of the ISE Holdings Bylaws was adopted in connection with the Eurex Acquisition (see supra note 15 and accompanying text), when ISE LLC was the sole national securities exchange controlled by ISE Holdings. See Eurex Acquisition Order, supra note 15. Article XI, Section 11.1(b) was subsequently amended to apply to any Controlled National Securities Exchange, which will include Topaz Exchange.

66 See ISE Holdings Certificate, Article FOURTH, Sections III.(a)(i)(A) and III.(b)(i). Article XI of the ISE Holdings Bylaws, which originally was adopted in connection with the Eurex Acquisition (see supra note 15 and accompanying text for a description of the Eurex Acquisition), waives the ISE Holdings ownership and voting limits to allow the Upstream Owners to own and vote all of the common stock of ISE Holdings. Article XI, Section 11.1(b) states that, in waiving the ISE Holdings ownership and voting limits to permit the Upstream Owners to own and vote the capital stock of ISE Holdings, the ISE Holdings Board has determined, with respect to each Upstream Owner, that: (i) such waiver will not impair the ability of ISE Holdings and each "Controlled National Securities Exchange" (i.e., any national securities exchange or facility thereof controlled, directly or indirectly, by ISE Holdings, including ISE, EDGA, EDGX, and as a result of this Order, Topaz Exchange) to carry out their respective functions and responsibilities under the Act; (ii) such waiver is in the best interests of ISE Holdings, its stockholders, and each Controlled National Securities Exchange; (iii) such waiver will not impair the ability of the Commission to enforce the Act; (iv) neither the Upstream Owner nor any of its related persons is subject to a statutory disqualification (within the meaning of Section 3(a)(39) of the Act, 15 U.S.C. 78c(a)(39)); and (v) neither the Upstream Owner nor any of its related persons is a member of such Controlled National Securities Exchange.

Exchange.[67] ISE Holdings is permitted under the Topaz Exchange LLC Agreement to assign all but not less than all of its interest in Topaz Exchange (and therefore no longer would be its sole owner), but the assignment of all of ISE Holdings' interest in Topaz Exchange will be subject to the rule filing procedures under Section 19 of the Act.[68]

As detailed above, ISE Holdings is owned by various Upstream Owners, none of which have similar ownership and voting limits in their governing documents. To facilitate compliance with the ISE Holdings ownership and voting limits, the Upstream Owners have committed to take reasonable steps necessary to cause ISE Holdings to be in compliance with the ISE Holdings ownership and voting limits. These commitments are contained in the governing documents for U.S. Exchange Holdings[69] and in corporate resolutions for the non-U.S. Upstream Owners.[70]

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67 See Topaz Exchange LLC Agreement, Article II, Section 2.1 and Topaz Exchange Constitution Article I, Section 1.1 (both of which define "Sole LLC Member" to mean ISE Holdings, as the sole member of Topaz Exchange).

68 See 15 U.S.C. 78s; see also Topaz Exchange LLC Agreement, Article VII, Section 7.1 and Topaz Exchange Constitution, Article I, Section 1.1.

69 For a U.S. Upstream Owner, the U.S. Exchange Holdings Certificate provides that, for so long as U.S. Exchange Holdings directly or indirectly controls a Controlled National Securities Exchange, U.S. Exchange Holdings will take reasonable steps necessary to cause ISE Holdings to be in compliance with the ISE Holdings' ownership and voting limits. See U.S. Exchange Holdings Certificate, Article THIRTEENTH.

70 See, e.g., Form of German Parent Corporate Resolutions (2007 Resolution Section (4)), Exhibit B to Topaz Exchange Form 1 Application. In its Form 1 Application, Topaz Exchange included these supplemental resolutions that each of the current Non-U.S. Upstream Owners of Topaz Exchange has adopted that, in part, incorporate provisions regarding the ownership and voting limits ("Topaz Exchange Resolutions") in the same manner and to the same extent as prior corporate resolutions signed by the Non-U.S. Upstream Owners apply to ISE ("2007 Resolutions"). The Topaz Exchange Resolutions were signed by the Non-U.S. Upstream Owners and extend to Topaz Exchange the commitments that the then non-U.S. upstream owners made in the 2007 Resolutions with respect to ISE. For example, Topaz Exchange represented in Exhibit B to its Form 1 Application that Deutsche Börse AG Executive Board executed its corporate resolution on November 10, 2009.

Further, in connection with the Eurex Acquisition, ISE implemented the Trust pursuant to a Trust Agreement ("2007 Trust Agreement")[71] among ISE Holdings, U.S. Exchange Holdings, trustees ("Trustees"), and a Delaware trustee, which agreement has been subsequently amended

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Since 2007, U.S. Exchange Holdings' governing documents and the non-U.S. upstream owners' 2007 Resolutions have been updated, where appropriate, to reflect changes in corporate structure and ownership as described herein. In 2010, to effect the registrations of EDGA and EDGX as national securities exchanges, and to maintain ISE Holdings' ownership and voting limits, as well as the independence of the regulatory function of EDGA and EDGX, the U.S. Exchange Holdings governing documents and the 2007 Resolutions were supplemented by each of the then non-U.S. upstream owners through supplemental resolutions ("DirectEdge Resolutions") that applied the commitments of the 2007 Resolutions to EDGA and EDGX, as affiliates of ISE, see supra note 13, in the same manner and to the same extent as the 2007 Resolutions applied to ISE and the U.S. Exchange Holdings governing documents were updated to apply prospectively to any other national securities exchange that ISE Holdings may control, either directly or indirectly, including, but not limited to, ISE, EDGA and EDGX. See Securities Exchange Act Release No. 61698 (March 12, 2010), 75 FR 13151 (March 18, 2010) (File Nos. 10-194 and 10-196) (order granting the exchange registration of EDGA and EDGX) ("DirectEdge Exchanges Order"). The Commission also approved changes to U.S. Exchange Holdings' and ISE Holdings' governing documents to apply these governing documents to any prospective national securities exchange that U.S. Exchange Holdings or ISE Holdings, as applicable, directly or indirectly controlled. See Securities Exchange Act Release Nos. 59135 (December 22, 2008), 73 FR 79954 (December 30, 2008) ("ISE Holdings Order") and 61498 (February 4, 2010), 75 FR 7299 (February 18, 2010) ("U.S. Exchange Holdings Order").

In 2012, new resolutions were executed by EGD, a Swiss corporation, when it became a wholly-owned subsidiary of Deutsche Börse, and thus a Non-U.S. Upstream Owner of ISE, EDGA and EDGX. See Deutsche Börse Acquisition Order, supra note 16.

71 The term of the Trust is perpetual, provided that ISE Holdings directly or indirectly controls a national securities exchange or a facility thereof, which would include Topaz Exchange.

to take into account subsequent acquisitions, including the current transaction.[72]

The current agreement ("2012 Trust Agreement") serves, in part, to effectuate the ownership and voting limits for ISE Holdings in the event that a person obtains an ownership or voting interest in excess of the limits established in the ISE Holdings Certificate without prior Commission approval. To accomplish that purpose, for as long as ISE Holdings controls, directly or indirectly, a national securities exchange, including Topaz Exchange, the Trust would accept, hold and dispose of Trust Shares[73] on the terms and subject to the conditions set forth

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72 See Eurex Acquisition Order, supra note 15, at Section II.C., for a more detailed description of the Trust. By its terms, the 2007 Trust Agreement related solely to ISE Holdings' ownership of ISE LLC, and not to any other national securities exchange that ISE Holdings might control, directly or indirectly. In 2010, the Commission approved proposed rule changes that revised the 2007 Trust Agreement to replace references to ISE with references to any Controlled National Securities Exchange (the 2007 Trust Agreement, as thereby amended, is referred to herein as the "2009 Trust Agreement"). See ISE Holdings Order and U.S. Exchange Holdings Order, supra note 70; see also DirectEdge Exchanges Order, supra note 70; 2009 Trust Agreement, Articles I and II, Sections 1.1 and 2.6.

Thus, the 2009 Trust Agreement will apply to Topaz Exchange upon the Commission's granting its registration as a national securities exchange because it is controlled directly by ISE Holdings. Except for the expanded scope, the 2009 Trust Agreement was substantially similar to the 2007 Trust Agreement. In 2012, the Commission approved a proposed rule change that revised the 2009 Trust Agreement to replace references to a former owner, SIX, to the new owner, EGD (the 2009 Trust Agreement, as thereby amended, is referred to herein as the "2012 Trust Agreement"). See Deutsche Börse Acquisition Order, supra note 16, for more detailed information on the addition of EGD as a Non-U.S. Upstream Owner of ISE, EDGA, and EDGX. Except for reflecting a new Upstream Owner of ISE Holdings, the 2012 Trust Agreement was substantially similar to the 2009 Trust Agreement.

73 Under the Trust, the term "Trust Shares" means either Excess Shares or Deposited Shares, or both, as the case may be. The term "Excess Shares" means that a person obtained an ownership or voting interest in ISE Holdings in excess of the ownership and voting limits pursuant to Article FOURTH of the ISE Holdings Certificate, for example, through ownership of one of the Non-U.S. Upstream Owners or U.S. Exchange Holdings, without obtaining the approval of the Commission. The term "Deposited Shares" means shares that are transferred to the Trust pursuant to the Trust's exercise of the Call Option. Under the Trust, the term "Call Option" means the option granted by the Trust beneficiary to the Trust to call the Voting Shares as set forth in Section 4.2 therein. See infra Section II.C.2.b for further discussion of the Call Option.

therein.[74] Specifically, if any person's ownership percentage exceeds the ownership limits or any person's voting control percentage exceeds the voting limits without Commission approval, the Excess Shares will be transferred automatically to the Trust pursuant to the terms prescribed in the ISE Holdings Certificate.[75] The Trust then would accept the Excess Shares and hold them for the benefit of the trust beneficiary, U.S. Exchange Holdings, who has the right to reacquire the Excess Shares either when a person no longer exceeds the ownership or voting limits or when such excess ownership percentage or voting control percentage is approved by the Commission in accordance with ISE Holdings Certificate.[76]

Although ISE Holdings is not independently responsible for regulation of Topaz Exchange, its activities with respect to the operation of Topaz Exchange must be consistent with, and must not interfere with, the self-regulatory obligations of Topaz Exchange.[77] As described above, the provisions applicable to direct and indirect changes in control of ISE Holdings and Topaz Exchange, as well as the voting limitation, are designed to help prevent any owner of ISE Holdings from exercising undue influence or control over the operation of Topaz Exchange and to help assure that Topaz Exchange is able to effectively carry out its regulatory obligations under the Act. In addition, these limitations are designed to address the conflicts of

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74 See 2012 Trust Agreement, Article IV, Section 4.1; see also ISE Holdings Certificate, Article FOURTH, Section III.(c); Eurex Acquisition Order, supra note 15, at 72 FR 71982 n.37 and accompanying text.

75 See id.

76 See 2012 Trust Agreement, Article IV, Section 4.1(f). In addition, as discussed in Section II.C.2.b below, the Trust also may accept, hold and dispose of Trust Shares in connection with the Call Option. Section 4.2(h) of the 2012 Trust Agreement governs when the Trustees can transfer Deposited Shares in connection with the Call Option. Section 4.3(a) of the 2012 Trust Agreement further permits the Trustees, upon receipt of written instructions from the Trust Beneficiary, to sell Trust Shares to a person or persons whose ownership percentage or voting control percentage will not violate the ownership or voting limits.

77 See also infra Section II.C.2. (Regulatory Independence).

interests that might result from a member of a national securities exchange owning interests in the exchange. As the Commission has noted in the past, however, a member's interest in an exchange, including an entity that controls an exchange, could become so large as to cast doubts on whether the exchange may fairly and objectively exercise its self-regulatory responsibilities with respect to such member.[78] A member that is a controlling shareholder of an exchange could seek to exercise that controlling influence by directing the exchange to refrain from, or the exchange may hesitate to, diligently monitor and conduct surveillance of the member's conduct or diligently enforce the exchange's rules and the federal securities laws with respect to conduct by the member that violates such provisions. As such, these requirements are designed to minimize the potential that a person or entity can improperly interfere with or restrict the ability of Topaz Exchange to effectively carry out its regulatory oversight responsibilities under the Act.

The Commission believes that Topaz Exchange's and ISE Holdings' proposed ownership and voting limitation provisions, coupled with the provisions in U.S. Exchange Holdings' governing documents, the Topaz Exchange Resolutions and the 2012 Trust Agreement described above,[79] are consistent with the Act, including Section 6(b)(1), which requires, in part, an exchange to be so organized and have the capacity to carry out the purposes of the Act.[80] In particular, these requirements are designed to minimize the potential that a person could

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78 See, e.g., DirectEdge Exchanges Order, supra note 70, and BATS Order, supra note 29; see also MIAX Order, supra note 30.

79 See supra notes 69-70, and accompanying text.

80 15 U.S.C. 78f(b)(1).

improperly interfere with or restrict the ability of the Commission or Topaz Exchange to effectively carry out their regulatory oversight responsibilities under the Act.[81]

2. Regulatory Independence and Oversight

a. ISE Holdings

Although ISE Holdings itself will not itself carry out regulatory functions, its activities with respect to the operation of Topaz Exchange must be consistent with, and not interfere with, the self-regulatory obligations of Topaz Exchange.[82] In this regard, Topaz Exchange and ISE Holdings' respective corporate documents include certain provisions that are designed to maintain the independence of the Topaz Exchange's self-regulatory function.[83] These provisions are substantially similar to those included in the governing documents of other exchanges that recently have been granted registration.[84] Specifically:

- The directors, officers, and employees of ISE Holdings must give due regard to the preservation of the independence of the self-regulatory function of Topaz Exchange and must not take actions that would interfere with the effectuation of decisions by the Topaz Exchange Board relating to its regulatory functions (including disciplinary

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81 In addition, the 2012 Trust Agreement, like the 2007 and 2009 Trust Agreements, is consistent with the provisions that other entities that directly or indirectly own or control a SRO have instituted and that have been approved by the Commission. See, e.g., Securities Exchange Act Release No. 55293 (February 14, 2007), 72 FR 8033 (February 22, 2007) (File No. SR-NYSE-2006-120) (order relating to the combination between NYSE Group, Inc. and Euronext N.V.). See also Eurex Acquisition Order, supra note 15, at 72 FR 71986 n.111.

82 See, e.g., BOX Order, supra note 39, and DirectEdge Exchanges Order, supra note 70.

83 See supra note 66, noting that the ISE Holdings Certificate and the ISE Holdings Bylaws were revised in 2010 to cover any Controlled National Securities Exchange, which would include Topaz Exchange.

84 See, e.g., BOX Order, supra note 39, and MIAX Order, supra note 30.

matters) or that would adversely affect the ability of Topaz Exchange to carry out its responsibilities under the Act.[85]

- ISE Holdings must comply with federal securities laws and the rules and regulations promulgated thereunder, and must cooperate with Topaz Exchange and the Commission pursuant to, and to the extent of, their respective regulatory authority. In addition, ISE Holdings' officers, directors, and employees must comply with federal securities laws and the rules and regulations thereunder and agree to cooperate with Topaz Exchange and the Commission pursuant to their respective regulatory authority.[86]
- ISE Holdings, and its officers, directors, employees, and agents are deemed to irrevocably submit to the jurisdiction of the U.S. federal courts, the Commission, and Topaz Exchange, for purposes of any suit, action, or proceeding pursuant to U.S. federal securities laws, and the rules and regulations thereunder, arising out of, or relating to, Topaz Exchange's activities.[87]

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85 See ISE Holdings Bylaws, Article I, Section 1.5. Similarly, Article V, Section 5.1(b) of the Topaz Exchange LLC Agreement requires each Topaz Exchange Board director to take into consideration the effect that his or her actions would have on the ability of Topaz Exchange to carry out its responsibilities under the Act and on the ability of Topaz Exchange to engage in conduct that fosters and does not interfere with Topaz Exchange's ability to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to and facilitating transactions in securities or assist in the removal of impediments to or perfection of the mechanisms for a free and open market and a national market system; and in general to protect investors and the public interest.

86 See ISE Holdings Certificate, Article TENTH. ISE Holdings also shall take reasonable steps necessary to cause its agents to cooperate with Topaz Exchange and the Commission pursuant to their respective regulatory authority. ISE Holdings Certificate, Article THIRTEENTH.

87 See ISE Holdings Bylaws, Article I, Section 1.4.

- All books and records of Topaz Exchange containing confidential information pertaining to the self-regulatory function of Topaz Exchange (including but not limited to confidential information regarding disciplinary matters, trading data, trading practices and audit information) shall be retained in confidence by Topaz Exchange and its officers, directors, employees and agents and will not be used by Topaz Exchange for any commercial purpose and shall not be made available to persons other than those officers, directors, employees and agents that have a reasonable need to know the contents thereof.[88]
- The books and records of Topaz Exchange and ISE Holdings must be maintained in the United States[89] and, to the extent they are related to the operation or administration of Topaz Exchange, ISE Holdings books and records will be subject at all times to inspection and copying by the Commission.[90]
- Furthermore, to the extent that they are related to the activities of Topaz Exchange, the books, records, premises, officers, directors, and employees of ISE Holdings will

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88 See Topaz Exchange LLC Agreement, Article VI, Section 4.1(b) and ISE Holdings Certificate, Article ELEVENTH. ISE Holdings LLC Agreement also provides that all books and records of Topaz Exchange reflecting confidential information pertaining to the self-regulatory function of Topaz Exchange will be subject to confidentiality restrictions. See ISE Holdings Certificate, Article ELEVENTH. The requirement to keep such information confidential shall not limit or impede the Commission's ability to access and examine such information or limit or impede the ability of officers, directors, employees, or agents of ISE Holdings to disclose such information to the Commission. See id.

89 See Topaz Exchange LLC Agreement, Article IV, Section 4.1 and ISE Holdings Bylaws, Article I, Section 1.3.

90 See ISE Holdings Certificate, Article TWELFTH.

be deemed to be the books, records, premises, officers, directors, and employees of Topaz Exchange, for purposes of, and subject to oversight pursuant to, the Act.[91]

- ISE Holdings will take necessary steps to cause its officers, directors, and employees, prior to accepting a position as an officer, director, or employee (as applicable) to consent in writing to the applicability of provisions regarding books and records, confidentiality, jurisdiction, and regulatory obligations, with respect to their activities related to Topaz Exchange.[92]
- ISE Holdings Certificate and ISE Holdings Bylaws require that, so long as ISE Holdings controls Topaz Exchange, any changes to those documents be submitted to the Topaz Exchange Board, and, if such change is required to be filed with, or filed with and approved by, the Commission before it may be effective pursuant to Section 19 of the Act and the rules thereunder, such change shall not be effective until filed with, or filed with and approved by, the Commission.[93]

b. Upstream Owners

Although the Upstream Owners will not carry out any regulatory functions, the activities of each of the Upstream Owners with respect to the operation of Topaz Exchange must be consistent with, and not interfere with, the self-regulatory obligations of Topaz Exchange. The 2007 Resolutions, as supplemented by the supplemental Resolutions for Topaz Exchange, the U.S. Exchange Holdings Certificate, and the U.S. Exchange Holdings Bylaws include certain provisions that are designed to maintain the independence of the self-regulatory function of

91 See id.

92 See ISE Holdings Bylaws, Article I, Section 1.6.

93 See ISE Holdings Certificate, Article FOURTEENTH; and ISE Holdings Bylaws, Article X; see also supra notes 67-68 and accompanying text discussing a similar provision for Topaz Exchange.

Topaz Exchange, enable Topaz Exchange to operate in a manner that complies with the U.S. federal securities laws, including the objectives and requirements of Sections 6(b) and 19(g) of the Act,[94] and facilitate the ability of Topaz Exchange, and the Commission to fulfill their regulatory and oversight obligations under the Act. Specifically:

- Each such Non-U.S. Upstream Owner and U.S. Exchange Holdings will comply with the U.S. federal securities laws and the rules and regulations thereunder and cooperate with the Commission and Topaz Exchange.[95] Also, each board member, officer, and employee of the Non-U.S. Upstream Owners, and of U.S. Exchange Holdings, in discharging his or her responsibilities, must comply with the U.S. federal securities laws and the rules and regulations thereunder, and must cooperate with the Commission and Topaz Exchange.[96]
- In discharging his or her responsibilities as a board member of a Non-U.S. Upstream Owner, or of U.S. Exchange Holdings, each such member must, to the fullest extent permitted by applicable law, take into consideration the effect that the actions of the Upstream Owner or U.S. Exchange Holdings, as applicable, will have on the ability

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94 15 U.S.C. 78f(b) and 15 U.S.C. 78s(g).

95 See, e.g., Form of German Parent Corporate Resolutions (2007 Resolution Section (1) and Topaz Exchange Resolution Section (2)(a)); and U.S. Exchange Holdings Certificate, Article ELEVENTH.

96 See, e.g., Form of German Parent Corporate Resolutions (2007 Resolution Sections (7)(a) and (8)(a) and Topaz Exchange Resolution Sections (2)(b) and (2)(c)); U.S. Exchange Holdings Certificate, Article TENTH. The Resolutions also provide that each Non-U.S. Upstream Owner will take reasonable steps necessary to cause each person who subsequently becomes a board member of the Non-U.S. Upstream Owner to agree in writing to certain matters included in the Resolutions. See, e.g., Form of German Parent Corporate Resolutions (2007 Resolution Section (7) and Topaz Exchange Resolution Section (2)(b)).

of Topaz Exchange to carry out its responsibilities under the Act.[97] In addition, each of the Non-U.S. Upstream Owners and U.S. Exchange Holdings, and their board members, officers, and employees, must give due regard to the preservation of the independence of the self-regulatory function of Topaz Exchange (or in the case of the Non-U.S. Upstream Owners, that they will take reasonable steps necessary to cause their officers and employees involved in the activities of Topaz Exchange to give due regard to preserving the independence of the self-regulatory functions of Topaz Exchange).[98]

- The Non-U.S. Upstream Owners (along with their respective board members, officers, and employees), and U.S. Exchange Holdings agree to keep confidential, to the fullest extent permitted by applicable law, all confidential information pertaining to the self-regulatory function of Topaz Exchange, including, but not limited to, confidential information regarding disciplinary matters, trading data, trading practices and audit information, contained in the books and records of Topaz Exchange and not use such information for any commercial purposes.[99]

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97 See, e.g., Form of German Parent Corporate Resolutions (2007 Resolution Section (7)(f) and Topaz Exchange Resolution Section (2)(b)); and U.S. Exchange Holdings Certificate, Article TENTH.

98 See, e.g., Form of German Parent Corporate Resolutions (2007 Resolution Sections (5), (7)(d), and (8)(d) and Topaz Exchange Resolution Section (2)); and U.S. Exchange Holdings Certificate, Article TWELFTH.

99 See, e.g., Form of German Parent Corporate Resolutions (2007 Resolution Sections (6), (7)(e) and (8)(e) and Topaz Exchange Resolution Section (2)); and U.S. Exchange Holdings Certificate, Article FOURTEENTH.

The Commission believes that any non-regulatory use of such information would be for a commercial purpose. See DirectEdge Exchanges Order, supra note 70, at 75 FR 13155 n.53.

- The books and records of the Non-U.S. Upstream Owners related to the activities of Topaz Exchange must at all times be made available for, and the books and records of U.S. Exchange Holdings must be subject at all times to, inspection and copying by the Commission and Topaz Exchange.[100]
- Books and records of U.S. Exchange Holdings related to the activities of Topaz Exchange will be maintained within the United States.[101]
- For so long as each of the Non-U.S. Upstream Owners or U.S. Exchange Holdings directly or indirectly controls Topaz Exchange, the books, records, officers, directors (or equivalent), and employees of each of the Non-U.S. Upstream Owners or of U.S. Exchange Holdings will be deemed to be the books, records, officers, directors, and employees of Topaz Exchange, as applicable.[102] And, for so long as U.S. Exchange Holdings directly or indirectly controls Topaz Exchange, the premises of U.S. Exchange Holdings will be deemed to be the premises of Topaz Exchange.[103]
- To the extent involved in the activities of Topaz Exchange, each of the Non-U.S. Upstream Owners, its board members, officers, and employees, irrevocably submit to the jurisdiction of the U.S. federal courts and the Commission for purposes of any suit, action or proceeding arising out of, or relating to, the activities of Topaz

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[100] See, e.g., Form of German Parent Corporate Resolutions (2007 Resolution Section (3) and Topaz Exchange Resolution Section (2)(a)); and U.S. Exchange Holdings Certificate, Article FIFTEENTH. See infra Section II.C.2.c for a discussion of the 2009 Procedure through which the Swiss companies would make available their books and records relating to the activities of the Topaz Exchange.

[101] See U.S. Exchange Holdings Certificate, Article FIFTEENTH.

[102] See, e.g., Form of German Parent Corporate Resolutions (2007 Resolution Sections (3) and (8)(c) and Topaz Exchange Resolution Sections (2)(a) and (2)(c)); and U.S. Exchange Holdings Certificate, Article FIFTEENTH.

[103] See U.S. Exchange Holdings Certificate, Article FIFTEENTH.

Exchange to the extent such board member, officer or employee are involved in the activities of Topaz Exchange.[104] Likewise, U.S. Exchange Holdings, its officers, directors, and employees whose principal place of business and residence is outside of the United States, to the extent such director, officer, or employee is involved in the activities of Topaz Exchange, irrevocably submit to the jurisdiction of the U.S. federal courts and the Commission for purposes of any suit, action or proceeding pursuant to the U.S. federal securities laws, and the rules or regulations thereunder, commended or initiated by the Commission arising out of, or relating to, the activities of Topaz Exchange.[105]

- The 2007 Resolutions, as supplemented by the Topaz Exchange Resolutions, and the U.S. Exchange Holdings Certificate and the U.S. Exchange Holdings Bylaws each require that any change to the applicable document (including any action by the Non-U.S. Upstream Owners that would have the effect of amending or repealing the Topaz Exchange Resolutions or the 2007 Resolutions) must be submitted to the Topaz Exchange Board.[106] If such change must be filed with, or filed with and approved by, the Commission under Section 19 of the Act,[107] and the rules thereunder, then such

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104 See, e.g., Form of German Parent Corporate Resolutions (2007 Resolution Sections (2), (7)(b), and (8)(b) and Topaz Exchange Resolution Section (2)).

105 See U.S. Exchange Holdings Bylaws, Article VI, Section 16.

106 See, e.g., Form of German Parent Corporate Resolutions (Topaz Exchange Resolution Section (3)); U.S. Exchange Holdings Certificate, Article SIXTEENTH; and U.S. Exchange Holdings Bylaws, Article VI, Section 9.

107 15 U.S.C. 78s.

change shall not be effective until filed with, or filed with and approved by, the Commission.[108]

The 2012 Trust Agreement, in addition to enforcing the ownership and voting limits,[109] also serves to effectuate compliance with the other commitments made under the Topaz Exchange Resolutions, which incorporate the 2007 Resolutions. To accomplish that purpose, the Trust would determine whether a Material Compliance Event[110] has occurred or is continuing. The Trust would determine whether the occurrence and continuation of a Material Compliance Event requires the exercise of the Call Option.[111] The Trust holds a Call Option over the capital stock of ISE Holdings that may be exercised if a Material Compliance Event has occurred and continues to be in effect, and upon such exercise, the Trust Beneficiary[112] and ISE Holdings, as applicable, will take such actions as are necessary to transfer, or cause the transfer to the Trust of

108 See, e.g., Form of German Parent Corporate Resolutions (Topaz Exchange Resolution Section (3)); U.S. Exchange Holdings Certificate, Article SIXTEENTH; and U.S. Exchange Holdings Bylaws, Article VI, Section 9. The requirement to submit changes to the Topaz Exchange Board endures for as long as U.S. Exchange Holdings directly or indirectly controls Topaz Exchange. See U.S. Exchange Holdings Bylaws, Article VI, Section 9.

109 See supra notes 61-63 and 73-76 and accompanying text for a discussion of the ownership and voting limits.

110 Under the 2012 Trust Agreement, a "Material Compliance Event" is any state of facts, development, event, circumstance, condition, occurrence, or effect that results in the failure of any of the Non-U.S. Upstream Owners to adhere to its respective commitments under the Resolutions adopted by the respective Non-U.S. Upstream Owners, in any material respect. See 2012 Trust Agreement, Article I, Section 1.1.

111 See supra note 73.

112 Under the Trust, the term "Trust Beneficiary" means U.S. Exchange Holdings.

a majority of the Voting Shares then outstanding.[113] The Trust will transfer Deposited Shares from the Trust back to the Trust Beneficiary, as provided in Section 4.2(h) therein, only if no Material Compliance Event is continuing or, notwithstanding its continuation, the Trustees determine that the retention of the Deposited Shares could not reasonably be expected to address the continuing Material Compliance Event, provided that the determination is filed with, or filed with and approved by, the Commission.[114]

The Commission believes that the provisions discussed above in Sections II.C.2.a. and b., which are designed to help maintain the independence of Topaz Exchange's regulatory function and help facilitate the ability of Topaz Exchange to carry out its regulatory responsibilities and operate in a manner consistent with the Act, are appropriate and consistent with the requirements of the Act, particularly with Section 6(b)(1), which requires, in part, an exchange to be so organized and have the capacity to carry out the purposes of the Act.[115] Whether Topaz Exchange operates in compliance with the Act, however, depends on how it and ISE Holdings in practice implement the governance and other provisions that are the subject of this Order.[116]

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113 See 2012 Trust Agreement, Article IV, Section 4.2. Specifically, if a Material Compliance Event occurs and continues to be in effect, the Trustees must take certain actions, including, after a specified cure period, the exercise of a Call Option for a transfer of the majority of capital stock of ISE Holdings that has the right by its terms to vote in the election of the ISE Holdings Board or on other matters.

114 See 2012 Trust Agreement, Article IV, Section 4.2.

115 15 U.S.C. 78f(b)(1).

116 The Commission has noted that it is reviewing the various standards and processes it uses to facilitate the registration of national securities exchanges and other entities required to register with the Commission and may issue a concept release designed to collect relevant information to evaluate aspects of these registration standards and processes, including the policy objectives of registration, and how best to achieve those policy objectives through registration and other means, and the relative benefits and costs of the various means available. See Securities Exchange Act Release No. 65543 (October 12, 2011), 76 FR 65784, 65786 fn. 13 (October 24, 2011).

Further, Section 19(h)(1) of the Act[117] provides the Commission with the authority "to suspend for a period not exceeding twelve months or revoke the registration of [an SRO], or to censure or impose limitations upon the activities, functions, and operations of [an SRO], if [the Commission] finds, on the record after notice and opportunity for hearing, that [the SRO] has violated or is unable to comply with any provision of [the Act], the rules or regulations thereunder, or its own rules or without reasonable justification or excuse has failed to enforce compliance" with any such provision by its members (including associated persons thereof).[118] If Commission staff were to find, or become aware of, through staff review and inspection or otherwise, facts indicating any violations of the Act, including without limitation Sections 6(b)(1)[119] and 19(g)(1),[120] these matters could provide the basis for a disciplinary proceeding under Section 19(h)(1) of the Act.[121]

Even in the absence of the provisions described above, under Section 20(a) of the Act,[122] any person with a controlling interest in Topaz Exchange would be jointly and severally liable with and to the same extent that Topaz Exchange is liable under any provision of the Act, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action. In addition, Section 20(e) of the Act[123] creates aiding and abetting liability for any person who knowingly provides substantial assistance to another person in violation of any provision of the Act or rule thereunder. Further, Section 21C

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117 See 15 U.S.C. 78s(h)(1).

118 See id.

119 See 15 U.S.C. 78f(b)(1)

120 See 15 U.S.C. 78s(g)(1).

121 See 15 U.S.C. 78s(h)(1).

122 See 15 U.S.C. 78t(a).

123 See 15 U.S.C. 78t(e).

of the Act authorizes the Commission to enter a cease-and-desist order against any person who has been "a cause of" a violation of any provision of the Act through an act or omission that the person knew or should have known would contribute to the violation.[124] These provisions are applicable to all entities controlling Topaz Exchange, including the Trust, ISE Holdings, U.S. Exchange Holdings, and the Non-U.S. Upstream Owners.

c. Swiss Resolutions and Procedure with FINMA

As discussed more fully in the Eurex Acquisition Order,[125] Swiss law is designed to protect Swiss sovereignty concerns and prohibits the direct delivery of information from the Swiss owners of Topaz Exchange to the Commission or Topaz Exchange with respect to the activities of Topaz Exchange. In light of the Swiss penal code,[126] the Swiss companies agreed to make their books and records relating to the activities of ISE, EDGA and EDGX available for inspection and copying by the Commission through FINMA.[127] The Swiss companies made the

124 See 15 U.S.C. 78u-3(a).

125 See supra note 15.

126 Art. 271 of the Swiss penal code, "Prohibited acts for a foreign state," states, in part: "Whoever, without being authorized, performs acts for a foreign state on Swiss territory that are reserved to an authority or an official, whoever performs such acts for a foreign party or another foreign organization, whoever aids and abets such acts, shall be punished with imprisonment and, in serious cases, sentenced to the penitentiary."

127 In 2007, the Swiss Federal Banking Commission ("SFBC") (the predecessor to FINMA) undertook to serve as a conduit for the delivery of information between the Commission and the Swiss companies relating to the activities of ISE. On January 1, 2009, the SFBC, the Swiss Federal Office of Private Insurance and the Swiss Anti-Money Laundering Control Authority merged to form FINMA, a new consolidated financial regulator for Switzerland. In 2009, a new undertaking was expanded to cover EDGA and EDGX and any future U.S. exchanges controlled by ISE Holdings. The 2009 undertaking became effective after the Commission approved the Form 1 applications of EDGA and EDGX. See DirectEdge Exchanges Order, supra note 70. The 2009 undertaking covers all U.S. markets that currently are, or in the future may be, controlled by ISE Holdings. Accordingly, by its terms, the new undertaking from 2009 also would apply to the activities of Topaz Exchange upon its registration. See http://www.sec.gov/about/offices/oia/oia_bilateral/switzerland_sfbc.pdf.

same agreement in connection with the Eurex Acquisition, and agreed to do so again with respect to the Topaz Exchange prior to the grant of registration to Topaz Exchange as a national securities exchange.[128] In November 2009, the Commission and FINMA both approved and signed the Undertaking Relating to the Oversight of Affiliated Markets ("2009 Undertaking") pursuant to which FINMA undertook to serve as a conduit for the delivery of information between the Commission and the Swiss owners of ISE Holdings ("Procedure")[129] for any national securities exchange registered under Section 6 of the Act that ISE Holdings controls or would, in the future, control, directly or indirectly.[130]

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128 See supra note 15. The forms of these agreements are included as part of the Form 1 Application. Form of Swiss Parent Corporate Resolutions; see also Form of EGD Corporate Resolutions. Based on the representation of Topaz Exchange in the submission of its Form 1 Application to the Commission, the resolutions were signed by the respective Swiss companies prior to the grant of registration by the Commission. See Exhibit B to Topaz Exchange Form 1 Application and Amendment No. 3.

129 Where necessitated by Swiss law, the Procedure provides: (1) if the Commission makes a request to any of the Swiss Upstream Owners for information related to the activities of a U.S. Market, including books and records related to the activities of such U.S. Market, FINMA shall deliver to the Commission without delay any responsive information provided to FINMA by the Swiss Upstream Owners; (2) written requests for information, including books and records, related to the activities of a U.S. Market shall be made by the Commission directly to the Swiss Upstream Owners, and FINMA would be copied on any such requests; and (3) a FINMA staff member shall participate in any oral exchanges between the Commission and any of the Swiss Upstream Owners. As used in the 2009 Undertaking, "U.S. Markets" means ISE, EDGX, EDGA, and any national securities exchange registered under Section 6 of the Act that ISE Holdings may, in the future, control, directly or indirectly. See 2009 Undertaking, paragraph 6.

Notwithstanding this Procedure, the Swiss Upstream Owners remain fully responsible for meeting all of their obligations as owners of a U.S. securities exchange, to be set forth in binding corporate resolutions.

130 FINMA serves as a conduit for the delivery of information and for participation in oral exchanges between the Commission and the Swiss companies, and would serve in that capacity for Topaz Exchange. The 2009 Undertaking explicitly states that it covers changes in Swiss companies that become future direct or indirect owners of the U.S. Markets. Specifically, when SIX Swiss Exchange AG's transferred its interest to the newly formed Swiss corporation, EGD, EGD was covered by the 2009 Undertaking. See supra note 16.

Subject to the terms and conditions relating to the Procedure, coupled with the fact that under the Topaz Exchange LLC Agreement, all trading records of Topaz Exchange must be maintained in the United States,[131] the Commission believes that the Procedure should not result in a level of access materially different from that agreed to by other entities that control U.S. national securities exchanges.[132]

3. Regulation of Topaz Exchange

As a prerequisite to the Commission's granting of an exchange's application for registration, an exchange must be so organized and have the capacity to carry out the purposes of the Act.[133] Specifically, an exchange must be able to enforce compliance by its members, and persons associated with its members, with the Act and the rules and regulations thereunder and the rules of the exchange.[134] The discussion below summarizes how Topaz Exchange proposes to structure and conduct its regulatory operations.

a. Corporate Governance Committee and Finance and Audit Committee

Topaz Exchange will have a Chief Regulatory Officer ("CRO") with general responsibility for supervision of the regulatory operations of Topaz Exchange. The CRO will

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131 See Topaz Exchange LLC Agreement, ARTICLE IV, Section 4.1 (Books and Records).

132 See Eurex Acquisition Order, supra note 15, at 72 FR 71984 n.66 and accompanying text; see also DirectEdge Exchanges Order, supra note 70. If a Non-U.S. Upstream Owner fails to make its books and record relating to the operation of Topaz Exchange available to the Commission, the Commission could bring an action under, among other provisions, Section 17 of the Act, 15 U.S.C. 78q, and Rule 17a-1(b) thereunder, 17 CFR 240.17a-1(b), against Topaz Exchange pursuant to Section 19(h) of the Act, 15 U.S.C. 78s(h).

133 See Section 6(b)(1) of the Act, 15 U.S.C. 78f(b)(1).

134 See id. See also Section 19(g) of the Act, 15 U.S.C. 78s(g).

report to the Corporate Governance Committee[135] and to the President/Chief Executive Officer, although the Topaz Exchange Board would retain the power to call the CRO to report directly to the Board as needed, and the CRO may call special meetings of the Board, as necessary.[136] The Corporate Governance Committee will meet regularly with the CRO to review regulatory matters.

The Corporate Governance Committee will monitor the regulatory program for sufficiency, effectiveness and independence, and will oversee trade practices and market surveillance, audits, examinations and other regulatory responsibilities with respect to members and the conduct of investigations. The Corporate Governance Committee also will supervise the CRO; will receive an annual report from the CRO assessing Topaz Exchange's self-regulatory program for the Board; will recommend changes that would ensure fair and effective regulation; and will review regulatory proposals and advise the Board as to whether and how such changes may impact regulation. The Corporate Governance Committee will review annually the regulatory budget and specifically inquire into the adequacy of the resources available in the budget for regulatory activities. The Corporate Governance Committee will authorize unbudgeted expenditures for necessary regulatory expenses. In addition, the Finance and Audit Committee will provide oversight over the systems of internal controls established by management and the Board and the Exchange's regulatory and compliance process.[137]

The Compensation Committee will set compensation for the CRO. The Corporate Governance Committee, in its sole discretion, will make hiring and termination decisions with

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135 The Corporate Governance Committee will consist of at least three directors, all of whom must be Non-Industry Directors. See Topaz Exchange Constitution, Article V, Section 5.4.

136 See Exhibit L to Topaz Exchange Form 1 Application.

137 See Exhibit L to Topaz Exchange Form 1 Application. See also Amendment No. 3.

respect to the CRO, in each case taking into consideration any recommendations made by the President/Chief Executive Officer. The Corporate Governance Committee will be informed about the compensation of the CRO, including factors affecting changes thereto.

b. Regulatory Funding

To help assure the Commission that it has and will continue to have adequate funding to be able to meet its responsibilities under the Act, Topaz Exchange represented that, prior to commencing operations as a national securities exchange, ISE Holdings will provide sufficient funding to Topaz Exchange for the exchange to carry out its responsibilities under the Act.[138] Specifically, Topaz Exchange represented that ISE Holdings will make a cash contribution to Topaz Exchange of $5 million, in addition to previously provided "in-kind" contributions of legal, regulatory and infrastructure-related services to Topaz Exchange[139] Topaz Exchange represented in its Form 1 Application that the cash and in-kind contributions to Topaz Exchange will be adequate to operate Topaz Exchange, including its regulatory program.[140] Further, Topaz Exchange, with ISE Holdings as its parent, will be affiliated with an existing exchange, ISE. Individuals currently employed by ISE have been providing, and will continue to provide, services to Topaz Exchange.[141]

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138 See Exhibit I to Topaz Exchange Form 1 Application.

139 Other applicants for registration as a national securities exchange have noted in their Form 1 applications similar funding commitments and representations. BOX Exchange represented that, prior to launch, BOX Group LLC would allocate sufficient operational assets, including regulatory infrastructure and industry and regulatory memberships, along with a $1,000,000 loan to BOX Exchange. In MIAX, the exchange represented that Miami International Holdings, Inc. would allocate sufficient operational assets and make a capital contribution of not less than $2,000,000 into MIAX capital account prior to launching operations. See, e.g., MIAX Order, supra note 30.

140 See Exhibit I to Topaz Exchange Form 1 Application.

141 See id.

Topaz Exchange represented in its Form 1 Application that there will be a written agreement between Topaz Exchange and ISE Holdings that requires ISE Holdings to provide adequate funding for Topaz Exchange's operation, including the regulation of Topaz Exchange.[142] This agreement further provides that ISE Holdings will reimburse Topaz Exchange for its costs and expenses to the extent Topaz Exchange's assets are insufficient to meet its costs and expenses.[143] Excess funds, as solely determined by Topaz Exchange, will be remitted to ISE Holdings.[144] Further, Topaz Exchange will receive all fees, including regulatory fees and trading fees, payable by Topaz Exchange's members, as well as any funds received from any applicable market data fees and OPRA tape revenue.[145] Regulatory funds, meaning the fees, fines or penalties derived from the regulatory operations of Topaz Exchange, will be used to fund the legal, regulatory and surveillance operations of Topaz Exchange.[146]

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142 See Amendment No. 3. Both BOX and MIAX also represented in their Form 1 applications that there would be explicit agreements with their respective holding companies to provide adequate funding for the exchanges' operations, including regulation.

143 See Exhibit I to Topaz Exchange Form 1 Application.

144 See id.

145 See id.

146 See id. See also Topaz Exchange LLC Agreement, Article III, Section 3.3. The Topaz Exchange LLC Agreement defines "Regulatory Funds" as fees, fines or penalties derived from the regulatory operations of the [Topaz Exchange], provided that such term shall not include revenues derived from listing fees, market data revenues, transaction revenues or any other aspect of the commercial operations of the [Topaz Exchange], even if a portion of such revenues are used to pay costs associated with the regulatory operations of the [Topaz Exchange]. Id. This definition is consistent with the rules of other SROs. See, e.g., MIAX LLC Agreement Section 16; and MIAX By-Laws Article IX, Section 9.4.

c. Rule 17d-2 Agreements; Regulatory Contracts with FINRA and ISE

Section 19(g)(1) of the Act,[147] among other things, requires every SRO registered as either a national securities exchange or national securities association to examine for, and enforce compliance by, its members and persons associated with its members with the Act, the rules and regulations thereunder, and the SRO's own rules, unless the SRO is relieved of this responsibility pursuant to Section 17(d) or Section 19(g)(2) of the Act.[148] Rule 17d-2 of the Act[149] permits SROs to propose joint plans to allocate regulatory responsibilities amongst themselves for their common rules with respect to their common members.[150] These agreements, which must be filed with and declared effective by the Commission, generally cover areas where each SRO's rules substantively overlap, including such regulatory functions as personnel registration and sales practices. Without this relief, the statutory obligation of each individual SRO could result in a pattern of multiple examinations of broker-dealers that maintain

147 15 U.S.C. 78s(g)(1).

148 15 U.S.C. 78q(d) and 15 U.S.C. 78s(g)(2), respectively.

149 See Section 17(d)(1) of the Act and Rule 17d-2 thereunder, 15 U.S.C. 78q(d)(1) and 17 CFR 240.17d-2. Section 17(d)(1) of the Act allows the Commission to relieve an SRO of certain responsibilities with respect to members of the SRO who are also members of another SRO. Specifically, Section 17(d)(1) allows the Commission to relieve an SRO of its responsibilities to: (i) receive regulatory reports from such members; (ii) examine such members for compliance with the Act and the rules and regulations thereunder, and the rules of the SRO; or (iii) carry out other specified regulatory responsibilities with respect to such members.

150 17 CFR 240.17d-2. Section 19(g)(1) of the Act requires every SRO to examine its members and persons associated with its members and to enforce compliance with the federal securities laws and the SRO's own rules, unless the SRO is relieved of this responsibility pursuant to Section 17(d) of the Act. Section 17(d) was intended, in part, to eliminate unnecessary multiple examinations and regulatory duplication with respect to Common Members. See Securities Exchange Act Release No. 12935 (October 28, 1976), 41 FR 49091 (November 8, 1976) ("Rule 17d-2 Adopting Release").

memberships in more than one SRO. Such regulatory duplication would add unnecessary expenses for common members and their SROs.

A 17d-2 plan that is declared effective by the Commission relieves the specified SRO of those regulatory responsibilities allocated by the plan to another SRO.[151] Many SROs have entered into Rule 17d-2 agreements.[152]

Topaz Exchange has represented to the Commission that it will enter into the following allocation of regulatory responsibilities pursuant to Rule 17d-2 of the Act ("17d-2 Plans"),[153] including the two existing multiparty plans applicable to options trading:

- Multiparty 17d-2 Plan for the Allocation of Regulatory Responsibility for Options Sales Practice Matters;[154]
- Multiparty 17d-2 Plan for the Allocation of Regulatory Responsibility for Options Related Market Surveillance Matters;[155] and

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151 See id.

152 See, e.g., Securities Exchange Act Release Nos. 59218 (January 8, 2009), 74 FR 2143 (January 14, 2009) (File No. 4-575) (Financial Industry Regulatory Authority, Inc. ("FINRA")/Boston Stock Exchange, Inc.); 58818 (October 20, 2008), 73 FR 63752 (October 27, 2008) (File No. 4-569) (FINRA/BATS Exchange, Inc.); 55755 (May 14, 2007), 72 FR 28087 (May 18, 2007) (File No. 4-536) (National Association of Securities Dealers, Inc. ("NASD") (n/k/a FINRA) and Chicago Board of Options Exchange, Inc. ("CBOE") concerning the CBOE Stock Exchange, LLC); 55367 (February 27, 2007), 72 FR 9983 (March 6, 2007) (File No. 4-529) (NASD/ISE) ("ISE Bilateral 17d-2 Plan"); and 54136 (July 12, 2006), 71 FR 40759 (July 18, 2006) (File No. 4-517) (NASD/The Nasdaq Stock Market LLC).

153 Rule 17d-2 under the Act permits SROs to propose joint plans for the allocation of regulatory responsibilities with respect to their common members (i.e., 17d-2 plans).

154 See Exhibit L to Topaz Exchange Form 1 Application. See also Securities Exchange Act Release No. 68363 (December 5, 2012), 77 FR 73711 (December 11, 2012) (File No. S7-966) (notice of filing and order approving and declaring effective an amendment to the multiparty 17d-2 plan concerning options-related sales practice matters).

155 See Exhibit L to Topaz Exchange Form 1 Application. See also Securities Exchange Act Release No. 68362 (December 5, 2012), 77 FR 73719 (December 11, 2012) (File No. 4-

- Bilateral 17d-2 Plan with FINRA that would cover, among other things, general inspection, examination, and enforcement activity.[156]

If the Commission declares effective the amendments to the multilateral 17d-2 Plans and the new bilateral 17d-2 Plan, another SRO (often FINRA) would assume certain regulatory responsibility for members of Topaz Exchange that are also members of the SRO that assumes the regulatory responsibilities. This regulatory structure would be consistent with that of other exchanges, including ISE.[157]

In addition, Topaz Exchange has entered into a third-party Regulatory Service Agreement ("RSA") with FINRA.[158] Under the RSA, FINRA[159] will carry out certain specified regulatory activities on behalf of Topaz Exchange. For example, FINRA, in its capacity as service provider to Topaz Exchange, will provide member operation services, including membership application review, conducting market surveillance investigation services, conducting routine and cause examination services, assisting Topaz Exchange with disciplinary proceedings pursuant to Topaz Exchange's rules including conducting hearings, and providing dispute resolution services to Topaz Exchange members on behalf of Topaz Exchange. Topaz

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551) (notice of filing and order approving and declaring effective an amendment to the multiparty 17d-2 plan concerning options-related market surveillance).

156 See Exhibit L to Topaz Exchange Form 1 Application. See also ISE Bilateral 17d-2 Plan, supra note 152.

157 Amendments to the multilateral 17d-2 Plans and the new bilateral 17d-2 Plan are not before the Commission as part of this Order and, therefore, the Commission is not acting on them at this time.

158 See, e.g., Exhibit L to Topaz Exchange Form 1 Application.

159 FINRA executed a single RSA with both ISE and Topaz Exchange as signatories. The single RSA, however, has two separate statements of work. The first statement of work describes the specified regulatory activities that FINRA will carry out on behalf of ISE. The second statement of work describes the specified regulatory activities that FINRA will carry out on behalf of Topaz Exchange.

Exchange, however, will retain ultimate legal responsibility for the regulation of its members and market.[160] This regulatory structure would be consistent with that of other exchanges.[161]

Topaz Exchange has also entered into a facilities management agreement ("FMA") with ISE.[162] Pursuant to the proposed FMA, ISE intends to provide to Topaz Exchange certain services, including, for example, business management services, facilities management services, IT services, fiscal services, as well as Commission and other regulatory compliance services and other legal services, such as surveillance programs, legal programs, systems and other operational services.[163] Topaz Exchange, however, will retain ultimate legal responsibility for the regulation of its members and market.

The Commission believes that it is consistent with the Act for Topaz Exchange to contract with other SROs to perform certain examination, enforcement, and disciplinary functions.[164] These functions are fundamental elements of a regulatory program, and constitute core self-regulatory functions. The Commission believes that both FINRA, as a SRO that provides contractual services to other SROs, and ISE, as an SRO that currently operates an

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160 See Amendment No. 3.

161 For example, ISE, EDGA, EDGX and BATS have entered into 17d-2 Plans and RSAs with FINRA.

162 See, e.g., Exhibit L to Topaz Exchange Form 1 Application. The FMA with ISE provides, in part, for the provision of Commission and other regulatory compliance services.

163 See Exhibit L of Topaz Exchange Form 1 Application; see also Amendment No. 3.

164 See, e.g., Regulation ATS Release, supra note 30. See also Securities Exchange Act Release Nos. 50122 (July 29, 2004), 69 FR 47962 (August 6, 2004) (SR-Amex-2004-32) (order approving rule that allowed Amex to contract with another SRO for regulatory services) ("Amex Regulatory Services Approval Order"); 57478 (March 12, 2008), 73 FR 14521 (March 18, 2008) (SR-NASDAQ-2007-004 and SR-NASDAQ-2007-080) ("NOM Approval Order"); Nasdaq Order, supra note 29; and BATS Order, supra note 29.

options exchange, should have the capacity to perform these functions for Topaz Exchange.[165] However, Topaz Exchange, unless relieved by the Commission of its responsibility,[166] bears the ultimate responsibility for self-regulatory responsibilities and primary liability for self-regulatory failures, not the SRO retained to perform regulatory functions on Topaz Exchange's behalf. In performing these regulatory functions, however, the SRO retained to perform specified regulatory functions may nonetheless bear liability for causing or aiding and abetting the failure of Topaz Exchange to perform its regulatory functions.[167] Accordingly, although FINRA and ISE will not act on their own behalves under their respective SRO responsibilities in carrying out these regulatory services for Topaz Exchange, as the SROs retained to perform regulatory functions, FINRA and ISE may have secondary liability if, for example, the Commission finds that the contracted functions are being performed so inadequately as to cause a violation of the federal securities laws by Topaz Exchange.

As part of its FMA with ISE, Topaz Exchange proposes to use dual employees to staff its regulatory services program. In other words, current ISE employees will also serve in a similar capacity for Topaz Exchange under the FMA. Topaz Exchange represents that the FMA will contain an obligation on the part of Topaz Exchange and ISE to preserve the other party's

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165 See, e.g., Amex Regulatory Services Approval Order, supra note 164; NOM Approval Order, supra note 164; and Nasdaq Order, supra note 29. The Commission notes that the RSA and FMA are not before the Commission and, therefore, the Commission is not acting on them.

166 See supra note 149.

167 For example, if failings by the SRO retained to perform regulatory functions have the effect of leaving an exchange in violation of any aspect of the exchange's self-regulatory obligations, the exchange will bear direct liability for the violation, while the SRO retained to perform regulatory functions may bear liability for causing or aiding and abetting the violation. See, e.g., MIAX Order, supra note 30; BOX Order, supra note 39; and Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388 (March 2, 2000) (File No. 10-127) (order granting the exchange registration of ISE) ("ISE Order").

information and materials which are confidential, proprietary and/or trade secrets and prevent unauthorized use or disclosure to third parties.[168]

The Commission believes that the use of ISE employees by Topaz Exchange is appropriate, as the operations, rules, and management of ISE and Topaz Exchange will overlap to a considerable degree such that Topaz Exchange should benefit by leveraging the experience of current ISE staff. The Commission has approved such arrangements in a similar context.[169] However, the Commission expects both ISE and Topaz Exchange to monitor the workload of their dual employees and supplement their staffs, if necessary, so that Topaz Exchange maintains sufficient personnel to allow it to carry out the purposes of the Act and enforce compliance with the rules of Topaz Exchange and the federal securities laws.

D. Trading System

1. Access to Topaz Exchange

Access to Topaz Exchange will be through the use of Exchange Rights.[170] Through an application process, organizations will be approved to become members of Topaz Exchange and to exercise trading rights.[171] Exchange Rights will not convey any ownership rights, but will

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168 See Exhibit L to Topaz Exchange Form 1 Application; see also Amendment No. 3.

169 See, e.g., Securities Exchange Act Release No. 61152 (December 10, 2009), 74 FR 66699 (December 16, 2009) (File No. 10-191) (order granting registration to C2 Options Exchange) ("C2 Order").

170 See Topaz Exchange Rule 300 Series. "Exchange Rights" means the PMM Rights, CMM Rights and EAM Rights collectively. See Topaz Exchange Rule 100(a)(17). PMM Rights, CMM Rights and EAM Rights have the meaning set forth in Article VI of Topaz Exchange LLC Agreement. See Topaz Exchange Rules 100(a)(12), 100(a)(15) and 100(a)(36).

171 The term "Member" means an organization that has been approved to exercise trading rights associated with Exchange Rights, and the term "Membership" refers to the trading privileges associated with Exchange Rights. See Topaz Exchange Rules 100(a)(23) and 100(a)(24). Under Topaz Exchange Rules 300 and 302(c), Topaz Exchange shall issue Memberships that confer the ability to transact on Topaz Exchange, although no rights

provide for voting rights for representation on the Topaz Exchange Board and will confer the ability to transact on Topaz Exchange.[172] Exchange Rights may not be leased and are not transferable except in the event of a change in control of a member or corporate reorganization involving a member.[173] There is no limit on the number of Exchange Rights issued by Topaz Exchange.[174]

Membership in Topaz Exchange will be open to any broker-dealer registered under Section 15(b) of the Act that meets the standards for membership set forth in the rules of Topaz Exchange.[175] The Exchange's denials from, and impositions of conditions upon, becoming or continuing to be a member may be appealed pursuant to rules governing hearing and review, described in Section II.E below.[176] In addition to its regular membership application process, Topaz Exchange also will provide a process whereby a current member of ISE in good standing that is a registered broker-dealer can submit an abbreviated "waive-in" application to Topaz Exchange.[177] This waive-in process is similar to arrangements in place at other exchanges.[178]

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shall be conferred upon a Member except those set forth in the Topaz Exchange LLC Agreement or Topaz Exchange Rules as amended from time to time. A Membership shall not convey any ownership interest in the Exchange. See Topaz Exchange Rules 300 and 302(c).

172 See Topaz Exchange Rules 300 and 302(c); see also Topaz Exchange LLC Agreement, Article VI, Sections 6.1 and 6.3.

173 See Topaz Exchange Rule 302(c). In such case, member status may be transferred to a qualified affiliate or successor upon written notice to Topaz Exchange. Id.

174 See Topaz Exchange Rule 300(a); see also Topaz Exchange LLC Agreement, Article VI, Section 6.1.

175 See Topaz Exchange Rule 301.

176 See Topaz Exchange Rule 1700 Series, which incorporates by reference ISE Rule 1700 Series.

177 See Topaz Exchange Rule 302(a).

178 See, e.g., C2 Options Exchange, Inc. Rule 3.1(c)(1) (containing a similar expedited waive-in membership process for members of CBOE).

Topaz Exchange will have three classes of membership: (1) PMMs; (2) CMMs; and (3) EAMs.[179] PMM and CMMs may seek appointment to become market makers in one or more options classes traded on the exchange.[180] Topaz Exchange proposes to allow firms that register as market makers to receive special privileges or rights over non-market maker members, such as participation entitlements for PMMs, if they satisfy certain affirmative and negative market making obligations on the exchange.[181] This is similar to arrangements in place at other exchanges, such as ISE.[182]

The Commission finds that Topaz Exchange's proposed membership rules are consistent with the Act, including Section 6(b)(2) of the Act,[183] which requires the rules of an exchange to provide that any registered broker or dealer or natural person associated with a broker or dealer may become a member of such exchange or associated with a member thereof. Topaz Exchange's proposed rules with respect to exchange membership are substantively similar to the rules of other exchanges.[184]

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179 See Topaz Exchange Rule 301(c).

180 See Topaz Exchange Rule 800 Series.

181 See Topaz Exchange Rules 713, 802 and 803. See infra Section II.D.3.b. for further discussion of market maker privileges and obligations.

182 See, e.g., ISE Rules 713, 802 and 803 (containing similar rights and obligations for market makers on ISE). However, some of Topaz Exchange's proposed access rules differ in some respects from the rules of ISE. For example, as a result of their differing membership structures, there is no limit on the number of PMMs that Topaz Exchange can approve for membership, whereas ISE can appoint only ten PMMs in total. There will still be only one PMM per options class on Topaz Exchange. There also will be no limit to the number of CMMs on Topaz Exchange, whereas ISE can appoint only 160 CMMs in total. EAM rights, however, will be unlimited on both ISE and Topaz Exchange. Topaz Exchange's approach is consistent with the rules of other exchanges that have no limit on the number of exchange rights, or their functional equivalent, that may be issued by the exchange. See, e.g., C2 Order, supra note 169.

183 15 U.S.C. 78f(b)(2).

184 See, e.g., MIAX Rule 200 Series ("Access").

The Commission notes that pursuant to Section 6(c) of the Act,[185] an exchange must deny membership to any person, other than a natural person, that is not a registered broker or dealer, any natural person that is not, or is not associated with, a registered broker or dealer, and registered broker-dealers that do not satisfy certain standards, such as financial responsibility or operational capacity. As a registered exchange, Topaz Exchange must independently determine if an applicant satisfies the standards set forth in the Act, regardless of whether an applicant is a member of another SRO.[186]

In addition, Topaz Exchange also will allow non-members to access Topaz Exchange as "sponsored customers" of a Topaz Exchange member, subject to certain rules.[187] The sponsoring member will be responsible for implementing policies and procedures to supervise and monitor the trading of its sponsored users to ensure compliance with all applicable federal securities laws and rules and Topaz Exchange rules.[188] Topaz Exchange's proposed sponsored access rules are similar to the rules of other exchanges that provide for sponsored access[189] and are consistent with Rule 15c3-5 under the Act.[190]

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185 15 U.S.C. 78f(c).

186 See, e.g., MIAX Order, supra note 30, at 77 FR 73074; BOX Order, supra note 39, at 77 FR 26337; BATS Order, supra note 29, at 73 FR 49502; and Nasdaq Order, supra note 29, at 71 FR 3555.

187 See Topaz Exchange Rule 706, Supplementary Material .01.

188 See Topaz Exchange Rule 706. See also 17 CFR 240.15c3-5.

189 See, e.g., ISE Rule 706; see also MIAX Rule 210.

190 17 CFR 240.15c3-5.

2. Linkage

Topaz Exchange intends to become a participant in the Plan Relating to Options Order Protection and Locked/Crossed Markets or any successor plan ("Linkage Plan").[191] If admitted as a participant to the Linkage Plan, other plan participants will be able to send orders to Topaz Exchange in accordance with the terms of the plan as applied to Topaz Exchange.

Topaz Exchange rules include relevant definitions; establish the conditions pursuant to which members may enter orders in accordance with the Linkage Plan; impose obligations on Topaz Exchange regarding how it must process incoming orders; establish a general standard that members and Topaz Exchange should avoid trade-throughs; establish potential regulatory liability for members that engage in a pattern or practice of trading through other exchanges; and establish obligations with respect to locked and crossed markets.

The Commission believes that Topaz Exchange has proposed rules that are designed to comply with the requirements of the Linkage Plan.[192] Further, as provided below, before Topaz Exchange can commence operations as an exchange, it must become a participant in the Linkage Plan.

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191 See Exhibit E to Topaz Exchange Form 1 Application, Section B ("Non-Member Access") for a discussion of the Linkage Plan. See also Securities Exchange Act Release No. 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009) (File No. 4-546) (order approving the National Market System Plan Relating to Options Order Protection and Locked/Crossed Markets Submitted by the Chicago Board Options Exchange, Incorporated, International Securities Exchange, LLC, The NASDAQ Stock Market LLC, NASDAQ OMX BX, Inc., NASDAQ OMX PHLX, Inc., NYSE Amex LLC, and NYSE Arca, Inc.).

192 See, e.g., Topaz Exchange Rules relating to Intermarket Linkage in Rule 1900 Series, which incorporates by reference ISE Rule 1900 Series. See also Amendment No. 3.

3. Market Makers

a. Registration of Market Makers

Members of Topaz Exchange may apply to become one of two types of market maker: PMMs or CMMs (collectively, "Market Makers"). Market Makers are entitled to receive certain benefits and privileges in exchange for fulfilling certain affirmative and negative market-making obligations.[193] Each class of Market Maker will receive a specific level of benefits and privileges in exchange for a specific level of obligation that such Market Maker assumes to the Topaz Exchange market.

To begin the process of registering as a PMM or CMM, a member will be required to file a written application with Topaz Exchange.[194] In reviewing a member's application for membership, Topaz Exchange will consider, among other things, the applicant's market making ability.[195] To qualify for registration as a Market Maker, a member of Topaz Exchange must meet the requirements established in Rule 15c3-1 under the Act[196] and the general requirements set forth in Topaz Exchange Rule 800 series, including the minimum financial requirements of Topaz Exchange Rule 809.[197] All members who are approved to become Market Makers will be designated as specialists on Topaz Exchange for all purposes under the Act and rules

193 Market Makers' benefits and obligations are discussed in greater detail in the following section.

194 See Topaz Exchange Rule 800(b).

195 See id. The provision permitting Topaz Exchange to consider "such other factors as [it] deems appropriate" must be applied in a manner that is consistent with the Act, including provisions that prohibit an exchange from acting in an unfairly discriminatory manner. See 15 U.S.C. 78f(b)(5); see also MIAX Order, supra note 30, at 77 FR 73074 n.149.

196 17 CFR 240.15c3-1.

197 See Topaz Exchange Rule 800 Series. See also Topaz Exchange Rule 1300 Series relating to Net Capital Requirements, which incorporates by reference ISE Rule 1300 Series.

thereunder.[198] Topaz Exchange will not limit the number of qualifying entities that may become Market Makers.[199]

In addition, all ISE market makers in good standing will be eligible for an Exchange Right in the same membership category in which they operate on ISE to trade on Topaz Exchange.[200] For example, a CMM in good standing on ISE will be eligible to become a CMM on Topaz Exchange, through the submission and approval of a Topaz Exchange Waive-In Membership Application.[201]

Once approved, a Market Maker may seek appointment to make markets in one or more options classes traded on the Topaz Exchange.[202] Topaz Exchange will provide non-ISE Members with at least sixty days advance written notice of the date upon which the Exchange will allocate options classes and appoint market makers in order to ensure that non-ISE Members have a reasonable opportunity to participate in those processes.[203] A market participant must have completed a membership application to be eligible to participate in the appointment and allocation processes.[204]

Either the Topaz Exchange Board or a committee thereof[205] will appoint classes of options contracts traded on Topaz Exchange to Market Makers taking into consideration: (1) the

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198 See Topaz Exchange Rule 800(a).

199 See Topaz Exchange Rule 300. See also Exhibit E to Topaz Exchange Form 1 Application, Section A ("Introduction").

200 See Topaz Exchange Rule 302(a).

201 See id. See also Exhibit F to Topaz Exchange Form 1 Application.

202 See Topaz Exchange Rule 802(a).

203 See Topaz Exchange Rule 302(b).

204 See Exhibit E to Topaz Exchange Form 1 Application, Section A ("Introduction").

205 See Topaz Exchange Rule 802(a). Topaz Exchange Rule 1700 Series provides the process for hearings, review, and arbitration of claims by persons economically aggrieved

financial resources available to the Market Maker; (2) the Market Maker's experience and expertise in market making or options trading; and (3) the maintenance and enhancement of competition among Market Makers in each option class to which they are appointed.[206] No appointment of a Market Maker will be without the Market Maker's consent to such appointment, provided that refusal to accept an appointment may be deemed sufficient cause for termination or suspension of a market maker's registration.[207] Topaz Exchange will appoint a PMM to each options class traded on Topaz Exchange.[208] Once appointed, Topaz Exchange will surveil a Market Maker's activity for continued compliance with all applicable rules and requirements, which are discussed in more detail below.[209]

The Commission finds that Topaz Exchange's proposed rules for the registration and appointment of Market Makers are consistent with the Act. In particular, Topaz Exchange's rules provide an objective process by which a member could become a Market Maker on Topaz Exchange and provide for oversight by Topaz Exchange to monitor for continued compliance by Market Makers with the terms of their application for such status. The Commission notes that Topaz Exchange's proposed Market Maker registration and appointment requirements are similar to those of other options exchanges.[210]

b. Market Maker Obligations

Pursuant to Topaz Exchange rules, Market Makers will be subject to a number of general

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by Topaz Exchange action, which would include denial of registration as a Market Maker.

206 See id.

207 See id.

208 See Topaz Exchange Rule 802(b).

209 See Topaz Exchange Rule 802(e).

210 See, e.g., ISE Rules 800 and 801 and MIAX Rule 600 (registration); ISE Rule 802 and MIAX Rule 602 (appointment).

obligations. In particular, the transactions of a Market Maker should constitute a course of dealings reasonably calculated to contribute to the maintenance of a fair and orderly market and a Marker Maker should not make bids or offers or enter into transactions that are inconsistent with such a course of dealings.[211] A Market Maker has a continuous obligation to engage, to a reasonable degree under the existing circumstances, in dealings for his own account when there exists, or it is reasonably anticipated that there will exist, a lack of price continuity, a temporary disparity between the supply of and demand for a particular options contract, or a temporary distortion of the price relationships between options contracts of the same class.[212] For all series of option classes which the Market Maker is appointed, the Market Maker is expected to: (1) compete with other Market Makers to improve the market; (2) make markets that, absent changed market conditions, will be honored for the number of contracts entered into the Topaz Exchange's system; (3) update market quotations in response to changed market conditions; (4) price options contracts fairly by, among other things, bidding and offering so as to create the prescribed bid/ask differentials.[213] These provisions are similar to arrangements in place at other options exchanges.[214]

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211 See Topaz Exchange Rule 803(a).

212 See Topaz Exchange Rule 803(b).

213 See Topaz Exchange Rule 803(b)(1)-(4). Specifically under Topaz Exchange Rule 803(b)(4), following the opening rotation, Market Makers must create differences of no more than \$5 between the bid and offer. Prior to the opening rotation, spread differentials shall be no more than \$.25 between the bid and offer for each options contract for which the bid is less than \$2, no more than \$.40 where the bid is at least \$2 but does not exceed \$5, no more than \$.50 where the bid is more than \$5 but does not exceed \$10, no more than \$.80 where the bid is more than \$10 but does not exceed \$20, and no more than \$1 where the bid is \$20 or greater, provided that the Topaz Exchange may establish differences other than the above for one or more options series.

214 See, e.g., ISE Rules 802 and 803 (containing similar rights and obligations for market makers on ISE). However, some of Topaz Exchange's access rules differ in some respect from the rules of ISE. See also supra note 182.

Further, Market Makers must maintain minimum net capital in accordance with Topaz Exchange rules, including the minimum financial requirement of Topaz Exchange Rule 809, in addition to the Act and rules and regulations thereunder.[215] Market Makers also must maintain information barriers between their market making activity and Other Business Activities[216] that are reasonably designed to prevent the misuse of material, non-public corporate or market information in the possession of persons on one side of the barrier from influencing the conduct of persons on the other side of the barrier.[217]

Topaz Exchange's rules governing Market Maker quoting obligations are tailored to the specific class of Market Maker (that is, PMM or CMM).[218] Specifically, a PMM will be subject to the highest standard applicable on Topaz Exchange, as a PMM must enter continuous two-sided quotations and enter into any resulting transactions in all of the series listed on the Topaz Exchange of the options classes to which it is appointed on a daily basis.[219] PMMs are also required to participate in the opening rotation.[220] Although a CMM is not required to enter quotations in the options classes to which it is appointed, whenever a CMM does enter a quote in

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215 See Topaz Exchange Rule 1300 Series, which incorporates by reference ISE Rule 1300 Series; see also Topaz Exchange Rule 809.

216 "Other Business Activities" means: (1) conducting an investment or banking or public securities business; (2) making markets in the stocks underlying the options in which it makes markets; or (3) handling listed options orders as agent on behalf of Public Customers or broker-dealers; (4) conducting non-market making proprietary listed options trading activities. See Topaz Exchange Rule 810(a).

217 See Topaz Exchange Rule 810.

218 See Topaz Exchange Rule 804.

219 See Topaz Exchange Rule 804(e)(1); see also Topaz Exchange Rule 804(c). A PMM shall be deemed to have provided continuous quotes pursuant to paragraph (e)(1) of Rule 804 if it provides two-sided quotes for 90% of the time that an options class is open for trading on the Topaz Exchange. See Topaz Exchange Rule 804, Supplementary Material .01; see also Amendment No. 3.

220 See Topaz Exchange Rule 701(b)(1). See also Amendment No. 3.

an options class to which it is appointed, the CMM must then provide continuous quotations in that class for 60% of the time the options class is open for trading on the Topaz Exchange.[221] Further, CMMs may be called upon by a Topaz Exchange official to submit a single quote or maintain continuous quotes in one or more series of options class to which the CMM is appointed whenever, in the judgment of such official, it is necessary to do so in the interest of fair and orderly markets.[222] For purposes of meeting the continuous quoting obligations discussed herein, a Market Maker's quote must meet the bid/ask differential requirements of Topaz Exchange Rule 803(b)(4).[223]

In options classes other than to which it is appointed, a Market Maker should not engage in transactions in an account in which it has an interest that are disproportionate in relation to, or in derogation of, the performance of its market making obligations as specified in the Topaz Exchange rules.[224] Further, the total number of contracts executed during a quarter by a CMM in options classes to which it is not appointed may not exceed 25% of the total number of contracts traded by such CMMs in classes to which it is appointed and with respect to which it was quoting pursuant to Topaz Exchange Rule 804(e)(2).[225] Similarly, the total number of contracts executed during a quarter by a PMM in options classes to which it is not appointed may not

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221 See Topaz Exchange Rule 804(e)(2). A CMM must maintain continuous quotations for at least 90% of the time the options class for which it receives Preferenced Orders is open for trading on the Topaz Exchange. See Topaz Exchange Rule 804(e)(2)(iii); see also Topaz Exchange Rule 713, Supplementary Material .03 regarding Preferenced Orders.

222 See Topaz Exchange Rule 804(e)(2)(iv).

223 See Topaz Exchange Rule 804(e)(1)-(2). See also supra note 213.

224 See Topaz Exchange Rule 803(d). Among other things, a Market Maker should not effect purchases or sales on the Topaz Exchange except in a reasonable and orderly manner. See id.

225 See Topaz Exchange Rule 805(b)(2).

exceed 10% of the total number of contracts traded per each PMM membership.[226]

If Topaz Exchange finds any failure by a Market Maker to properly perform as a market maker, such Market Maker may be subject to suspension or termination.[227] Topaz Exchange may suspend or terminate any appointment of a Market Maker under Topaz Exchange Rule 802 and may make additional appointments whenever, in Topaz Exchange's judgment, the interests of a fair and orderly market are best served by such action.[228]

Market Makers receive certain benefits for carrying out their responsibilities.[229] For example, a broker-dealer or other lender may extend "good faith" credit to a member of a national securities exchange or registered broker-dealer to finance its activities as a market maker or specialist.[230] PMMs are also entitled to certain participation entitlements.[231] In addition, market makers are excepted from the prohibition in Section 11(a) of the Act.[232]

The Commission believes that a market maker must be subject to sufficient and commensurate affirmative obligations, including the obligation to hold itself out as willing to buy and sell options for its own account on a regular or continuous basis, to justify favorable treatment.[233] The Commission further believes that the rules of all U.S. options markets need not

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226 See Topaz Exchange Rule 805(b)(3).

227 See Topaz Exchange Rule 800.

228 See Topaz Exchange Rule 802(d).

229 See, e.g., MIAX Order, supra note 30 (discussing the benefits and obligations of market makers).

230 See 12 CFR 221.5 and 12 CFR 220.7; see also 17 CFR 240.15c3-1(a)(6) (capital requirements for market makers).

231 See Topaz Exchange Rule 713, Supplementary Material .01(b)-(c). See also infra notes 261-268 and accompanying text (describing the PMM participation entitlements).

232 15 U.S.C. 78k(a).

233 See MIAX Order, supra note 30, at 77 FR 73076; and BOX Order supra note 39; see also, e.g., C2 Order, supra note 169.

provide the same standards for market maker participation, so long as they impose affirmative obligations that are consistent with the Act.[234]

The Commission believes that Topaz Exchange's Market Maker participation requirements impose appropriate affirmative obligations on Topaz Exchange's Market Makers that are commensurate with the benefits afforded to such participants, as discussed above, and, accordingly, are consistent with the Act. The Commission believes that the specific levels of benefits conferred on the different classes of Market Makers (PMMs and CMMs) are appropriately balanced by the obligations imposed by Topaz Exchange's rules. The Commission further believes that Topaz Exchange's market maker requirements,[235] which are identical to ISE's rules[236] and similar to other options exchanges' rules,[237] impose sufficient appropriate obligations that are consistent with the Act.

Finally, the Commission believes that the Act does not mandate a particular market model for exchanges, and while Market Makers may become an important source of liquidity on Topaz Exchange, they will likely not be the only source as Topaz Exchange is designed to match buying and selling interest of all Topaz Exchange participants.

4. Order Display, Execution, and Priority

Topaz Exchange proposes to operate a fully automated electronic options trading platform to buy or sell securities with a continuous, automated matching function.[238] Liquidity will be derived from Topaz Exchange members acting as principal or as agent electronically

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234 See id.

235 See Topaz Exchange Rule 803.

236 See, e.g., ISE Rule 800 Series.

237 See, e.g., MIAX Order, supra note 30, and BOX Order, supra note 39.

238 See Exhibit E to Topaz Exchange Form 1 Application.

submitting quotes as well as market and various types of limit orders to buy or to sell.[239] Non-members also may access Topaz Exchange pursuant to Topaz Exchange rules governing "sponsored access."[240] All of these electronic submissions to Topaz Exchange will be from remote locations, as there will be no trading floor.[241] Topaz Exchange's Optimise system generally will automatically execute incoming orders.[242] Non-opening trades will occur when a buy order/quote and a sell order/quote match on the Topaz Exchange's order book.[243] All options will be traded in decimals on Topaz Exchange and will be consistent with the Penny Pilot.[244]

239 See id.

240 See id.

241 See id.

242 See Topaz Exchange Rule 714.

243 See Exhibit E to Topaz Exchange Form 1 Application.

244 See Topaz Exchange Rule 710 and Supplementary Material .01. The Commission has approved exchange rules on a pilot basis that permit an exchange to quote series with premiums under $3 in pennies and series with premiums of $3 and over in nickels in approximately 360 options classes ("Penny Pilot"). In addition, these rules allow all series in QQQQs, IWM, and SPY to be quoted in pennies. See, e.g., Securities Exchange Act Release Nos. 60711 (September 23, 2009), 74 FR 49419 (September 28, 2009); 61061 (November 24, 2009), 74 FR 62857 (December 1, 2009) (File No. SR-NYSEArca-2009-44) (approving Penny Pilot program expansions for NYSE Arca). Proposed Supplementary Material .01 to Rule 710 would permit Topaz Exchange to operate a pilot to permit certain options classes to be quoted and traded in increments as low as $0.01, consistent with these previously approved rules. Specifically, this pilot is consistent with the penny pilot on ISE, which was last extended on June 21, 2013 and is scheduled to expire on December 31, 2013. See Securities Exchange Act Release No. 69828 (June 21, 2013), 78 FR 38745 (June 27, 2013) (File No. SR-ISE-2013-40). Similar to ISE, Topaz Exchange has further agreed to submit to the Commission such reports regarding the Penny Pilot as the Commission may request. See Exhibit B to Topaz Exchange Form 1 Application.

All orders submitted to Topaz Exchange's trading platform must have a designated price and size (limit orders)[245] or must be orders to buy or sell a stated amount of a security at the national best bid or offer when the order reaches Topaz Exchange (market orders).[246] Members may submit the following orders to Topaz Exchange: Market Orders; Limit Orders (including Marketable Limit, Fill-or-Kill, Immediate or Cancel, Non-Displayed Penny Order, Intermarket Sweep, and Stopped Orders);[247] or Contingency Orders (including All-Or-None, Stop, Stop Limit, Customer Participation, Reserve, Attributable, Customer Cross, Qualified Contingent Cross, Minimum Quantity,[248] Do-Not-Route, Add Liquidity, Opening Only, and Good-Till-Date

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245 A limit order is an order to buy or sell a stated number of options contracts at a specified price or better. Topaz Exchange Rule 715(b).

246 A market order is an order to buy or sell a stated number of options contracts that is to be executed at the best price obtainable when the order reaches Topaz Exchange. Topaz Exchange Rule 715(a).

247 See Topaz Exchange Rule 715. A Marketable Limit Order is a limit order to buy (sell) at or above (below) the best offer (bid) on the Topaz Exchange. A Fill-or-Kill Order is a limit order that is to be executed in its entirety as soon as it is received and, if not so executed, treated as cancelled. An Immediate-or-Cancel Order is a limit order that is to be executed in whole or in part upon receipt and any portion not so executed is to be treated as cancelled. A Non-Displayed Penny Order is a limit order that specifies a one-cent price increment in a security that has a minimum trading increment pursuant to Topaz Exchange Rule 710 that is larger than one-cent. An Intermarket Sweep Order is a limit order that meets the requirements of Topaz Exchange Rule 1900(h), which incorporates by reference ISE Rule 1900(h). A Stopped Order is a limit order that meets the requirements of Topaz Exchange Rule 1901(b)(8), which incorporates by reference ISE Rule 1901(b)(8). To execute Stopped Orders, members must enter them into the Facilitation Mechanism or Solicited Order Mechanism pursuant to Topaz Exchange Rule 716.

248 The NASDAQ Letter noted that both Topaz Exchange Rules 715(l) and 715(q) appear to describe Minimum Quantity Orders and urged that Topaz Exchange clarify the difference between these two types of Minimum Quantity Orders. See NASDAQ Letter, supra note 6. Topaz Exchange stated that it will correct the duplicative definition. See Topaz Exchange Response Letter, supra note 7, and Amendment No. 3. The Commission believes that Topaz Exchange's revision to Topaz Exchange Rule 715(l) appropriately addresses the commenter's concern.

Orders).[249] Like ISE, Topaz Exchange also will permit flash mechanisms, which thereby permit certain orders to first be exposed at the NBBO to all Topaz Exchange members for execution at the National Best Bid or Offer ("NBBO") before an unaffiliated broker will, under contract with Topaz Exchange, route the order to another market for execution.[250]

249 See Topaz Exchange Rule 715. An All-or-None Order is a limit or market order that is to be executed in its entirety or not at all. A Stop Order is an order that becomes a market order when the stop price is elected. A Stop Limit Order is an order that becomes a limit order when the stop price is elected. A Customer Participation Order is a limit order on behalf of a Public Customer (as defined in Topaz Exchange Rule 100(a)(38)) that, in addition to the limit order price in standard increments according to Topaz Exchange Rule 710, includes a price stated in one-cent increments at which the Public Customer wishes to participate in trades executed in the same options series in penny increments through the Price Improvement Mechanism pursuant to Topaz Exchange Rule 723. A Reserve Order is a limit order that contains both a displayed portion and a non-displayed portion. An Attributable Order is a market or limit order which displays the user firm ID for purposes of electronic trading on Topaz Exchange. A Customer Cross Order is comprised of a Priority Customer Order (as defined in Topaz Exchange Rule 100(a)(37B) to buy and a Priority Customer Order to sell at the same price and for the same quantity. A Qualified Contingent Cross order is comprised of an order to buy or sell at least 1000 contracts that is identified as being part of a qualified contingent trade (as defined in Topaz Exchange Rule 715, Supplementary Material .02) coupled with a contra-side order to buy or sell an equal number of contracts. A Minimum Quantity Order is an order that is initially available for partial execution only for a specified number of contracts or greater. A Do-Not-Route Order is a market or limit order that is to be executed in whole or in part on Topaz Exchange only. An Add Liquidity Order is a limit order that is to be executed in whole or in part on Topaz Exchange (i) only after being displayed on Topaz Exchange's limit order book; and (ii) without routing any portion of the order to another market center. An Opening Only Order is a limit order that can be entered for the opening rotation only. A Good-Till-Date Order is a limit order to buy or sell which, if not executed, will be cancelled at the sooner of the end of the expiration date assigned to the order, or the expiration of the series. These order types are the same order types that are available on ISE, except that ISE also includes several complex order types that are not proposed for Topaz Exchange. See Topaz Exchange Rule 715; ISE Rules 715 and 722; see also Exhibit B to Topaz Exchange Form 1 Application.

250 See Topaz Exchange Rule 1901, Supplementary Material .02 (which incorporates by reference ISE Rule 1901, Supplementary Material .02). See also Amendment No. 3 (removing exposure and routing obligation from PMMs under Topaz Exchange Rule 800 Series).

Quotes entered by PMMs and CMMs must, like Limit Orders, be priced and have a designated size.[251] Orders will be accepted for any security traded on Topaz Exchange, whether submitted by a member on a proprietary or agency basis in any size,[252] whereas quotes for any security traded on Topaz Exchange may only be submitted by PMMs and CMMs and only in the options classes to which the market makers are appointed.[253] Topaz Exchange will be required to maintain a full audit trail of every incoming and outgoing message (including all orders and quotes) submitted to the Topaz Exchange's system.[254] Members may receive status reports regarding orders submitted to Topaz Exchange or change or cancel an order at any time before that order is executed on Topaz Exchange, except as otherwise specified in Topaz Exchange Rule 723 (Price Improvement Mechanism for Crossing Transactions).[255]

All orders and quotes submitted to Topaz Exchange will be displayed unless designated otherwise by the member submitting the order.[256] Displayed orders and quotes will be displayed on an anonymous basis (except for Attributable Orders,[257] which will allow voluntary disclosure

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251 See Topaz Exchange Rule 804(b). The NASDAQ Letter noted that proposed Topaz Exchange Rule 804(g) and Supplementary Material .01 appear to be identical and urged that Topaz Exchange clarify this provision. See NASDAQ Letter, supra note 6. Topaz Exchange stated that it will correct the duplicative provision. See Topaz Exchange Response Letter, supra note 7, and Amendment No. 3. The Commission believes that Topaz Exchange's revision to Topaz Exchange Rule 804, Supplementary Material .01 appropriately addresses the commenter's concern.

252 See Topaz Exchange Rule 713(a).

253 See Topaz Exchange Rule 804(a).

254 See 17 CFR 240.17a-5. See also Exhibit E to Topaz Exchange Form 1 Application, Section C.

255 See Exhibit E to Topaz Exchange Form 1 Application, Section C.

256 See Topaz Exchange Rule 704.

257 An Attributable Order is a market or limit order which displays the user firm's ID for purposes of trading on the Topaz Exchange. Use of Attributable Orders would be voluntary. This order type is consistent with similar order types on other exchanges. See, e.g., CBOE Rule 6.53(o) (attributable order type).

of firm identification information) at a member's specified price. Non-Displayed Orders (the non-displayed portion of a Reserve Order or a Non-Displayed Penny Order) will not be displayed to anyone and will not have time priority over displayed orders at the same price.[258]

Topaz Exchange will utilize a pro-rata priority scheme with a Priority Customer preference.[259] This scheme is the same as what the Commission has approved for ISE.[260]

In addition, under Topaz Exchange rules, PMMs are granted certain participation entitlements. For example, PMMs will be entitled to a participation entitlement with respect to each incoming order if they have a quote at the NBBO.[261] The PMM participation entitlement will apply only to any remaining balance after any Priority Customer[262] orders have first been

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258 See Topaz Exchange Rules 715(b)(4) and 715(g).

259 See Topaz Exchange Rule 713, Supplementary Material 01. Under this priority methodology, the highest bid and lowest offer will have priority except that Priority Customer Orders will have priority over professional interest and all market maker interest at the same price. Subject to certain limits, Professional Orders and market maker quotes at the best price receive allocations based upon the percentage of the total number of contracts available at the best price that is represented by the size of the Professional Order or quote. If there were two or more Priority Customer Orders for the same options series at the same price, priority will be afforded based on the sequence in which such orders were received. Topaz Exchange rules will define "Priority Customer" as a person or entity that is not a broker or dealer in securities, and does not place more than 390 orders in listed options per day on average during a calendar month for its own beneficial accounts. "Professional Orders," i.e., orders for the account of a person or entity that is not a Priority Customer, will be subordinate to Priority Customer Orders for priority and fee purposes. Professional Orders will include orders of broker-dealers and orders of those Public Customers that are not Priority Customers. See Topaz Exchange Rules 100(a)(37A)-(37C) for definitions of Priority Customer, Priority Customer Order and Professional Order, respectively.

260 See, e.g., ISE Rule 713, Priority of Quotes and Orders.

261 See Topaz Exchange Rule 713, Supplementary Material .01. Specifically, the PMM's participation entitlement will be equal to the greater of: (i) the proportion of the total size at the best price represented by the size of its quote, or (ii) 60% of the contracts to be allocated if there is only one other Market Maker quotation at the NBBO or 40% if there are two or more other Market Maker quotes at the NBBO. See Topaz Exchange Rule 713, Supplementary Material .01(b).

262 See supra note 259 for the definition of Priority Customer.

opportunity for price improvement after an auction for eligible orders above the NBBO);[270] a Facilitation Mechanism (which affords members an opportunity to cross orders after an auction and provides the facilitating member the opportunity to receive 40% of the agency order);[271] and a Solicited Order Mechanism (which allows members representing agency orders the opportunity to cross large size solicited orders after an auction).[272] These mechanisms are consistent with

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270 See Topaz Exchange Rule 723. Topaz Exchange will operate a pilot program whereby there will be no minimum size requirements for orders to be eligible for the PIM. See Exhibit B to Topaz Exchange Form 1 Application; see also Topaz Exchange Rule 723, Supplementary Material .03.

271 See Topaz Exchange Rule 716(d). The NASDAQ Letter stated that it appears that the rule concerning the Facilitation Mechanism was internally inconsistent in part. Specifically, the NASDAQ Letter noted that proposed Topaz Exchange Rule 716(d)(3)(i) stated that Priority Customer bids (offers) that are priced higher (lower) than the facilitation price will be executed at the facilitation price, and further noted that the same section of the rule also stated that a facilitation order would be cancelled at the end of the exposure period if an execution would take place a price that is inferior to the best bid (offer) on Topaz. See NASDAQ Letter, supra note 6. The NASDAQ Letter suggested that this means that a Priority Customer bidding higher than the facilitation price would cause the facilitation order to be cancelled. See id. Topaz Exchange clarified this point by explaining that, because Topaz Exchange is a price priority exchange, Topaz Exchange will not execute a facilitation order at a price that is inferior to the Topaz Exchange best bid or offer ("Topaz BBO") at the time of execution. Topaz Exchange noted that, since interest on the opposite side of a facilitation order participates in the execution of the facilitation order, the only instance where a better priced Priority Customer Order might be outside of the Topaz BBO is when the order is on the same side of the market as the facilitation order. In other words, the text of Rule 716(d) means that better-priced Priority Customer Orders on the opposite side of the market from the order being facilitated will be given the benefit of executing at the facilitation price, whereas better-priced Priority Customer Orders on the same side of the market as the order being facilitated will cause the facilitation order to be cancelled. See Topaz Exchange Response Letter, supra note 7.

272 See Topaz Exchange Rule 716(e). With respect to the Block Order, Facilitation and Solicited Order Mechanisms described in Topaz Exchange Rule 716(b), (d) and (e), the NYSE Euronext Letter II recommended clarifying language to describe what terms, if any, should be contained within a "broadcast message." See NYSE Euronext Letter II, supra note 6. Topaz Exchange stated that it would amend the various sections of the rule to clarify the terms of the broadcast message. See Topaz Exchange Response Letter, supra note 7, and Amendment No. 3. The Commission believes that Topaz Exchange's revisions to Topaz Exchange Rule 716(b), (d), and (e) appropriately address the commenter's concerns.

substantially similar mechanisms currently existing on other options exchanges, including identical mechanisms on ISE with respect to non-complex orders.[273]

Members will be able to access Topaz Exchange through a variety of electronic systems, and non-members will be able to access Topaz Exchange pursuant to sponsored access arrangements with Topaz Exchange members, pursuant to Topaz Exchange rules.[274] As noted above, Topaz Exchange also intends to become a participant in the Linkage Plan.[275] The manner in which Topaz Exchange proposes to comply with the Linkage Plan is identical to the manner in which ISE complies with the Linkage Plan.[276] To comply with the Linkage Plan, Topaz Exchange, among other things, will prohibit its members from effecting a transaction at a price that is inferior to the NBBO, unless an exception applies.[277] Topaz Exchange will provide a centralized process for sending intermarket sweep orders to other exchanges on behalf of Public Customer Orders.[278] Topaz Exchange will contract with one or more unaffiliated brokers to route orders to other exchanges when necessary to comply with the Linkage Plan. In circumstances where marketable Public Customer Orders are received when Topaz Exchange is

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273 See ISE Rules 716 and 723.

274 See, e.g., Topaz Exchange Rule 706, Supplementary Material .01.

275 See Topaz Exchange Rule 1900 Series, which incorporates by reference ISE Rule 1900 Series.

276 The Commission recently approved a change in the way in which ISE complies with the Linkage Plan by now contracting with one or more unaffiliated brokers to route intermarket sweep orders of Public Customers to other exchanges when necessary. See Securities Exchange Act Release No. 69396 (April 18, 2013), 78 FR 24273 (April 24, 2013) (File No. SR-ISE-2013-18). PMMs no longer have the responsibility of either executing the Public Customer Order at a price that at least matches the NBBO or obtaining better prices from the away market(s) by sending one or more intermarket sweep orders on the Public Customer's behalf. See also Amendment No. 3 (removing exposure and routing obligation from PMMs under Topaz Exchange's Rule 800 Series).

277 See Topaz Exchange Rule 714; see also ISE Rule 714.

278 See Topaz Exchange Rule 1901, which incorporates by reference ISE Rule 1901.

not at the NBBO or orders are received that would lock or cross another market, they will be exposed to Topaz Exchange members for up to one second.[279] If, after a Public Customer Order is exposed, such order cannot be executed in full on Topaz Exchange at the then-current NBBO or better and is marketable, the lesser of the full displayed size of the protected bid(s) or protected offer(s) that are priced better than the Topaz Exchange's quote or the balance of the order will be sent to a contracted unaffiliated broker, and any additional balance of the order that is not marketable against the then-current NBBO will be placed on the Topaz Exchange book.[280]

The Commission believes that Topaz Exchange's proposed display, execution, and priority rules are consistent with the Act. In particular, the Commission finds that the proposed rules are consistent with Section 6(b)(5) of the Act,[281] which, among other things, requires that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest, and to not permit unfair discrimination between customers, issuers, or dealers. The Commission also finds that the proposed rules are consistent with Section 6(b)(8) of the Act,[282] which requires that the rules of an exchange not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The trading rules of Topaz Exchange are substantially similar to the current ISE trading rules, which were approved at the time ISE's registration as a

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279 See Topaz Exchange Rule 1901, Supplementary Material .02, which incorporates by reference ISE Rule 1901, Supplementary Material .02.

280 See id. Any additional balance of the order will be executed on Topaz Exchange if it is marketable.

281 15 U.S.C. 78f(b)(5).

282 15 U.S.C. 78f(b)(8).

national securities exchange was granted[283] or filed with and approved by the Commission (or otherwise became effective) pursuant to Section 19(b) of the Act.[284] The Commission believes that Topaz Exchange's trading rules, in general, do not raise any novel or controversial issues.[285]

5. Section 11(a) of the Act

Section 11(a)(1) of the Act[286] prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion (collectively, "covered accounts"), unless an exception applies. The Exchange has represented that it has analyzed its rules proposed hereunder, and believes that they are consistent with Section 11(a) of the Act and rules thereunder. For the reasons set forth below, based on Topaz Exchange's representations,

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283 See ISE Order, supra note 167.

284 The Commission notes, however, that some of Topaz Exchange's rules differ in some respects from the rules of ISE. For example, Topaz Exchange is not proposing to incorporate ISE's rules relating to the trading of equity securities or to incorporate any rules concerning the trading of complex or multi-legged orders at this time.

285 With respect to clearing rules, the three commenters recommended clarifying language with respect to Topaz Exchange Rule 712(b), specifically ". . . or other guarantee given by such Clearing Member to such Member . . . ." The commenters noted that this language lacks clarity whether Topaz Exchange Rule 712(b) requires some form of written authorization between a clearing member and a member in order for the member to give up the name of a particular clearing member. See CBOE Letter, NASDAQ Letter and NYSE Euronext Letter I, supra note 6. The NASDAQ Letter noted that a written, transparent and auditable authorization is needed to provide proper safeguards and protections for clearing members and to ensure clearing members are in compliance with aspects of the Commission Rule 15c3-3 in general. See NASDAQ Letter, supra note 6. The NYSE Euronext Letter I noted that the requirements for a letter of authorization were also not clearly defined and that Topaz Exchange should have rule text that governs the terms and revocation of letters of authorization. Topaz Exchange clarified this point by noting that ISE has interpreted and applied its identical rule to require the submission of written authorization in order for an ISE member to give up a particular clearing member's name. Topaz Exchange further noted that it would amend the rule to make clear that written authorization is required. See Topaz Exchange Response Letter, supra note 7, and Amendment No 3. The Commission believes that Topaz Exchange's revision to Topaz Exchange Rule 712(b) appropriately addresses the commenters' concerns.

286 15 U.S.C. 78k(a)(1).

the Commission believes that Topaz Exchange's order execution algorithm, including the Facilitation, Solicitation and Customer Cross processes (but excluding the Price Improvement Mechanism), will allow members to meet the requirements of Rule 11a2-2(T) for executions on Topaz Exchange. Additionally, the Commission believes that Topaz Exchange members' executions that occur through the Price Improvement Mechanism will be consistent with the requirements in Section 11(a)(1)(G) of the Act and rule 11a1-1(T) thereunder.

a. Rule 11a2-2(T)

Rule 11a2-2(T) under the Act,[287] known as the "effect versus execute" rule, provides exchange members with an exemption from the Section 11(a)(1) prohibition. Rule 11a2-2(T) permits an exchange member, subject to certain conditions, to effect transactions for covered accounts by arranging for an unaffiliated member to execute the transactions on the exchange. To comply with Rule 11a2-2(T)'s conditions, a member: (i) may not be affiliated with the executing member; (ii) must transmit the order from off the exchange floor; (iii) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution;[288] and (iv) with respect to an account over which the member has investment discretion, neither the member nor its associated person may retain any compensation in connection with effecting the transaction except as provided in the Rule.

In a letter to the Commission,[289] Topaz Exchange requested that the Commission concur with its conclusion that Topaz Exchange members that enter orders through the Topaz Exchange

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287 17 CFR 240.11a2-2(T).

288 The member may, however, participate in clearing and settling the transaction. See Securities Exchange Act Release No. 14563 (March 14, 1978), 43 FR 11542 (March 17, 1978) (regarding the NYSE's Designated Order Turnaround System) ("1978 Release").

289 See Letter from Michael Simon, General Counsel, Secretary and Chief Regulatory Officer, Topaz Exchange, to Elizabeth Murphy, Secretary, Commission, dated December 14, 2012 ("Exchange 11(a) Request Letter").

system, including the Facilitation, Solicitation and Customer Cross processes, (but excluding those transactions effected through the PIM process), satisfy the requirements of Rule 11a2-2(T). For the reasons set forth below, the Commission believes that Topaz Exchange members that enter orders through the Topaz Exchange system, including the Facilitation, Solicitation and Customer Cross processes, but excluding those transactions effected through the PIM process, will satisfy the conditions of Rule 11a2-2(T).

Rule 11a2-2(T)'s first condition is that the order be executed by an exchange member who is unaffiliated with the member initiating the order. The Commission has stated that the requirement is satisfied when automated exchange facilities, such as the Topaz Exchange system, including the Facilitation, Solicitation and Customer Cross processes, are used, as long as the design of these systems ensures that members do not possess any special or unique trading advantages over non-members in handling their orders after transmitting them to the Exchange.[290] Topaz Exchange has represented that the design of the trading platform ensures that no member has any special or unique trading advantage in the handling of its orders after transmitting its orders to Topaz Exchange.[291] Based on the Exchange's representation, the Commission believes that the Topaz Exchange trading system, including the Facilitation,

290 In considering the operation of automated execution systems operated by an exchange, the Commission noted that while there is no independent executing exchange member, the execution of an order is automatic once it has been transmitted into each system. Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange, the Commission has stated that executions obtained through these systems satisfy the independent execution requirement of Rule 11a2-2(T). See Securities Exchange Act Release No. 15533 (January 29, 1979), 44 FR 6084, 6086 n.25 (January 31, 1979) (File No. S7-613) (regarding the American Stock Exchange ("Amex") Post Execution Reporting System, the Amex Switching System, the Intermarket Trading System, the Multiple Dealer Trading Facility of the Cincinnati Stock Exchange, the PCX Communications and Execution System, and the Philadelphia Stock Exchange Automated Communications and Execution System ("1979 Release")).

291 See Exchange 11(a) Request Letter, supra note 289.

Solicitation and Customer Cross processes, will satisfy this requirement.

Second, Rule 11a2-2(T) requires orders for covered accounts to be transmitted from off the exchange floor. Topaz Exchange will not have a physical trading floor, and like other automated systems, will receive orders electronically through remote terminals or computer-to-computer interfaces. In the context of other automated trading systems, the Commission has found that the off-floor transmission requirement is met if a covered account order is transmitted from a remote location directly to an exchange's floor by electronic means.[292] Orders sent to Topaz Exchange, regardless of where it executes within the Topaz Exchange system, including as a Facilitation, a Solicitation or a Customer Cross process, will be transmitted from remote terminals directly to Topaz Exchange by electronic means. Since the Topaz Exchange trading system receives all orders electronically through remote terminals or computer-to-computer interfaces, the Commission believes that the trading system, including the Facilitation, Solicitation and Customer Cross processes, will satisfy the off-floor transmission requirement.

Third, Rule 11a2-2(T) requires that the member not participate in the execution of its order once it has been transmitted to the member performing the execution.[293] Topaz Exchange

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[292] See, e.g., Securities Exchange Act Release Nos. 59154 (December 23, 2008) 73 FR 80468 (December 31, 2008) (SR-BSE-2008-48) (order approving proposed rules of BX); 49068, (January 13, 2004), 69 FR 2775 (January 20, 2004) (SR-BSE-2002-15) (establishing, among other things, BOX as an options trading facility of BSE); 44983, (October 25, 2001), 66 FR 55225 (November 1, 2001) (SR-PCX-00-25) (approving the PCX's use of the Archipelago Exchange as its equity trading facility); 29237 (May 24, 1991), 56 FR 24853 (May 31, 1991) (SR-NYSE-90-52 and SR-NYSE-90-53) (regarding NYSE's Off-Hours Trading Facility). See 1978 Release, supra note 288. See also 1979 Release, supra note 290.

[293] The member may cancel or modify the order, or modify the instructions for executing the order, but only from off the Exchange floor. See 1978 Release, supra note 288, at 43 FR 11547. The Commission has stated that the non-participation requirement is satisfied under such circumstances so long as such modifications or cancellations are also transmitted from off the floor. See id. (stating that the "non-participation requirement does not prevent initiating members from canceling or modifying orders (or the

represented that at no time following the submission of an order is a member able to acquire control or influence over the result or timing of an order's execution. According to Topaz Exchange, orders submitted through the Topaz Exchange system, including the Facilitation, Solicitation and Customer Cross processes, also meet the non-participation requirement. The execution of a member's order depends not on the member entering the order, but rather on what orders, bids, or offers are present in the system at the time the member submits the order and on the priority of those orders, bids or offers.[294] Topaz Exchange represents that orders sent to Topaz Exchange and through the Facilitation, Solicitation and Customer Cross processes will be centrally processed and executed automatically by Topaz Exchange.[295] Topaz Exchange further represents that orders sent to Topaz Exchange will be transmitted from remote terminals directly to the system by electronic means.[296] Once an order is submitted to Topaz Exchange, the order is executed against another order based on the established matching algorithms for the Topaz Exchange system, including the Facilitation, Solicitation and Customer Cross processes.[297] Trades will execute when orders or quotations on Topaz Exchange match one another based on their priority.[298] As Topaz Exchange stated in its Exchange 11(a) Request Letter, the execution does not depend on the participant but rather upon what other orders are entered into the Topaz Exchange system, including the Facilitation, Solicitation and Customer Cross processes, at or around the same time as the subject order; what orders are on Topaz Exchange; or submitted as

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instructions pursuant to which the initiating member wishes orders to be executed) after the orders have been transmitted to the executing member, provided that any such instructions are also transmitted from off the floor").

294 See Exchange 11(a) Request Letter, supra note 289.

295 See id.

296 See id.

297 See id.

298 See id.

Responses; and where the order is ranked based on the priority ranking algorithm.[299] Therefore, at no time following the submission of an order to the Topaz Exchange system, including through the Facilitation, Solicitation or Customer Cross processes, is a participant able to acquire control or influence the result or timing of orders submitted to the Topaz Exchange system, including through the Facilitation, Solicitation or Customer Cross processes.[300] Accordingly, the Commission believes that the non-participation requirement will be met when orders are executed automatically through use of the Topaz Exchange system, including the Facilitation, Solicitation and Customer Cross processes.

Fourth, in the case of a transaction effected for an account with respect to which the initiating member or an associated person thereof exercises investment discretion, neither the initiating member nor any associated person thereof may retain any compensation in connection with effecting the transaction, unless the person authorized to transact business for the account has expressly provided otherwise by written contract referring to Section 11(a) of the Act and Rule 11a2-2(T).[301] Topaz Exchange members trading for covered accounts over which they exercise investment discretion must comply with this condition in order to rely on the rule's

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299 See id.

300 See id.

301 17 CFR 240.11a2-2(T)(a)(2)(iv). In addition, Rule 11a2-2(T)(d) requires a member or associated person authorized by written contract to retain compensation, in connection with effecting transactions for covered accounts over which such member or associated person thereof exercises investment discretion, to furnish at least annually to the person authorized to transact business for the account a statement setting forth the total amount of compensation retained by the member in connection with effecting transactions for the account during the period covered by the statement. See 17 CFR 240.11a2-2(T)(d). See also 1978 Release, supra note 288, at 43 FR 11548 (stating "[t]he contractual and disclosure requirements are designed to assure that accounts electing to permit transaction-related compensation do so only after deciding that such arrangements are suitable to their interests").

exemption.[302]

b. Section 11(a)(1)(G) and Rule 11a1-1(T)

Section 11(a)(1)(G) of the Act provides an additional exemption from the general prohibition set forth in Section 11(a)(1) for any transaction for a member's own account, provided that: (i) such member is primarily engaged in certain underwriting, distribution, and other activities generally associated with broker-dealers and whose gross income is derived principally from such business and related activities; and (ii) the transaction is effected in compliance with the rules of the Commission, which, as a minimum, assure that the transaction is not inconsistent with the maintenance of fair and orderly markets and yields priority, parity, and precedence in execution to orders for the account of persons who are not members or associated with members of the exchange.[303] In addition, Rule 11a1-1(T) under the Act specifies that a transaction effected on a national securities exchange for the account of a member which meets the requirements of Section 11(a)(1)(G)(i) of the Act is deemed, in accordance with the requirements of Section 11(a)(1)(G)(ii), to be not inconsistent with the maintenance of fair and orderly markets and to yield priority, parity, and precedence in execution to orders for the account of non-members or persons associated with non-members of the exchange, if such transaction is effected in compliance with certain requirements.[304]

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302 See Exchange 11(a) Request Letter, supra note 289.

303 See 15 U.S.C. 78k(a)(1)(G).

304 Rule 11a1-1(T)(a)(1)-(3) provides that each of the following requirements must be met: (1) A member must disclose that a bid or offer for its account is for its account to any member with whom such bid or offer is placed or to whom it is communicated, and any member through whom that bid or offer is communicated must disclose to others participating in effecting the order that it is for the account of a member; (2) immediately before executing the order, a member (other than the specialist in such security) presenting any order for the account of a member on the exchange must clearly announce or otherwise indicate to the specialist and to other members then present for the trading in such security on the exchange that he is presenting an order for the account of a member;

Topaz Exchange represented that its Price Improvement Mechanism, or PIM, is a process set forth in Topaz Exchange Rule 723 whereby an EAM can provide price improvement opportunities for a transaction.[305] As Topaz Exchange stated in its Exchange 11(a) Request Letter, Topaz Exchange's proposed PIM rules will require that Priority Customer interest, at any given price, be executed in full before Professional Orders and market maker quotes.[306] Additionally, Topaz Exchange's proposed PIM rules will require non-member Professional Orders to be executed in full before any proprietary interest of members (i.e., proprietary interest from EAMs and market makers).[307] Because Topaz Exchange Rule 723(d) will require Topaz Exchange members to yield priority to Priority Customers and non-member Professional Orders in the PIM process, the Commission believes that the proposal with respect to transactions effected through the PIM process will be consistent with Section 11(a)(1)(G) and Rule 11a1-1(T) thereunder.[308] The Commission also reminds exchanges and their members, however, that, in

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and (3) notwithstanding rules of priority, parity, and precedence otherwise applicable, any member presenting for execution a bid or offer for its own account or for the account of another member must grant priority to any bid or offer at the same price for the account of a person who is not, or is not associated with, a member, irrespective of the size of any such bid or offer or the time when entered. See 17 CFR 240.11a1-1(T)(a)(1)-(3).

305 The PIM is a process wherein an EAM may seek to facilitate an order it represents as agent, and/or a transaction wherein the EAM solicited interest to execute against an order it represents as agent (a "Crossing Transaction"). A Crossing Transaction is comprised of the order the EAM represents as agent (the "Agency Order") and a counter-side order for the full size of the Agency Order (the "Counter-Side Order"). The Counter-Side Order may represent interest for the Member's own account, or interest the Member has solicited from one or more other parties, or a combination of both. See Exchange 11(a) Request Letter, supra note 289. See also Topaz Exchange Rule 723.

306 See Exchange 11(a) Request Letter, supra note 289. See also Topaz Exchange Rule 723(d)(1).

307 See Exchange 11(a) Request Letter, supra note 289. See also Topaz Exchange Rule 723(d)(3).

308 See Securities Exchange Act Release No. 50819 (December 8, 2004), 69 FR 75093 (December 15, 2004) (File No. SR-ISE-2003-06).

addition to yielding priority to non-member orders at the same price, members must also meet the other requirements under Section 11(a)(1)(G) of the Act and Rule 11a1-1(T) thereunder (or satisfy the requirements of another exception) to effect transactions for their own accounts.

E. Discipline and Oversight of Members

As noted above, one prerequisite for the Commission's grant of an exchange's application for registration is that a proposed exchange must be so organized and have the capacity to be able to carry out the purposes of the Act.[309] Specifically, an exchange must be able to enforce compliance by its members and persons associated with its members with the Act and the rules and regulations thereunder and the rules of the exchange.[310]

Topaz Exchange rules codify Topaz Exchange's disciplinary jurisdiction over its members, thereby facilitating its ability to enforce its members' compliance with its rules and the federal securities laws.[311] Topaz Exchange's rules permit it to sanction members for violations of the Act and the rules and regulation thereunder and Topaz Exchange's rules by, among other things, expelling or suspending members; limiting members' activities, functions, or operations; fining or censuring members; suspending or barring a person from being associated with a member; or any other fitting sanction in accordance with Topaz Exchange rules.[312]

Topaz Exchange's disciplinary and oversight functions will be administered in accordance with Chapter 16 of the Topaz Exchange rules, which incorporates by reference Chapter 16 of ISE rules, governing disciplinary jurisdiction. Unless delegated to another SRO

309 See 15 U.S.C. 78f(b)(1).

310 See id.

311 See Topaz Exchange Rule 1600(a) (which incorporates by reference ISE Rule 1600(a)).

312 See id. See also MIAX Rule 1000 and BOX Exchange Rule 12000 Series (containing identical provisions).

pursuant to the terms of an effective 17d-2 Plan,[313] Topaz Exchange regulatory staff (including regulatory staff of another SRO that may be acting on Topaz Exchange's behalf pursuant to a regulatory services agreement) will, among other things, investigate potential securities laws violations and initiate charges pursuant to Topaz Exchange rules.[314]

Upon a finding of probable cause of a violation within the disciplinary jurisdiction of Topaz Exchange and where further proceedings are warranted,[315] Topaz Exchange will conduct a hearing on disciplinary matters before a professional hearing officer[316] and two members of the Business Conduct Committee[317] ("Panel").[318] The Topaz Exchange member (or its associated

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313 See supra notes 154-156 and accompanying text (concerning the multiparty 17d-2 Plans to which Topaz Exchange has committed to join).

314 See Topaz Exchange Rule 1602 (which incorporates by reference ISE Rule 1602). As noted above, Topaz Exchange has entered into an RSA with FINRA and a FMA with ISE under which FINRA and ISE, respectively, will perform certain regulatory functions on behalf of Topaz Exchange. Topaz Exchange may perform some or all of the functions specified in Chapter 16 of the Topaz Exchange Rules. See Topaz Exchange Rule 1615 (which incorporates by reference ISE Rule 1615).

315 See Topaz Exchange Rule 1604 (which incorporates by reference ISE Rule 1604). If there is probable cause for finding a violation, Topaz Exchange's regulatory staff will prepare a statement of charges including the allegations and specifying the provisions of the Act and the rules and regulations promulgated thereunder, provisions of the Topaz Exchange Constitution or rules, or interpretations or resolutions of which such acts are in violation. The CRO must approve the statement of charges.

316 See Topaz Exchange Rule 1606 (which incorporates by reference ISE Rule 1606); see also Topaz Exchange Rule 1615, Supplemental Material .01 (which incorporates by reference ISE Rule 1615, Supplemental Material .01).

317 Pursuant to a Resolution of the Topaz Exchange Board, the President and CEO shall establish Topaz Exchange's Business Conduct Committee, pursuant to a charter. The Committee shall consist of no more than 21 persons, all of whom are employees of members of Topaz Exchange, representing members as follows: at least three persons shall represent PMMs; at least three persons shall represent CMMs that are not also PMMs; and at least four persons shall represent EAMs that neither are, nor are affiliated with, a PMM or CMM. See Amendment No. 3.

318 See Topaz Exchange Rule 1606 (which incorporates by reference ISE Rule 1606). A Panel may make a determination without a hearing and may impose a penalty as to violations that the member or associated person has admitted or has failed to answer or

person) or the Topaz Exchange regulatory staff may petition for review of the Panel's decision by the Topaz Exchange Board.[319] Any review will be conducted by the Topaz Exchange Board or a committee thereof composed of at least three of its directors, at least one of which shall be an Industry Director[320] (whose decision must be ratified by the Topaz Exchange Board).[321] In addition, the Topaz Exchange Board on its own motion may order review of a disciplinary decision.[322] The Topaz Exchange Board may affirm, reverse, or modify, in whole or in part, the Panel's decision.[323] The decision of the Topaz Exchange Board will be in writing and will be final.[324]

Appeals from any determination that impacts access to Topaz Exchange, such as termination or suspension of membership, will be instituted under, and governed by, the provisions in the Chapter 17 of the Topaz Exchange rules, which incorporates by reference the provisions in Chapter 17 of ISE rules. Topaz Exchange's Chapter 17 applies to persons

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that otherwise do not appear to be in dispute. See Topaz Exchange Rule 1608 (which incorporates by reference ISE Rule 1608). A member or associated person alleged to have committed a disciplinary violation may submit a written offer of settlement to the Panel, or CRO if a Panel is not yet been appointed, which the Panel or CRO may accept or reject. See Topaz Exchange Rule 1609 (which incorporates by reference ISE Rule 1609). If the second offer of settlement is rejected (such decision is not subject to review), a hearing will proceed in accordance with Topaz Exchange Rule 1606 (which incorporates by reference ISE Rule 1606). See also Topaz Exchange Rule 1609 (which incorporates by reference ISE Rule 1609).

319 See Topaz Exchange Rule 1610 (which incorporates by reference ISE Rule 1610).

320 See Topaz Exchange Rule 1704 (which incorporates by reference ISE Rule 1704) (detailing the composition of the Appeals Committee); see also Amendment No. 3. Any director who participated in a matter before it was appealed to the Topaz Exchange Board shall not participate in any review of the action by the Board concerning the matter. See Topaz Exchange Rule 1704.

321 See Topaz Exchange Rule 1610 (which incorporates by reference ISE Rule 1610).

322 See id.

323 See id.

324 See id.

economically aggrieved by any of the following actions of Topaz Exchange including, but not limited to: (a) denial of an application to become a Member; (b) barring a person from becoming associated with a Member; and (c) limiting or prohibiting services provided by the Topaz Exchange or services of any exchange member.[325]

Any person aggrieved by an action of Topaz Exchange within the scope of the Chapter 17 may file a written application to be heard within thirty days[326] after such action has been taken.[327] Applications for hearing and review will be referred to the Business Conduct Committee, which will appoint a hearing panel of no less than three members of such Committee.[328] The decision of the hearing panel made pursuant to Chapter17 of the Topaz Exchange rules is subject to review by the Topaz Exchange Board, either on its own motion, or upon written request submitted by the applicant or the President of Topaz Exchange.[329] The

325 See Topaz Exchange Rule 1700 (which incorporates by reference ISE Rule 1700). As noted above, Topaz Exchange has entered into an RSA with FINRA and a FMA with ISE under which FINRA and ISE, respectively, will perform certain regulatory functions on behalf of Topaz Exchange. For example, FINRA may perform some or all of the functions specified in Chapter 17 of Topaz Exchange rules. See supra notes 158-160 and accompanying text. See also Topaz Exchange Rule 1706 (which incorporates by reference ISE Rule 1706).

326 An applicant may file for an extension of time within thirty days of Topaz Exchange's action. An application for such an extension will be ruled upon by the Chairman of the Business Conduct Committee and is not subject to appeal. See Topaz Exchange Rule 1701 (which incorporates by reference ISE Rule 1701).

327 See Topaz Exchange Rule 1701 (which incorporates by reference ISE Rule 1701).

328 See Topaz Exchange Rule 1702 (which incorporates by reference ISE Rule 1702).

329 See Topaz Exchange Rule 1704 (which incorporates by reference ISE Rule 1704). The Topaz Exchange Board, or a committee of the Topaz Exchange Board, will have sole discretion to grant or deny either request. See id.

review will be conducted by the Topaz Exchange Board or a committee of the Topaz Exchange Board composed of at least three directors.[330]

The Commission finds that Topaz Exchange's proposed disciplinary and oversight rules and structure, as well as its proposed process for persons economically aggrieved by certain Topaz Exchange actions, are consistent with the requirements of Sections 6(b)(6) and 6(b)(7) of the Act[331] in that they provide fair procedures for the disciplining of members and persons associated with members. The Commission further finds that the proposed Topaz Exchange rules, which incorporate by reference ISE rules, are designed to provide Topaz Exchange with the ability to comply, and with the authority to enforce compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulations thereunder, and the rules of Topaz Exchange.[332] The Commission notes that Topaz Exchange's proposed disciplinary and oversight rules and structures are similar to the rules of other exchanges.[333]

F. Listing Requirements

Topaz Exchange does not intend to offer original listings when it commences operations. Instead, Topaz Exchange will list and trade only standardized option contracts that are listed on other national securities exchanges and cleared by the Options Clearing Corporation.[334] Topaz Exchange's listing rules, including the criteria for the underlying securities of the options to be

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330 See Topaz Exchange Rule 1704 (which incorporates by reference ISE Rule 1704). The Topaz Exchange Board or its designated committee may affirm, reverse, or modify in whole or in part, the decision of the hearing panel. The decision of the Topaz Exchange Board or its designated committee will be in writing and will be final. See Topaz Exchange Rule 1704 (which incorporates by reference ISE Rule 1704).

331 15 U.S.C. 78f(b)(6) and (b)(7), respectively.

332 See Section 6(b)(1) of the Act, 15 U.S.C. 78f(b)(1).

333 See, e.g., MIAX Order, supra note 30, and BOX Order, supra note 39.

334 See Exhibit H to Topaz Exchange Form 1 Application.

traded, incorporate by reference all of the listing rules of ISE.[335] The Commission finds that Topaz Exchange's proposed initial and continued listing rules are consistent with the Act, including Section 6(b)(5),[336] in that they are designed to protect investors and the public interest and to promote just and equitable principles of trade. Before beginning operation, Topaz Exchange will need to become a participant in the Plan for the Purpose of Developing and Implementing Procedures Designed to Facilitate the Listing and Trading of Standardized Options Submitted Pursuant to Section 11A(a)(3)(B) of the Act ("OLPP").[337] In addition, before beginning operation, Topaz Exchange will need to become a participant in the Options Clearing Corporation.

III. Exemption from Section 19(b) of the Act With Regard to ISE, CBOE, NYSE, and FINRA Rules Incorporated by Reference

Topaz Exchange proposes to incorporate by reference certain ISE, CBOE, NYSE and FINRA rules.[338] Thus, for certain Topaz Exchange rules, Topaz Exchange members will comply

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335 See Topaz Exchange Rule 500 Series (which incorporates by reference ISE Rule 500 Series) (Securities Traded on the Exchange). See also MIAX Rule 400 Series and BOX Rule 5000 Series.

336 15 U.S.C. 78f(b)(5).

337 15 U.S.C. 78k-1(a)(3)(B).

338 Specifically, Topaz Exchange proposes to incorporate by reference the following ISE Rules: Chapter 4 (Business Conduct), Chapter 5 (Securities Traded on the Exchange), Chapter 6 (Doing Business with the Public), Chapter 10 (Closing Transactions), Chapter 11 (Exercises and Deliveries), Chapter 12 (Margins), Chapter 13 (Net Capital Requirements), Chapter 14 (Records, Reports and Audits), Chapter 15 (Summary Suspension), Chapter 16 (Discipline), Chapter 17 (Hearings and Review), Chapter 18 (Arbitration), Chapter 19 (Order Protection; Locked and Crossed Market), Chapter 20 (Index Rules), Chapter 22 (Rate-Modified Foreign Currency Options Rules). The following rules are cross-referenced in the ISE rules: ISE Rule 1202 (Margin Requirements) cross-references the same CBOE and NYSE rules that may be in effect from time to time; ISE Rule 1615 (Disciplinary Functions) cross-references the FINRA Code of Procedure and ISE Rule 1800 cross-references the 12000 and 13000 Series of the FINRA Manual and FINRA Rule 2268.

with a Topaz Exchange rule by complying with the referenced ISE, CBOE, NYSE or FINRA rule.

In connection with the proposal to incorporate the ISE, CBOE, NYSE and FINRA rules by reference, Topaz Exchange requested, pursuant to Rule 240.0-12 under the Act,[339] an exemption under Section 36 of the Act from the rule filing requirements of Section 19(b) of the Act for changes to the Topaz Exchange rules that are effected solely by virtue of a change to a cross-referenced ISE, CBOE, NYSE or FINRA rule.[340] Topaz Exchange proposes to incorporate by reference categories of rules, rather than individual rules within a category, that are not trading rules. In addition, Topaz Exchange agrees to provide written notice to its members whenever FINRA, ISE, CBOE or NYSE proposes a change to a cross-referenced rule[341] and whenever any such proposed changes are approved by the Commission or otherwise become effective.[342]

Using the authority under Section 36 of the Act, the Commission previously exempted certain SROs from the requirement to file proposed rule changes under Section 19(b) of the Act.[343] The Commission is hereby granting Topaz Exchange's request for exemption, pursuant

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339 17 CFR 240.0-12.

340 See Letter from Michael Simon, General Counsel, Secretary and Chief Regulatory Officer, Topaz Exchange, to Elizabeth M. Murphy, Secretary, Commission, dated December 14, 2012 ("Section 19(b) Exemption Request").

341 See id.

342 Topaz Exchange will provide such notice through a posting on the same website location where Topaz Exchange posts its own rule filings pursuant to Rule 19b-4 under the Act, within the required time frame. The website posting will include a link to the location on the FINRA, ISE, CBOE or NYSE website where FINRA's, ISE's, CBOE's or NYSE's proposed rule change is posted. See id.

343 See, e.g., DirectEdge Exchanges Order, supra note 70, BATS Order, supra note 29, C2 Order, supra note 169, Nasdaq Order, supra note 29 and NOM Approval Order, supra note 164.

to Section 36 of the Act, from the rule filing requirements of Section 19(b) of the Act with respect to the rules that Topaz Exchange proposes to incorporate by reference. The exemption is conditioned upon Topaz Exchange providing written notice to Topaz Exchange members whenever FINRA, ISE, CBOE or NYSE proposes to change an incorporated by reference rule and when the Commission approves any such changes. The Commission believes that the exemption is appropriate in the public interest and consistent, with the protection of investors because it will promote more efficient use of Commission's and SROs' resources by avoiding duplicative rule filings based on simultaneous changes to identical rule text sought to be implemented by more than one SRO.

IV. Conclusion

IT IS ORDERED that the application of Topaz Exchange for registration as a national securities exchange be, and it hereby is, granted.

IT IS FURTHERED ORDERED that operation of Topaz Exchange is conditioned on the satisfaction of the requirements below:

A. Participation in National Market System Plans Relating to Options Trading. Topaz Exchange must join: (1) The Plan for the Reporting of Consolidated Options Last Sale Reports and Quotation Information (Options Price Reporting Authority); (2) the OLPP; (3) the Linkage Plan; and (4) the Plan of the Options Regulatory Surveillance Authority.

B. Participation in Multiparty Rule 17d-2 Plans. Topaz Exchange must become a party to the multiparty Rule 17d-2 agreements concerning options sales practice regulation and market surveillance.

C. Participation in the Options Clearing Corporation. Topaz Exchange must become an Options Clearing Corporation participant exchange.

D. Participation in the Intermarket Surveillance Group. Topaz Exchange must join the Intermarket Surveillance Group.

E. Effective Regulation. Topaz Exchange must have, and represent in a letter to the staff in the Commission's Office of Compliance Inspections and Examinations that it has, adequate procedures and programs in place to effectively regulate Topaz Exchange.

F. Trade Processing and Exchange Systems. Topaz Exchange must have, and represent in a letter to the staff in the Commission's Division of Trading and Markets that it has, adequate procedures and programs in place, as detailed in Commission Automation Policy Review guidelines, to effectively process trades and maintain the confidentiality, integrity, and availability of Topaz Exchange's systems.[344]

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[344] On November 16, 1989, the Commission published its first Automation Review Policy ("ARP I"), in which the Commission created a voluntary framework for SROs to establish comprehensive planning and assessment programs to determine systems capacity and vulnerability. On May 9, 1991, the Commission published its second Automation Review Policy ("ARP II") to clarify the types of review and reports expected from SROs. See Securities Exchange Act Release Nos. 27445 (November 16, 1989), 54 FR 48703 (November 24, 1989) and 29185 (May 9, 1991), 56 FR 22490 (May 15, 1991). The Commission has proposed Regulation Systems Compliance and Integrity, which, if adopted, would replace this policy. See Securities Exchange Act Release No. 69077 (March 8, 2013), 78 FR 18084 (March 25, 2013) (File No. S7-01-13).

IT IS FURTHER ORDERED, pursuant to Section 36 of the Act,[345] that Topaz Exchange shall be exempted from the rule filing requirements of Section 19(b) of the Act with respect to the FINRA, ISE, CBOE and NYSE rules that Topaz Exchange proposes to incorporate by reference, subject to the conditions specified in this Order that Topaz Exchange provide written notice to Topaz Exchange members whenever FINRA, ISE, CBOE or NYSE propose to change an incorporated by reference rule and when the Commission approves any such changes.

By the Commission.

Kevin M. O'Neill

Kevin M. O'Neill
Deputy Secretary

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[345] 15 U.S.C. 78mm.

Commissioner Paredes not participating

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Release No. 70044 / July 26, 2013

Admin. Proc. File No. 3-14208

In the Matter of

TZEMACH DAVID NETZER KOREM

OPINION OF THE COMMISSION

TRANSFER AGENT PROCEEDING

Grounds for Remedial Action

Civil Injunction

Former controlling principal of unregistered transfer agent was permanently enjoined from violating the antifraud provisions of the federal securities laws. *Held*, it is in the public interest to bar respondent from association with any transfer agent, broker, dealer, investment adviser, municipal securities dealer, municipal advisor, or nationally recognized statistical rating organization.

APPEARANCES:

Tzemach David Netzer Korem, pro se.

James M. Carlson, for the Division of Enforcement.

Appeal filed: September 6, 2011
Last brief received: October 24, 2011

I.

Respondent Tzemach David Netzer Korem has been enjoined from violating the antifraud provisions of the federal securities laws[1] and criminally convicted of conspiracy to commit securities fraud.[2] Korem appeals from a follow-on administrative proceeding in which an administrative law judge barred him from associating with any transfer agent.[3] Korem asserts that the bar is unwarranted. The Division of Enforcement cross-appealed, arguing that Korem also should be barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, or nationally recognized statistical rating organization.

We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal. Consistent with our recently issued decision in *John W. Lawton*,[4] we find that it is in the public interest, based on the facts of this case, not only to bar Korem from associating with any transfer agent but also to bar him from associating with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, or nationally recognized statistical rating organization.

II.

A. The Market Manipulation Scheme and the Civil Injunctive Action that Followed

Korem was the controlling principal of First Public Securities Transfer Corp., an unregistered transfer agent. First Public Securities Transfer Corp. served as the transfer agent for ZNext Mining Corporation, Inc., an international mining company engaged in the exploration and development of new and underdeveloped mine sites. ZNext's common stock was quoted in the "Pink Sheets."[5]

Korem owned or controlled over one million shares of ZNext's penny stock. In December 2009, he and Jean R. Charbit, a stock promoter who also owned shares of ZNext, devised a classic "pump and dump" scheme.[6] Their plan was to falsely generate the appearance of market interest in the company's stock, induce the unsuspecting public to invest at ever increasing prices, and sell their own shares into the rising market.

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1 *SEC v. Charbit*, Civil Action No. 10-CV-23604 (S.D. Fla. Dec. 17, 2010).

2 *United States v. Korem*, No. 1:10-cr-20732-UU (S.D. Fla. Feb. 10, 2011).

3 *Tzemach David Netzer Korem*, Admin. Proc. File No. 3-14208, 2011 WL 3407850, at *5 (Aug. 5, 2011).

4 Investment Advisers Act Release No. 3513, 2012 WL 6208750 (Dec. 13, 2012).

5 The Pink Sheets, now known as OTC Markets Group, Inc. with three operating systems that include OTCQX, OTCQB, and OTC Pink, is an electronic inter-dealer quotation system. http://www.otcmarkets.com/about/otc-markets-history (last visited Feb. 14, 2013).

6 *See, e.g.*, *SEC v. Cavanagh*, 445 F.3d 105, 107 (2d Cir. 2006); *United States v. Salmonese*, 352 F.3d 608, 612 (2d Cir. 2003).

As part of that scheme, Korem and Charbit agreed in January 2010 to pay a kickback of cash and ZNext stock to a purportedly corrupt stock broker. In exchange, the stock broker agreed to buy $300,000 worth of ZNext stock through client accounts over which he had discretionary trading authority. Those purchases were to take place over the course of several weeks. Unbeknownst to Korem and Charbit, however, the stock broker was an undercover agent with the Federal Bureau of Investigation working a "sting" operation.

Also unbeknownst to Korem and Charbit, an FBI informant posed as an intermediary for the stock broker. The informant told the two that "there would be a problem if the broker's superiors or the Commission discovered the kickback."[7] So to make it less detectable, Korem and Charbit decided to disguise the payments. On January 8, 2010, Charbit handed $3,000 in cash to the intermediary, who was to pay the stock broker. That same day, Korem, acting on behalf of First Public Securities Transfer Corp., issued a stock certificate for $100,000 worth of ZNext stock in the name of the stock broker's purported girlfriend. Charbit also gave the intermediary a ZNext press release that Korem "designed . . . to mask any spike in trading volume caused by the broker's [upcoming] purchase."[8] The press release stated that ZNext would be fast-tracking its gold mining activities to take advantage of rising gold prices.

On January 14, ZNext issued a press release that was nearly identical to the one Korem designed. On January 15, the FBI agent posing as a stock broker bought 25,000 shares of ZNext stock for $1,000. On January 16, the intermediary told Charbit that the stock broker would no longer participate in the scheme, ostensibly because his compliance officer had questioned the trade. Law enforcement ended the sting operation shortly thereafter.

In October 2010, the Commission filed a complaint against Korem and Charbit in the United States District Court for the Southern District of Florida.[9] The complaint, as amended on November 18, 2010, alleged that Korem violated § 17(a) of the Securities Act of 1933, § 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder.[10] Korem agreed to settle the matter, and on December 17, the court enjoined him from violating the antifraud provisions of the federal securities laws, barred Korem from participating in any offering of penny stock, and imposed a civil penalty (the amount of which was to be determined by the court at a later date).[11]

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7 *SEC v. Charbit*, Civil Action No. 10-CV-23604, First Am. Injunctive Compl. at 5 (S.D. Fla. Nov. 18, 2010).

8 *Id.*

9 *SEC v. Charbit*, Civil Action No. 10-CV-23604, Injunctive Compl. (S.D. Fla. Oct. 7, 2010). Subsequently, Charbit consented to an injunction against violating the antifraud provisions of the federal securities laws, and agreed to a penny stock bar and a civil monetary penalty. *Id.* (S.D. Fla. Feb. 22, 2011). Pursuant to SEC Rule of Practice 323, 17 C.F.R. § 201.323, we take official notice of this order, all other final orders issued by the district court in this proceeding, and the related criminal action discussed below.

10 15 U.S.C. §§ 77q(a), 78j(b); 17 C.F.R. § 240.10b-5.

11 *SEC v. Charbit*, Civil Action No. 10-CV-23604 (S.D. Fla. Dec. 17, 2010). Although the amount of the civil penalty was to be determined by the court "upon motion of the Commission," *id.* at 3, the Commission subsequently

(continued...)

As part of that settlement, Korem expressly agreed not to contest the factual allegations of the complaint in any later disciplinary proceeding based on the injunction.[12] He also expressly acknowledged that the permanent injunction could have collateral consequences.[13]

B. Korem's Criminal Conviction

On November 12, 2010, Korem signed a plea agreement in connection with a parallel criminal case pursued by the United States Attorney's Office for the Southern District of Florida.[14] In that agreement, Korem admitted that he conspired with Charbit to manipulate the publicly quoted price of ZNext stock from four cents to fifty cents per share.[15] Korem, Charbit, and others made or planned to make timed press releases to give the investing public the false and misleading impression that the broker's buying activity was induced by positive news about ZNext, rather than the undisclosed kickback.[16] While the conspiracy was halted by law enforcement officials before it resulted in actual losses to victims, Korem and the others acted with the specific intent of defrauding investors out of more than $300,000.[17]

On February 10, 2011, a federal district court found Korem guilty of conspiracy to commit securities fraud.[18] It sentenced Korem to twenty-four months in prison, to be followed by three years of supervised release.[19] As a condition of his supervised release, Korem must obtain written

(...continued)
filed a notice of voluntary dismissal of its claims for civil penalties against Korem and Charbit. *Id.* (S.D. Fla. June 14, 2011).

12 *SEC v. Charbit*, Civil Action No. 10-CV-23604, Consent of Defendant Tzemach David Netzer Korem at ¶¶ 11-12 (S.D. Fla. Dec. 10, 2010). Specifically, his consent stated that,

> in any disciplinary proceeding before the Commission based on the entry of the injunction in this action, Korem understands that he shall not be permitted to contest the factual allegations of the Amended Complaint in this action. . . . Korem understands and agrees to comply with the Commission's policy "not to permit a defendant or respondent to consent to a judgment or order that imposes a sanction while denying the allegation in the complaint or order for proceedings." 17 C.F.R. § 202.5. In compliance with this policy, Korem agrees . . . not to take any action or to make or permit to be made any public statement denying, directly or indirectly, any allegation in the Amended Complaint or creating the impression that the Amended Complaint is without factual basis . . . .

Id.

13 *Id.* at ¶ 11.

14 *United States v. Korem*, Crim. Action No. 10-20732-CR-UU (S.D. Fla. Nov. 18, 2010).

15 *Id.* at 10.

16 *Id.*

17 *Id.*

18 *United States v. Korem*, Crim. Action No. 10-20732-CR-UU (S.D. Fla. Feb. 10, 2011).

19 *Id.* at 2-3.

approval from the court before entering into any self-employment, and he is prohibited from penny stock trading.[20]

C. The Follow-On Administrative Proceeding

On January 28, 2011, we initiated this follow-on administrative proceeding against Korem, pursuant to Exchange Act § 17A(c)(4)(C), to determine whether he had been enjoined from, among other things, violating the antifraud provisions of the securities laws and, if so, what (if any) remedial action was appropriate in the public interest.[21] On August 5, 2011, the law judge granted the Division of Enforcement's motion for summary disposition pursuant to Commission Rule of Practice 250,[22] agreeing there was no dispute that Korem had been enjoined from violating various provisions of the federal securities laws.[23] The law judge found that Korem's conduct "was egregious and recent, but short-lived, having been stopped by law enforcement."[24] She also found that Korem's antifraud violations and criminal conviction evidenced a "high degree of scienter."[25] Although the law judge found that "Korem has acknowledged the wrongful nature of his conduct and vowed not to repeat it or to work in the securities industry again," she determined that Korem "would be free to resume association with a transfer agent absent a bar."[26] Accordingly, the law judge found it to be in the public interest to bar Korem from associating with any transfer agent. She rejected the Division's request to impose collateral bars from associating with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, or nationally recognized statistical rating organization. In so doing, she noted that the conduct upon which the injunction was based occurred before Congress authorized the Commission to impose collateral bars under § 925 of the Dodd-Frank Act. Because at the time the law judge entered her order "[n]either the Commission nor the courts ha[d] approved such retroactive application of [Section 925's] provisions in any litigated case," she declined to impose collateral bars on Korem.[27]

Korem appealed the sanction imposed. The Division cross-appealed the law judge's decision not to impose a full collateral bar.

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20 *Id.*

21 *Tzemach David Netzer Korem*, Exchange Act Release No. 63788, 2011 WL 281606 (Jan. 28, 2011).

22 17 C.F.R. § 201.250.

23 *Korem*, 2011 WL 3407850, at *1.

24 *Id.* at *5.

25 *Id.*

26 *Id.*

27 *Id.* at *4 n.6.

III.

A. The Imposition of a Bar in All Capacities Is Appropriate.

Exchange Act § 17A(c)(4)(C) authorizes us to censure, place limitations on, suspend, or bar any person who is permanently enjoined from engaging in any conduct or practice in connection with the purchase or sale of securities and who was associated with or seeking association with a transfer agent "at the time of the alleged misconduct."[28] The record establishes—and Korem does not contest—that Korem is enjoined from engaging in fraudulent conduct in connection with the purchase or sale of securities. During the events at issue, Korem was also the controlling principal of First Public Securities Transfer Corp. and directly engaged in the performance of its functions as a transfer agent. He therefore was an associated person of a transfer agent at the time of his misconduct.[29] We find that the statutory requirements for the imposition of remedial sanctions have been satisfied.

We next turn to assessing what additional sanctions, if any, are in the public interest. Among other things, we consider 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 conduct, and the likelihood that the respondent's occupation will present opportunities for future violations.[30] Our "inquiry into . . . the public interest is a flexible one, and no one factor is dispositive."[31] Based on these factors, and under the facts of this case, we conclude that a bar from association with any transfer agent, broker, dealer, investment adviser, municipal securities dealer, municipal advisor, or NRSRO is warranted.

Korem's actions were egregious. Market manipulation—which Korem was intent on achieving—is one of the most egregious securities law violations.[32] It "'attacks the very foundation

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28 15 U.S.C. § 78q-1(c)(4)(C). The same sanctions may also be imposed against such person if he has been convicted of a felony or misdemeanor within the past ten years, if the Commission also finds that the offense involved (among other things) the purchase or sale of a security. *Id.* Korem's criminal conviction occurred after the issuance of the OIP, which relied only upon the civil injunctive action as its predicate.

29 Exchange Act § 3(a)(49), 15 U.S.C. § 78c(a)(49) (defining the terms "person associated with a transfer agent" and "associated person of a transfer agent" as any person directly engaged in the management, direction, supervision, or performance of any of the transfer agent's activities with respect to transfer agent functions, and any person directly or indirectly controlling such activities or controlled by the transfer agent in connection with such activities).

30 *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981).

31 *David Henry Disraeli*, Exchange Act Release No. 57027, 2007 WL 4481515, at *15 (Dec. 21, 2007), *petition denied*, 334 F. App'x 334 (D.C. Cir. 2009) (per curiam).

32 *See Robert J. Prager*, Exchange Act Release No. 51974, 2005 WL 1584983, at *14 & n.63 (July 6, 2005) (noting that manipulation is a "very grave violation," and that its elimination is "one of the central goals of the federal securities laws") (citing *R.B. Webster Inv., Inc.*, Exchange Act Release No. 34659, 51 SEC 1269, 1994 WL 512475, at *6 (Sept. 13, 1994)).

(continued...)

and integrity of the free market system'" and "'runs counter to the basic objectives of the securities laws.'"[33]

Market manipulation is "virtually a term of art [when] used in connection with securities markets, [and] connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."[34] It refers to practices that are intended to mislead investors—such as "rigged prices"—by artificially affecting market activity.[35] It subverts the goals of the Exchange Act, which are intended to "insure the maintenance of fair and honest markets"[36]—that is, "markets where prices may be established by the free and honest balancing of investment demand with investment supply."[37] Where trading injects elements of artificiality into the market, the market has been fabricated. As we have previously stated:

> Actual buying with the design to create activity, prevent price falls, or raise prices for the purpose of inducing others to buy is to distort the character of the market as a reflection of the combined judgments of buyers and sellers, and to make of it a stage-managed performance.[38]

Having consented to a permanent injunction, and pleaded guilty to parallel criminal charges, Korem cannot challenge the injunction or criminal conviction in this proceeding.[39] We

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Exchange Act § 9(a)(2), which prohibits the manipulation of prices of securities listed for trading on a national exchange, was considered by Congress to be "the very heart of the act," and its purpose was to outlaw every device "used to persuade the public that activity in a security is the reflection of a genuine demand instead of a mirage." *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 794 (2d Cir. 1970) (citing 3 L. LOSS, SECURITIES REGULATION 1549-55 (2d ed. 1961)). The manipulative activities expressly prohibited by § 9(a) for listed securities are violations of Exchange Act § 10(b) [15 U.S.C. § 78j(b)], and Rule 10b-5 promulgated thereunder [17 C.F.R. § 240.10b-5], when done with respect to an over-the-counter security. *See, e.g., United States v. Charnay*, 537 F.2d 341, 350-51 (9th Cir.1976); *SEC v. Resch-Cassin & Co.*, 362 F. Supp. 964, 975 (S.D.N.Y. 1973); *Edward J. Mawod & Co.*, Exchange Act Release No. 13512, 46 SEC 865, 1977 WL 173385, at *4 (May 6,1977), *aff'd sub nom. Edward J. Mawod & Co. v. SEC*, 591 F.2d 588 (10th Cir. 1979).

33 *Terrance Yoshikawa*, Exchange Act Release No. 53731, 2006 WL 1113518, at *8 (Apr. 26, 2006) (quoting *Pagel, Inc.*, 1985 WL 548387, at *7).

34 *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1975).

35 *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977). Put another way, market manipulation is "the creation of deceptive value or market activity for a security, accomplished by an intentional interference with the free forces of supply and demand." *Swartwood, Hesse, Inc.*, Exchange Act Release No. 31212, 50 SEC 1301, 1992 WL 252184, at *5 (Sept. 22, 1992). *Accord Pagel, Inc.*, 1985 WL 548387, at *3.

36 15 U.S.C. § 78b.

37 *Secs. Exch. Bill of 1934*, H.R. REP. No. 73-1383, at 11 (1934).

38 *Halsey, Stuart & Co.*, Exchange Act Release No. 4310, 30 SEC 106, 1949 WL 36458, at *4 (Sept. 21, 1949). *Accord Pagel, Inc.*, 1985 WL 548387, at *3.

39 *Joseph P. Galluzzi*, Exchange Act Release No. 46405, 55 SEC 1110, 2002 WL 1941502, at *3 (Aug. 23, 2002) (finding that a party cannot challenge his injunction or criminal conviction in a subsequent administrative proceeding); *[...]d Harold Westerfield*, Exchange Act Release No. 41126, 54 SEC 25, 1999 WL 100954, at *4 n.22 (Mar. 1, 1999)

(continued...)

have previously held that "antifraud injunctions merit the most stringent sanctions and that our 'foremost consideration must . . . be whether [the] sanction protects the trading public from further harm.'"[40] To that end, we have said that an antifraud injunction "has especially serious implications for the public interest."[41] Ordinarily, and in the absence of evidence to the contrary, it is in the public interest to bar a respondent who is enjoined from violating the antifraud provisions.[42]

Korem asserts that "this case falls short of the meaning of egregious" because "there was no harm or loss, nor could there have been," given that the scheme was "one short-lived event" and part of a "sting operation."[43] We disagree. Although the record does not contain evidence of direct investor harm, "our focus is on the welfare of investors generally and the threat one poses to investors and the markets in the future."[44] Korem participated in a fraudulent scheme to falsely generate the appearance of market interest in ZNext's stock and to obtain personal financial gain by selling his shares in the company at an artificially inflated price. His failure to achieve the goals of that fraud does not mitigate the fact that he attempted to perpetrate a serious crime that was thwarted only because law enforcement intervened.

(...continued)
(same); *Demitrios Julius Shiva*, Exchange Act Release No. 38389, 52 SEC 1247, 1997 WL 112328, at *2 (Mar. 12, 1997) (rejecting attempts to challenge basis for injunction, noting "we have long refused to permit a respondent to re-litigate issues that were addressed in a previous civil proceeding against the respondent"); 17 C.F.R. § 202.5(e) (stating that respondent who consents to judgment may not deny allegations of the complaint).

We may consider Korem's criminal conviction in assessing sanctions even though it was not charged in the OIP. *Don Warner Reinhard*, Exchange Act Release No. 63720, 2011 WL 121451, at *5 & n.21(Jan. 14, 2011) (considering in a follow-on administrative proceeding respondent's criminal conviction, which was not included in the OIP, in assessing the public interest) (citing *Robert Bruce Lohmann*, Exchange Act Release No. 48092, 56 SEC 573, 2003 WL 21468604, at *5 & n.20 (June 26, 2003) (finding that matters "not charged in the OIP" may nevertheless be considered "in assessing sanctions")).

40 *Sherwin Brown*, Advisers Act Release No. 3217, 2011 WL 2433279, at *6 & n.18 (June 17, 2011) (citing *James C. Dawson*, Advisers Act Release No. 3057, 2010 WL 2886183, at *6 (July 23, 2010)).

41 *Marshall E. Melton*, Advisers Act Release No. 2151, 56 SEC 695, 2003 WL 21729839, at *9 (July 25, 2003).

42 *Id.*

43 Korem's Opp'n Br. at 10; Korem's Pet. for Review at 1; Korem's Br. in Supp. at 1, 2. Korem objects to the "version of the facts" in his criminal plea agreement regarding the FBI's undercover operation and suggests that we instead consider the facts presented in the criminal complaint, "which makes more clear that there were no real stock brokers with 'discretionary clients' involved in the sting operation." Korem's Pet. for Review at 2. Korem is collaterally estopped from attacking the facts underlying his conviction. *See supra* note 39. He also expressly waived his right to collaterally attack the conviction. *United States v. Korem*, Crim. Action No. 10-20732-CR-UU, ¶ 14 (S.D. Fla. Nov. 18, 2010). Moreover, we do not find that the two documents differ on this point to any significant degree. In any event, we have relied primarily on the facts set forth in the injunctive complaint as the basis for our findings. To the extent that Korem disputes the facts in the injunctive complaint, he is collaterally estopped from doing so. *Supra* note 39.

44 *Gary M. Kornman*, Exchange Act Release No. 59403, 2009 WL 367635, at *9 n.41 (Feb. 13, 2009) (citing *Christopher A. Lowry*, Advisers Act Release No. 2052, 55 SEC 1133, 2002 WL 1997959, at * 6 (Aug. 30, 2002), *aff'd*, 340 F.3d 501 (8th Cir. 2003); *Arthur Lipper Corp.*, Exchange Act Release No. 11773, 46 SEC 78, 1975 WL 163472, at *15 (Oct. 24, 1975), *aff'd*, 547 F.2d 171 (2d Cir. 1976)).

Solely because of this intervention, Korem's misconduct was short-lived. Though we consider "the isolated or recurrent nature of the infraction" when deciding whether it is in the public interest to order additional sanctions, we have repeatedly declined to credit a respondent whose misconduct stopped only after it was detected by regulators.[45] Thus, the fact that Korem's misconduct was of limited duration carries little weight given that law enforcement ended the scheme. Had it not been a sting operation, Korem could have seen the scheme through to its conclusion with great harm to the investing public. Moreover, while Korem's misconduct took place during a compressed period of time, the various steps Korem took within that period to advance the scheme demonstrate that it was not the product of a momentary lapse in judgment, nor done without deliberate thought.[46]

Korem's role in the plot also demonstrates that he acted with a high degree of scienter. The Securities Act § 17(a)(1), Exchange Act § 10(b), and Rule 10b-5 charges underlying the judgment to which Korem consented, required knowing, willful, or, at the very least, reckless conduct.[47] His efforts to conceal his misconduct further demonstrate that he acted with intent.[48] Upon learning of the stock broker's concerns about receiving the stock portion of kickback directly, Korem disguised that payment by issuing $100,000 worth of ZNext stock in the name of the broker's purported girlfriend. Korem then designed a false press release, which ZNext issued, to mask any spike in trading volume caused by the broker's purchase.

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45 *Cf. Gregory O. Trautman*, Exchange Act Release No. 61167A, 2009 WL 6761741, at *20 (Dec. 15, 2009) (considering the nature of the infraction and finding against respondent where misconduct stopped only after it was detected by regulators); *Joseph John VanCook*, Exchange Act Release No. 61039, 2009 WL 4005083, at *15 (Nov. 20, 2009) (same) *petition denied*, 653 F.3d 130 (2d Cir. 2011); *Ofirfan Mohammed Amanat*, Exchange Act Release No. 54708, 2006 WL3199181, at *10 (Nov. 3, 2006) (same).

46 *See United States v. Chaplin's, Inc.*, 646 F.3d 846, 853 (11th Cir. 2011). After devising the overall scheme, Korem and Charbit devoted significant effort towards the logistics of making it work. This included kickback payments to the perceived accomplice, and modifications to those payments to better avoid detection (such as issuing $100,000 worth of stock certificates in the name of the stock broker's purported girlfriend and the preparation of a bogus press release to justify the purchases).

47 *Aaron v. SEC*, 446 U.S. 680, 695-97 (1980). A finding of recklessness satisfies the scienter requirement. *Disraeli*, 2007 WL 4481515, at *5 (finding that "violations of Section 17(a)(1), Section 10(b), and Rule 10b-5 require scienter" and that " [s]cienter may be established by recklessness, defined as ... an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the [actor] or is so obvious that the actor must have been aware of it") (citing *SEC v. Dain Rauscher, Inc.*, 254 F.3d 852, 856 (9th Cir. 2001); *SEC v. Rubera*, 350 F.3d 1084, 1094 (9th Cir. 2003); *accord Rockies Fund, Inc. v. SEC*, 428 F.3d 1088, 1093 (D.C. Cir. 2005); *SEC v. Infinity Group Co.*, 212 F.3d 180, 192 (3d Cir. 2000); *SEC v. McNulty*, 137 F.3d 732, 741 (2d Cir. 1998); *Meadows v. SEC*, 119 F.3d 1219, 1226 (5th Cir. 1997); *SEC v. Carriba Air, Inc.*, 681 F.2d 1318, 1324 (11th Cir. 1982)). Korem also agreed to be enjoined from future violations of Securities Act §§ 17(a)(2) and 17(a)(3), 15 U.S.C. §§ 77q(a)(2) and 77q(a)(3), where proof of scienter is not an element. *Aaron*, 446 U.S. at 695-97.

48 *See Phillip J. Milligan*, Exchange Act Release No. 61790, 2010 WL 1143088, at *5 & n.20 (Mar. 26, 2010) (citing *Justin F. Ficken*, Exchange Act Release No. 58802, 2008 WL 4610345, at *3 (Oct. 17, 2008) (finding that concealment of improper trading demonstrated scienter)).

Korem acknowledged the wrongful nature of his past conduct and took responsibility for it by settling the earlier parallel case pursued by the U.S. Attorney's Office.[49] And although Korem vowed never to repeat his misdeeds or work in the securities industry again, his past criminal history, the degree of scienter involved in the misconduct at issue, and his efforts to conceal his misconduct cause us concern about the sincerity of Korem's assurances.[50] Korem's statement that his "track record of exiting an industry after being convicted in it, demonstrates that [he] will not enter into the securities industry in the future since he has been convicted in that industry"[51] does little to dispel that concern. If, however, Korem's promise to remain out of the securities industry is sincere, a bar imposes no substantial burden on him while prophylactically protecting the investing public.

Given the nature of Korem's misconduct, we believe that an appropriate sanction should include a bar from associating with any transfer agent and collateral bars from associating with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, or NRSRO. Korem's deliberate attempt to deceive the investing public by manipulating the market for his own personal gain and concealing his fraudulent actions raises significant doubts about his integrity and his fitness to remain in the securities industry in any capacity.[52] As we have stated, "[t]he securities industry presents continual opportunities for dishonesty and abuse, and depends heavily on the integrity of its participants and on investors' confidence."[53] A fundamental purpose common to all federal securities laws and, in turn, applicable to all securities professionals bound by them, is "to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry."[54] It is therefore essential that the "highest ethical standards prevail in every facet of the securities industry."[55]

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49 *See, e.g.*, Korem's Br. in Supp. at 1; Korem's Pet. for Review at 2.

50 Courts have held that the existence of a past violation, without more, is not a sufficient basis for imposing a bar. *Lawton*, 2012 WL 6208750, at *9 & n.42 (citing *McCarthy*, 406 F.3d 179, 189 (2d Cir. 2005); *PAZ Sec., Inc. v. SEC*, 566 F.3d 1172, 1175-76 (D.C. Cir. 2009)). In this proceeding, however, we consider past conduct as evidence in a "broader inquiry into whether a person presents a future risk to the public interest because, as the Supreme Court has recognized, the 'degree of intentional wrongdoing evident in a defendant's past conduct' is an important indication of the defendant's propensity to subject the trading public to future harm." *Id.* (citing *Aaron v. SEC*, 446 U.S. 680, 701 (1980)). "[T]he existence of a violation raises an inference that it will be repeated." *Geiger v. SEC*, 363 F.3d 481, 489 (D.C.Cir. 2004).

51 Korem's Opp'n Br. at 7.

52 *See Dawson*, 2010 WL 2886183, at *6 (finding that respondent's antifraud injunction, which was based on allegations involving efforts to conceal misconduct, raised "significant doubts about his integrity and his fitness to remain in the securities industry").

53 *Conrad P. Seghers*, Advisers Act Release No. 2656, 2007 WL 2790633, at *7 (Sept. 26, 2007); *see also Paul K. Grassi, Jr.*, Exchange Act Release No. 52858, 2005 WL 3199274, at *3 (Nov. 30, 2005); *Frank Kufrovich*, Exchange Act Release No. 45437, 55 SEC 616, 2002 WL 215446, at *5 (Feb. 13, 2002); *William F. Lincoln*, Exchange Act Release No. 39629, 53 SEC 452, 1998 WL 80228, at *7 (Feb. 9, 1998); *Philip S. Wilson*, Exchange Act Release No. 23348, 48 SEC 511, 1986 WL 626145, at *5 (June 19, 1986); *Walter H. T. Seager*, Exchange Act Release No. 20831, 47 SEC 1040, 1984 WL 589596, at *3 (Apr. 6, 1984).

54 *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963).

55 *Id.* at 186-87 (internal citation omitted).

Korem's violations were neither technical in nature nor based solely on his status as a transfer agent. The antifraud provisions that he violated apply broadly to the conduct of all participants in the securities industry. Broker-dealers and municipal securities dealers, like transfer agents, "routinely gain access to sensitive financial and investment information about investors and other market participants."[56] Investment advisers, municipal advisors, and NRSROs "routinely learn confidential and potentially market-moving information about securities, issuers, and potential transactions."[57] Securities professionals have a heightened responsibility to safeguard such information and not to misuse their access to sensitive or confidential information for their own financial gain.[58] The deliberate manner in which Korem flouted this responsibility suggests that he is likely to engage in future misconduct that "strikes at the heart of the pricing process on which all investors rely."[59]

B. Imposing a Full Collateral Bar Is Not Impermissibly Retroactive.

The law judge's pre-*Lawton* ruling that barring Korem from associating with a broker, dealer, investment adviser, municipal securities dealer, municipal advisor, or NRSRO would be impermissibly retroactive is erroneous for the reasons we explained in *Lawton*.[60] The Dodd-Frank Act amended Exchange Act § 17A(c)(4)(C) to authorize us to bar persons associated with or seeking association with a transfer agent from association with a broker, dealer, investment adviser, municipal securities dealer, municipal advisor, or NRSRO—bars that were not previously available under the securities laws.[61] Although Congress enacted the Dodd-Frank amendment after Korem committed his misconduct, we held in *Lawton* that such collateral bars "are not impermissibly retroactive as applied in follow-on proceedings addressing pre-Dodd-Frank conduct because such bars are prospective remedies whose purpose is to protect the investing public from future harm."[62] Korem's conduct, as detailed above, "demonstrates that allowing him

56 *Lawton*, 2012 WL 6208750, at *11.

57 *Id.*

58 *Id.*

59 *Michael J. Markowski*, Exchange Act Release No. 43259, 54 SEC 830, 2000 WL 1264292, at *6 (Sept. 7, 2000) (citation omitted) (holding that deliberate manipulation of the market is "serious" misconduct that "strikes at the heart of the pricing process on which all investors rely"), *aff'd*, 274 F.3d 525 (D.C. Cir. 2001). Moreover, Korem, by his own admission, has a criminal history dating back to the 1980s that compounds our concerns about his integrity and fitness and demonstrates that he poses a substantial threat to investors.

60 *Lawton*, 2012 WL 6208750, at *5-10.

61 Prior to the Dodd-Frank Act, in an administrative proceeding pursuant to Exchange Act § 17A(c)(4)(C), the Commission could suspend or bar respondents only from association with a transfer agent. Dodd-Frank expanded the relief available under Exchange Act § 17A(c)(4)(C), 15 U.S.C. § 78q-1(c)(4)(C).

Lawton, 2012 WL 6208750, at *10.

to enter the securities industry in *any capacity* would create too great a risk that future efforts to detect securities violations would be impaired, causing harm to the public."[63]

C. Korem's Remaining Objections Have No Merit.

Korem asserts that the Commission lacks the authority to bar him—in any capacity—because his "past association never involved registered securities, nor any role that required registration" as a transfer agent.[64] Exchange Act § 17A(c)(4)(C) authorizes the Commission to proceed against "any person associated, seeking to become associated, or, at the time of the alleged misconduct, associated or seeking to become associated with the transfer agent" without reference to whether the associated person or transfer agent is registered with the Commission.[65] When Congress amended Exchange Act § 17A to include paragraph (c)(4)(C), it vested the Commission with "administrative adjudicatory authority [over transfer agents in follow-on administrative proceedings] comparable to that applicable to brokers, dealers, municipal securities dealers, and investment advisers."[66] As a result,

> [t]he grounds for instituting proceedings against, and imposing sanctions on, associated persons of transfer agents [are] the same as those applicable to other securities professionals, including violations of the securities laws and convictions and injunctions relating to financial services industry activities. The available sanctions also [are] the same—bar, suspension, censure, and placing of limitations on the activities of the transfer agent professional.[67]

It is well established that we are authorized to sanction an associated person of an unregistered broker-dealer or investment adviser in a follow-on administrative proceeding.[68] We

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63 *Id.* at *12 (emphasis in original) (imposing bar in a follow-on proceeding against investment adviser from association with investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization).

64 Korem's Pet. for Review at 1-2.

65 15 U.S.C. § 78q-1(c)(4)(C).

66 *SEC Authorization Act of 1987, Report of the Senate Comm. on Banking, Housing, and Urban Affairs*, S. REP. NO. 105, 100th Cong., 1st Sess. 19 (1987) (citing Exchange Act §§ 15(b)(4) and (6), 15 U.S.C. §§ 78o(b)(4) and (6); Exchange Act §§ 15B(c)(2) and (4), 15 U.S.C. §§ 78o-4(c)(2) and (4); and §§ 203(e) and (f) of the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-3(e) and (f)).

67 *Id.* at 20.

68 *See, e.g., Martin A. Armstrong*, Advisers Act Release No. 2926, 2009 WL 2972498, at *3 & n.7 (Sept. 17, 2009) (barring, pursuant to Investment Advisers Act §§ 203(e) and (f), an associated person of an unregistered investment adviser from associating with any investment adviser, based on conviction and injunction regarding securities laws violations) (citing *Teicher v. SEC*, 177 F.3d 1016, 1017 (D.C. Cir. 1999)); *Vladislav Steven Zubkis*, Exchange Act Release No. 52876, 2005 WL 3299148, at *6 (Dec. 2, 2005) (barring, pursuant to Exchange Act § 15(b)(6)(A), an associated person of an unregistered broker-dealer from associating with any broker-dealer and from participating in any penny stock offering, based on injunction prohibiting securities laws violations); *Alexander V. Stein*, Advisers Act Release No. 1497, 52 SEC 296, 1995 WL 358127, at *2 & n.10 (June 8, 1995) (finding that the Commission's authority to institute follow-on administrative proceedings under § 203(f) of the Investment Advisers Act rests on

(continued...)

find, based on the plain language of the statute, its legislative history, and longstanding analogous precedent, that we are authorized to do the same with respect to persons associated with, or seeking association with, a transfer agent (and those who, at the time of the alleged misconduct, were associated with, or were seeking to become associated, with a transfer agent) regardless of the registration status of the transfer agent or respondent.

There also is no merit to Korem's contention that the securities at issue must be registered with the Commission for us to impose a sanction. Exchange Act §§ 17A(c)(4)(C) and 15(b)(4)(C) authorize the Commission to sanction an associated person of a transfer agent if that person has been permanently enjoined from engaging in any conduct or practice in connection with the purchase or sale of "*any* security."[69] Congress's use of such broad language shows its intent that the security in question need not be registered with the Commission. Moreover, Exchange Act § 3(a)(10) defines the term "security" to include any "stock" and contains no requirement that the stock be registered with the Commission.[70] We have also routinely imposed sanctions in follow-on proceedings, which have been affirmed by federal Courts of Appeals, where the violative conduct at issue involved unregistered securities.[71] Accordingly, the registration status of the security at issue in the underlying proceeding has no bearing on our authority under the statute.

Korem also appears to assert that a bar of any kind is redundant because he already is enjoined from engaging in any conduct related to the purchase or sale of any security, and the penny stock bar imposed by the district court precludes him from serving as an unregistered transfer agent given that "all of the securities in that arena are penny stocks."[72] The injunctive and criminal judgments, however, are not as broad as Korem suggests. While they bar him from participating in penny stock transactions, the injunction is otherwise limited to prohibiting him from violating certain antifraud provisions of the federal securities laws. Korem asserts that he does not intend to re-enter the securities industry or commit further violations. But we find that Korem's assertions do not outweigh the significant risk that he would commit additional misconduct in the future if we permitted him to remain in the securities industry in any capacity.

(...continued)
whether the respondent acted as an investment adviser regardless of respondent's registration status) (internal citations omitted); *John Kilpatrick*, Exchange Act Release No. 23251, 48 SEC 481, 1986 WL 626187, at *4 (May 19, 1986) (noting that § 15(b)(6) of the Exchange Act authorizes the Commission to sanction "any person associated . . . with a broker or dealer" without being limited to registered broker-dealers).

69 15 U.S.C. §§ 78q-1(c)(4)(C); 78o(b)(4)(C) (emphasis added).

70 15 U.S.C. § 78c(a)(10).

71 *Cf. James E. Franklin*, Exchange Act Release No. 56649, 2007 WL 2974200, at *8 (Oct. 12, 2007) (barring respondent, in a proceeding under Exchange Act § 15(b)(6), from participating in any penny stock offering based on, among other things, a finding that respondent was enjoined from any conduct or practice in connection with the purchase or sale of a security where at least one of the underlying securities was not registered), *petition denied*, 2008 U.S. App. LEXIS 15246 (D.C. Cir. 2008) (per curiam); *Conrad P. Seghers*, Advisers Act Release No. 2656, 2007 WL 2790633, at *1 & n.6 (Sept. 26, 2007) (barring respondent from association with any investment adviser based on injunction from violating federal securities laws where underlying securities were not registered or required to be registered), *petition denied*, 548 F.3d 129 (D.C. Cir. 2008).

Korem's Pet. for Review at 2.

Korem further objects to "any additional bar" because "it could serve as a tipping point against his ability to earn a living in a non-securities related-business" due to the effects of "greater tarnishment to his name."[73] However, the collateral bars we find warranted are not punitive but are imposed "to protect the public interest from future harm at his hands."[74] A bar from association with any transfer agent, broker, dealer, investment adviser, municipal securities dealer, municipal advisor, or NRSRO is remedial and will protect the public interest by deterring Korem and others from violating the provisions of the federal securities laws, misleading investors, and manipulating the market.

Korem additionally argues that *res judicata* prohibits the institution of this administrative proceeding because his case "was already wrapped up in settlement" in the federal court system.[75] We have rejected such arguments in the past because the Exchange Act expressly authorizes us to institute administrative proceedings based on an injunction.[76] Moreover, Korem does not satisfy the elements of a *res judicata* defense. *Res judicata*, or claim preclusion, "bars litigation of any claim for relief that was available in a prior suit between the same parties or their privies, whether or not the claim was actually litigated."[77] To sustain the defense, a party must establish: (i) a final judgment on the merits in a prior suit, (ii) an identity of the cause of action in both the earlier and the later suit, and (iii) an identity of parties or their privies in the two suits.[78] While a final judgment was entered in the injunctive action, the cause of action in that proceeding was predicated on Korem's fraudulent conduct whereas this proceeding was instituted on the basis of

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73 Korem's Pet. for Review at 1. For example, Korem asserts that "the term 'transfer agent' is found outside the securities business." *Id.* He argues that restricting him from association with "'any' transfer agent, would go beyond the SEC's jurisdiction." *Id.* Our authority to bar Korem from association with a transfer agent extends only so far as the relevant sections of the Exchange Act permit. *See* Exchange Act § 3(a)(25), 15 U.S.C. ' 78c(a)(25) (defining transfer agent as any person who engages on behalf of an issuer of securities or on behalf of itself as an issuer of securities in (i) countersigning such securities upon issuance; (ii) monitoring the issuance of such securities with a view to preventing unauthorized issuance, a function commonly performed by a person called a registrar; (iii) registering the transfer of such securities; (iv) exchanging or converting such securities; or (v) transferring record ownership of securities by bookkeeping entry without physical issuance of securities certificates); Exchange Act § 3(a)(49), *supra* note 29. The bars we are imposing extend only to activity within our statutory authority.

74 *Leo Glassman*, Exchange Act Release No. 11929, 46 SEC 209, 1975 WL 160418, at *2 (Dec. 16, 1975).

75 Korem's Pet. for Review at 1. Korem attached to his opposition brief a notice filed by the Division in the district court in which it voluntarily dismissed its claims for civil penalties against Korem and Charbit. *See supra* note 11. Korem states that "the SEC therein stated that ALL ISSUES ARE NOW RESOLVED" and that, as a result, "the doctrine of res judicata comes into full force and effect." Korem's Opp'n Br. at 1.

76 15 U.S.C. ' 78q-1(c)(4)(C); *see, e.g., Michael T. Studer*, Exchange Act Release No. 50411, 57 SEC 890, 2004 WL 2104496, at *3 (Sept. 20, 2004) (rejecting respondent's *res judicata* claim regarding the institution of administrative proceedings following a district court's entry of a permanent injunction where the Commission's authority to institute proceedings based on an injunction was expressly authorized in the Exchange Act).

77 *Kornman*, 2009 WL 367635, at *13 & n.83 (citing *Transaero, Inc. v. La Fuenza Aerea Boliviana*, 162 F.3d 724, 731 (2d Cir. 1998) (internal quotation marks and citation omitted)); *see also Parklane Hosiery Co., Inc. v. Shore*, 439 U.S. 322, 326-27 n.5 (1979).

78 *Kornman*, 2009 WL 367635, at *13 & n.84 (citing *Jones* v. SEC, 115 F.3d 1173, 1178 (4th Cir. 1997) (internal quotation marks and citations omitted)).

the injunction itself.[79] Indeed, the present proceeding is expressly authorized by Exchange Act § 17A(c)(4)(C).[80] Additionally, Korem acknowledged the possibility of an administrative proceeding when he consented to the entry of a permanent injunction. The consent, among other things, explicitly prohibits Korem from contesting the factual allegations of the complaint in the injunctive action "in any disciplinary proceeding before the Commission based on the entry of the injunction."[81]

Finally, Korem challenges the Commission's authority to bring this action based on the Double Jeopardy Clause of the Fifth Amendment of the United States Constitution. The Double Jeopardy Clause provides that no person shall "be subject for the same offense to be twice put in jeopardy of life or limb."[82] The Supreme Court has "held that the Double Jeopardy Clause does not protect against all additional sanctions 'that could, in common parlance, be described as punishment,' but 'only against . . . multiple criminal punishments for the same offense.'"[83] We have held that a bar imposed in an administrative proceeding is not a criminal punishment within the meaning of the Double Jeopardy Clause.[84]

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79 *See id.* at *13 & n.85 (finding that the basis for the criminal proceeding that resulted in a conviction was respondent's misconduct while the basis for the follow-on administrative proceeding was the criminal conviction itself, concluding that the two cause of actions differed) (citing *Lawlor v. Nat'l Screen Serv. Corp.*, 349 U.S. 322, 327-28 (1995) (holding that *res judicata* does not apply where claim advanced in the second suit did not exist at time of first suit)). *Accord Studer*, 2004 WL 2104496, at *3.

80 15 U.S.C. § 78q-1(c)(4)(C).

81 *SEC v. Charbit*, Civil Action No. 10-CV-23604, Consent of Defendant Tzemach David Netzer Korem at ¶¶ 11-12 (S.D. Fla. Dec. 10, 2010), *supra* n.12.

82 U.S. Const. Amend. V.

83 *Kornman*, 2009 WL 367635, at *12 & n.73 (citing *Hudson v. United States*, 522 U.S. 93, 98-99 (1997) (internal quotation marks omitted)).

84 *See id.* & n.75 (rejecting application of Double Jeopardy Clause to investment adviser bar following a criminal conviction on the basis that "no scienter finding is required, the sanction is remedial because it is designed to protect the public, and the sanction is not historically viewed as punishment," and that Congress intended to provide for a civil sanction given that it "confers authority solely on the Commission to institute follow-on administrative proceedings under" the Exchange Act) (citing *Cox v. CFTC*, 138 F.3d 268, 272 (7th Cir. 1998) (internal citations omitted)); *William F. Lincoln*, Exchange Act Release No. 39629, 53 SEC 452, 1998 WL 80228, at *4, 5 (Feb. 9, 1998) (concluding that a broker-dealer bar and penny stock bar are civil in nature and rejecting respondent's claim that the bars were criminal punishments within the meaning of the Double Jeopardy Clause)).

In sum, a bar from association with any transfer agent, broker, dealer, investment adviser, municipal securities dealer, municipal advisor, or NRSRO is remedial and will protect the public interest by deterring Korem and others from violating the provisions of the federal securities laws, misleading investors, and manipulating the market.

An appropriate order will issue.[85]

By the Commission (Chair WHITE and Commissioners WALTER and AGUILAR); Commissioner GALLAGHER, concurring in part and dissenting with respect to the bar from association with municipal advisors and nationally recognized statistical rating organizations; Commissioner PAREDES not participating.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

[85] We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are consistent 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
Release No. 70044 / July 26, 2013

Admin. Proc. File No. 3-14208

In the Matter of
TZEMACH DAVID NETZER KOREM

ORDER IMPOSING REMEDIAL SANCTIONS

On the basis of the Commission's Opinion issued this day, it is

ORDERED that Tzemach David Netzer Korem be barred from association with any transfer agent, broker, dealer, investment adviser, municipal securities dealer, municipal advisor, or nationally recognized statistical rating organization.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Paredes not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9435 / July 29, 2013

SECURITIES EXCHANGE ACT OF 1934
Release No. 70057 / July 29, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15391

In the Matter of **West Clark Community Schools,** **Respondent.**	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against the West Clark Community Schools ("School District").

II.

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

III.

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

Summary

1. In March 2005, in accordance with Rule 15c2-12 of the Exchange Act ("the Rule"),[2] the West Clark Community Schools contractually undertook to annually disclose certain financial information, operating data and event notices in connection with a $52 million municipal bond offering. In December 2007 the School District, in connection with a $31 million municipal bond offering, affirmatively stated in public bond offering documents that it had not failed, in the previous five years, to comply in all material respects with any prior disclosure undertakings. This statement, as well as a Certificate and Affidavit signed by the School District attesting that the offering documents did not contain any untrue statement of material fact, were materially false. In fact, between at least 2005 and 2010 the School District never submitted any of its contractually required disclosures.

2. As a result of the conduct described above, the School District violated Section 17(a)(2) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5(b) thereunder.

Respondent

3. West Clark Community Schools is a corporate entity and political subdivision, located in Clark County, Indiana, and formed under Indiana law. It employs approximately 400 staff at eight different schools to teach approximately 4,500 students. An elected, five member Board of School Trustees ("School Board") governs the School District.[3]

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

[2] Rule 15c2-12 prohibits, among other things and subject to certain exemptions, any underwriter from purchasing or selling municipal securities unless it has reasonably determined that the issuer of municipal securities, or an obligated person, has undertaken in a written agreement or contract, sometimes referred to as a Continuing Disclosure Agreement ("CDA"), to provide annual financial information and notices of certain material events ("Event Notices") to certain information repositories. An "obligated person" generally means any person or entity that is committed by contract or other arrangement to support payment of all or part of the obligations on the municipal securities being offered. The School District was an obligated person, and not the issuer, in the 2007 Offering. Additionally, Rule 15c2-12(f)(3) defines what information must be included in a final Official Statement. Among other things, this definition requires a description of the issuer's or obligated person's disclosure undertakings, as well as a description of any instances in the previous five years in which an issuer or obligated person failed to comply in all material respects with any previous disclosure undertakings.

[3] The Indiana State Constitution restricts the amount of debt Indiana school districts are allowed to incur. As a result, the Indiana legislature allows school districts to create distinct legal entities called "school building corporations," through which a school district can issue debt. These school building corporations are essentially shells, created and controlled by the school district for the limited purpose of providing funding for the benefit of the school district. In this matter, the School District offered bonds through its shell conduit issuer, the West Clark 2000

Related Entity

4. City Securities Corporation ("City Securities") is a broker-dealer headquartered in Indianapolis, Indiana, with approximately 200 employees and seven branch offices throughout Indiana. City Securities has been a registered broker-dealer with the Commission since 1936 and conducts a general securities business with an emphasis on the underwriting and sale of municipal securities by issuers located in the State of Indiana.

The School District's 2005 Municipal Bond Offering

5. In March 2005 the School District, using City Securities as its sole underwriter, publicly offered $52 million of municipal bonds ("2005 Offering").

6. Pursuant to Rule 15c2-12, the School District executed a Continuing Disclosure Agreement ("CDA") in connection with the 2005 Offering. As part of the CDA, the School District covenanted and agreed to, among other things, submit an annual report containing certain financial information and operating data to the appropriate national and state repositories, as well as timely notices of certain specified events pertaining to the bonds at issue.[4] Further, the School District contracted to submit notices in the event it was unable to provide the contractually required annual report.

7. The president of the School Board (now deceased) signed the CDA on behalf of the School District.

8. The School District received and reviewed various drafts of both the preliminary, and what ultimately became the final, Official Statement for the 2005 Offering. As required by Rule 15c2-12, the final Official Statement included a summary description of the provisions of the CDA. The School District authorized and approved the Official Statement for the 2005 Offering, which was then disseminated to the public in connection with the offer and sale of the bonds.

The School District's 2007 Municipal Bond Offering

9. In December 2007 the School District, again using City Securities as its sole underwriter, publicly offered $31 million of municipal bonds ("2007 Offering").

10. The School District again received and reviewed various drafts of both the preliminary, and what ultimately became the final, Official Statement for the 2007 Offering. The Official Statement for the 2007 Offering included a section titled "Compliance with Previous Undertakings" which read: "[i]n the previous five years, the School [District] has never failed to comply, in all material

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School Building Corporation ("Building Corporation"). Consequently, under Rule 15c2-12, the School District constitutes an obligated person with respect to the Building Corporation's municipal bond offerings.

[4] In December 2008, Rule 15c2-12 was amended to designate the Electronic Municipal Market Access system ("EMMA") as the central repository for ongoing disclosures by municipal issuers effective July 1, 2009.

respects, with any previous undertakings . . ." The School District, including the now-deceased president of the School Board, reviewed, authorized and approved the Official Statement for the 2007 Offering, which was then disseminated to the public.

11. The statement contained in the "Compliance with Previous Undertakings" section of the Official Statement for the 2007 Offering was materially false. Between 2005 and 2010, the School District never submitted any annual reports, or any notice of its failure to submit annual reports, as required under the terms of its CDAs.

12. In addition, at the closing for the 2007 Offering, the School District executed a Certificate and Affidavit, attesting that the 2007 Official Statement did not "contain any untrue statement of material fact or omit to state a material fact required to be stated therein or necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." Under the terms of the Bond Purchase Contract with City Securities, execution of the Certificate and Affidavit by the School District was a prerequisite to City Securities's obligation to purchase the 2007 Offering.

13. The now-deceased president of the School Board signed the Certificate and Affidavit on behalf of the School District.

14. The School District's assertions in the 2007 Certificate and Affidavit were materially false. As discussed above, the Official Statement for the 2007 Offering contained untrue statements of material fact.

15. The School District knew, or was reckless in not knowing, that it never submitted any of the reports, notices or disclosures required by the CDA. In addition, the School District either knew, or was reckless in not knowing, that the Official Statement for the 2007 Offering, and the Certificate and Affidavit signed in connection with the 2007 Offering, contained materially false information.

Legal Discussion

16. Municipal securities issuers, or obligated persons such as the School District, are subject to the antifraud provisions of the federal securities laws. Section 17(a)(2) of the Securities Act prohibits any person from, directly or indirectly, "obtain[ing] money or property by means of any untrue statement of a material fact" or misleading omissions. Section 10(b) and Rule 10b-5(b) of the Exchange Act prohibit the making of (1) a false statement or omission; (2) of material fact; (3) with scienter; (4) in connection with the purchase or sale of any security. *See* SEC v. McConville, 465 F.3d 780, 786 (7th Cir. 2006). A fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. *See* Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988). The Supreme Court has previously defined scienter as "a mental state embracing intent to deceive, manipulate or defraud." *Id.* Recklessness is sufficient to establish scienter under Section 10(b) and Rule 10b-5. Miller v. Champion Enter., Inc., 346 F.3d 660, 672 (6th Cir. 2003). "Recklessness" has been defined for purposes of liability under Section 10(b) of the Exchange Act as an "extreme departure from the standards of ordinary care, which

presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." McConville v. SEC, 465 F.3d 780, 788 (7th Cir. 2006), 2007 U.S. App. LEXIS 926 (Jan. 17, 2007). Section 17(a)(2) violations do not require proof of scienter. Aaron v. SEC, 446 U.S. 680, 697 (1980). There is a substantial likelihood that a reasonable investor determining whether to purchase the municipal securities would attach importance to the School District's failure to comply with its prior continuing disclosure undertakings

17. Rule 15c2-12 was adopted in an effort to improve the quality and timeliness of disclosures to investors in municipal securities. Disclosure of sound financial information is critical to the integrity of not just the primary market, but also the secondary markets for municipal securities.[5] Therefore, the Rule requires an underwriter to obtain a written agreement, for the benefit of the holders of the securities, in which the issuer undertakes (among other things) to annually submit certain financial information. Failure to provide such annual financial information is the type of information required to be disclosed to a customer by a broker-dealer and is a significant factor to be taken into account by a dealer in determining whether or not to recommend a security.[6]

18. In addition, it is important for investors and the market to know the scope of any ongoing disclosure undertakings, and the type of information to be provided. The Rule therefore requires that the undertakings provided pursuant to the Rule be described in the final Official Statement. This allows investors to ascertain whether the undertakings have been satisfied.[7]

19. Moreover, critical to any evaluation of an undertaking to make disclosures, is the likelihood that the issuer or obligated person will abide by the undertaking.[8] Therefore, the Rule requires disclosure in the final Official Statement of all instances in the previous five years in which any person providing an undertaking failed to comply in all material respects with any previous undertakings. This provides an incentive for issuers, or obligated persons, to comply with their undertakings, allowing underwriters, investors and others to assess the reliability of the disclosure representations.[9]

20. As a result of the conduct described above, the School District violated Section 17(a)(2) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5(b) thereunder.

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[5] *See* Securities Exchange Act Release No. 34-33741 (March 9, 1994), 59 FR 12748 (March 17, 1994) ("1994 Interpretive Release"), at 12752.

[6] *See* Securities Exchange Act Release No. 34-34961 (November 10, 1994), 59 FR 59590 (November 17, 1994) ("1994 Adopting Release"), at 59602-3.

[7] *See id.* at 59594.

[8] *See id.*

[9] *See* 1994 Adopting release, 59 FR 59590, at 59595.

Undertakings

The School District has undertaken to:

21. Within one hundred eighty (180) days of the entry of this Order, and with the assistance of counsel:

a. Ensure that all contractually required disclosure submissions are current and accurate.

b. Adopt and ratify enhanced, written disclosure policies and procedures regarding its contractual continuing disclosure obligations ("Disclosure Policies"). Among other things, these Disclosure Policies will designate an individual at the School District to be responsible for ensuring compliance with all contractually required disclosure submissions, and will require that individual to annually certify to the superintendent of the School District that the submissions are current and accurate. That individual shall further certify that any information regarding the School District in any preliminary and final offering documents of any future securities offerings for which the School District is an issuer or obligated person is accurate and complete, and shall ensure that the terms of the Order are disclosed in any such offering documents within five years from the date of the Order. The School District will submit a copy of the Disclosure Policies on EMMA within thirty (30) days of adoption and ratification. If the Disclosure Policies are amended, such amendments will be provided to EMMA as soon as practicable after such amendments take effect.

c. Implement annual training for personnel involved in the bond offering and disclosure process ("Bond Offering Personnel"). The School District will designate an individual or entity to be responsible for providing such training, which shall include a complete review of all Disclosure Policies and the School District's obligations under the federal securities laws. Upon completion of the annual training, all Bond Offering Personnel will provide a signed certification of completion to the superintendent of the School District, as well as a signed certification that they have reviewed, understand and will comply with the Disclosure Policies.

d. Establish policies and procedures to ensure that the School District submits all documents, reports and notices required to be submitted to the Municipal Securities Rulemaking Board ("MSRB") pursuant to any contractually required continuing disclosure obligation through EMMA in an electronic format, accompanied by identifying information, in the manner prescribed by the MSRB.

22. Within one hundred eighty (180) days of the entry of this Order, the School District shall file an affidavit with the Commission certifying its compliance with this Order and providing a copy of all Disclosure Policies, with a copy to Elaine C. Greenberg, Chief, Municipal Securities and Public Pensions Unit, U.S. Securities and Exchange Commission, Philadelphia Regional Office, The Mellon Independence Center, 701 Market Street, Philadelphia, PA 19106-1532.

23. In determining whether to accept the Offer, the Commission has considered these undertakings.

IV.

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

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, the School District shall cease and desist from committing or causing any violations 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.

By the Commission.

Elizabeth M. Murphy
Secretary

By: Jill M. Peterson
Assistant Secretary

Commissioner Gallagher not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 70058 / July 29, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3635 / July 29, 2013

INVESTMENT COMPANY ACT OF 1940
Release No. 30633 / July 29, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15392

In the Matter of **RONALD S. ROLLINS** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 (""Exchange Act"), Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Ronald S. Rollins ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant Section 15(b) of the Securities Exchange Act of 1934, Sections 203(f) and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

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

Summary

These proceedings arise out of the fraudulent activities of Timothy J. Roth ("Roth") who misappropriated over $16 million from investment advisory accounts managed by Comprehensive Capital Management, Inc. From June 2003 until February 2011, while an associated person of CCM, Roth transferred mutual fund shares and cash from client accounts at a custodial broker-dealer to a nominee account he controlled in the name of KeyOp Exercise, Inc. ("KeyOp account"). The KeyOp account was held at CCM's clearing broker-dealer which served as the custodian of CCM's clients' assets (the "Custodial Broker-Dealer"). Roth began making unauthorized transfers from these client accounts in May 2004. Roth accomplished this by using falsified transfer authorization forms and by abusing the standing authority several clients gave him over their advisory accounts. Roth used the stolen shares and cash to fund several companies he owned or controlled and to trade securities on margin in the KeyOp account for his own benefit.

While serving as the Chief Compliance Officer for CCM and as Roth's direct supervisor, Rollins failed reasonably to supervise Roth with a view to preventing his violations. Rollins also willfully aided and abetted and caused CCM's violations of the Custody Rule, certain books and records provisions, and certain compliance provisions of the Advisers Act in connection with Roth's misconduct. From June 2003 through February 2011, Rollins failed reasonably to supervise Roth through his failures to reasonably implement CCM's policies governing custody, reviews of transactions, books and records, e-mail, and annual office audits. Through his failures to reasonably implement these policies, Rollins aided and abetted and caused CCM's violation of the Custody Rule of the Advisers Act, the Advisers Act's books and records provisions, and the Advisers Act's rules requiring firms to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act.

Respondent

1. **Ronald S. Rollins**, age 62, is a resident of Plainfield, New Jersey. From September 2002 until he was demoted in January 2012, Rollins served as Chief Compliance

[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.

Officer for CCM and a broker-dealer affiliated with CCM, and was Roth's direct supervisor at all relevant times. Rollins' employment was terminated in July 2012.

Other Relevant Persons and Entities

2. **Timothy J. Roth**, age 56, is a resident of Stonington, Illinois. Roth became an associated person of CCM in 2002 and a registered representative with a broker-dealer affiliated with CCM in 2005, with offices in Champaign County, Illinois. On February 28, 2011, immediately upon learning of certain of Roth's conduct, CCM terminated its relationship with Roth and reported his conduct to law enforcement authorities. On March 21, 2011, the Commission filed an emergency injunctive action against Roth, alleging that he stole millions from CCM advisory clients from October 2010 through February 2011. *See SEC v. Timothy J. Roth, et al.*, 11-cv-02079 (C.D. Ill.). In October 2011, the U.S. Attorney's Office for the Central District of Illinois charged Roth with one count each of mail fraud and money laundering in connection with the same conduct alleged by the Commission. On October 25, 2011, Roth pled guilty to one count each of mail fraud and money laundering in connection with the conduct described in this Order. On January 31, 2013, Roth was sentenced to 151 months in prison and ordered to pay $16,151,964 in restitution. *See U.S. v. Timothy J. Roth*, 11-cr-20048 (C.D. Ill.).

3. **Comprehensive Capital Management, Inc.** ("CCM") is a New Jersey corporation headquartered in Parsippany, New Jersey. CCM has been registered with the Commission as an investment adviser firm since 2004.

4. **KeyOp Exercise, Inc.** was an Illinois corporation headquartered in Champaign, Illinois. KeyOp Exercise's only purpose was to serve as the name on the KeyOp account at the Custodial Broker-Dealer. Roth used the KeyOp account as a pass-through account for distributions from deferred compensation plans that he advised. Roth controlled the company and its accounts at all times.

Background

5. From 2003 through February 2011, while associated with CCM, Roth advised individual clients and small business employers which offered non-qualified compensation plans to certain high-level employees through what were known as mutual fund option benefit plans ("Plans"). During that period, Roth misappropriated millions of dollars from several clients. These individuals and Plans were advisory clients of CCM. Cash and securities belonging to the individual and Plan clients were held in accounts at the Custodial Broker-Dealer in the clients' names. Roth advised the employer in selecting which mutual funds to offer. The mutual fund shares were then purchased by the employer and held in its account at the Custodial Broker-Dealer. Generally, when an employee wanted a distribution of funds from the Plan, the employer or a trustee overseeing the Plan would send to Roth's office a signed letter of authorization which granted Roth the authority to order a transfer of a specific number of mutual fund shares from the Plan account to the KeyOp account at the Custodial Broker-Dealer. Shortly after the shares had been transferred to the KeyOp account, Roth would place an order redeeming the shares and would send the proceeds to the employee or another party for the benefit of the employee.

6. KeyOp was a company Roth incorporated in March 2003 to serve as the name of the nominee account at the Custodial Broker-Dealer used in connection with Roth's business of advising the Plans. In June 2003, Roth opened an account at the Custodial Broker-Dealer in the name of KeyOp with CCM's predecessor firm named as the investment adviser.

7. In June 2003 and at other times thereafter, Roth explained to Rollins what the Plans were, how they operated, how the distribution process was supposed to work, and the purpose of the KeyOp account. Roth explained that the only securities or cash that were supposed to be present in the KeyOp account were client mutual fund shares that were about to be sold and the proceeds from those sales. Roth further explained that neither the securities nor the cash were to remain in the KeyOp account for more than the few days it typically took to transfer the assets to the requesting employee. Roth also explained that no trading was supposed to occur in the KeyOp account other than the sale of client mutual fund shares. Rollins and CCM gave Roth their approval to operate the Plan business in the manner he described.

8. In July 2003, Rollins realized that CCM had custody over client assets held in the KeyOp account, which was in violation of firm policy. In an effort to avoid having custody of these assets, Rollins directed Roth to find a new owner for KeyOp Exercise. Rollins informed Roth that neither Roth nor a family member could be the owner. In response, Roth transferred nominal ownership of KeyOp Exercise to a friend. Rollins never communicated with the new owner and took no steps to learn about the new owner's background, qualifications, or relationship with Roth.

9. Despite the nominal change in ownership, Rollins recognized that the use of the KeyOp account could still present custody-related issues for the firm. Rollins drafted a memo in 2004 in which he wrote that "Compliance will continue to monitor this activity and will focus on this matter during the on-site visit of this location in 2004." As KeyOp's investment adviser, CCM had complete access to all KeyOp account information through the Custodial Broker-Dealer's website at all times. Rollins and CCM, however, never monitored the KeyOp account or the activity within it, despite knowing that the account held CCM client assets.

10. Roth continued to control the activities within the KeyOp account through February 2011, despite the nominal change in ownership. The new owner did not play any role in KeyOp's operation. Roth created a stamp of the nominal owner's signature and used it on checks, letters of authorizations, and wire transfer requests. Roth never told the nominal owner of any distribution requests or sought his authorization before conducting any activity within the account. In 2007, Roth installed his adult children as the KeyOp owners, replacing his friend, but Roth continued to maintain sole control and use of the KeyOp account. Rollins and CCM did not learn about this second change of ownership until February 2011.

11. Between May 2004 and February 2011, Roth stole approximately $16 million from certain of his KeyOp Exercise Plan clients and individual clients. Roth used the stolen shares and cash to form and support several companies he owned or controlled, to trade in ETFs on margin in the KeyOp account for his own benefit, and to serve as collateral for this margin

trading.

12. Roth used several methods to carry out his thefts, all of which made it appear that the fraudulent transfers had been authorized by the client or trustee:

a. starting in at least 2004, Roth convinced several individual clients to sign blank letters of authorization and wire transfer requests, which permitted him to have client securities and cash transferred from the client accounts at the Custodial Broker-Dealer to the KeyOp account and bank accounts Roth controlled. From May 2004 through February 2011, Roth stole more than $1.85 million from these individual clients.

b. from August 2006 through February 2011, Roth falsely told the trustee for several Plan clients that employees had requested distributions, and presented fabricated letters of authorization, which the trustee signed. Roth stole more than $2 million from Plan clients in this way.

c. beginning in 2008, Roth convinced several Plan clients to give Roth standing authority to transfer assets from the Plan clients' accounts to the KeyOp account without a signed letter of authorization. Roth did not tell his clients that his control of the KeyOp account allowed him to use the shares as he wished once they were in the KeyOp account. From late 2008 until February 2011, Roth used his standing authority to steal more than $12.1 million from these clients.

d. from December 2008 through February 2011, Roth also made at least 16 unauthorized transfers totaling over 1.1 million shares from Plan clients to the KeyOp account. Roth moved these shares to the KeyOp account to serve as collateral to support his margin trading. He returned the shares to the clients' accounts within two months. When a third-party record administrator e-mailed Roth in 2010 and questioned their legitimacy, Roth claimed the transfers were mistakes.

<u>CCM Had Custody of Client Assets</u>

13. From 2003 through February 2011, CCM had custody of client assets when the assets were held in the KeyOp account at the Custodial Broker-Dealer because Roth held or had access to client accounts through his control over the KeyOp Exercise entity and the KeyOp account. From December 2008 through February 2011, CCM also had custody of several clients' assets, which were held by the Custodial Broker-Dealer because of the standing authority Roth had over these clients' accounts.

14. From 2003 through February 2011, when CCM's clients' assets were held in the KeyOp account at the Custodial Broker-Dealer, CCM failed to maintain client assets with a qualified custodian either (1) in a separate account for each client under that client's name; or (2)

in accounts that contained only the client's funds and securities under the adviser's name as agent or trustee for the client. The KeyOp account at the Custodial Broker-Dealer was neither an account in the client's name nor an account under CCM's name as agent or trustee for the clients. Second, CCM also failed to ensure that clients whose assets were held in the KeyOp account at the Custodial Broker-Dealer received a copy of the KeyOp account statements from the Custodial Broker-Dealer.[2] Prior to March 2010, it alternatively would have been permissible for CCM to send the account statements, provided CCM also arranged for the account to undergo an annual surprise examination. Third, from 2003 through February 2011, CCM did not arrange for surprise examinations of the KeyOp account at the Custodial Broker-Dealer, and from March 2010 through February 2011, CCM did not arrange for surprise examinations of those client accounts over which Roth (and thus CCM) had standing authority.

CCM and Rollins Failed Reasonably to Supervise Roth

15. Under CCM's written policies and procedures, Rollins was responsible for implementing CCM's policy prohibiting the firm from having custody of client assets. With respect to Roth, Rollins failed to reasonably implement this prohibition. Rollins knew that client assets were transferred to the KeyOp account at the Custodial Broker-Dealer as part of Roth's advisory business. However, after 2003, Rollins took no action to ensure, consistent with CCM's policies, that neither Roth nor CCM held, directly or indirectly, client assets, or had access to them through the KeyOp account. Likewise, Rollins took no action to determine whether Roth had standing authority over client accounts at the Custodial Broker-Dealer. Roth continued to hold or had access to client assets, which was in violation of CCM's custody policy. Because of Rollins' failure to reasonably implement CCM's policies, CCM continued to retain custody of client assets held at the Custodial Broker Dealer. CCM did not arrange for Roth's clients to receive copies of the KeyOp account statements nor arranged for annual surprise examinations of the KeyOp account or client accounts.

16. The CCM Investment Adviser Policies and Procedures Manual stated that Rollins was responsible for developing, adopting, implementing, and enforcing all of the firms' supervisory and compliance policies and procedures. Rollins was also the direct supervisor for all of the registered personnel, including Roth, from 2002 through at least February 2011.

17. **Failure to implement custody policy**. From March 2003 through February 2011, CCM and Rollins failed to reasonably implement CCM's custody policy that prohibited the firm from having custody of client assets by permitting client assets to be held in the KeyOp account at the Custodial Broker-Dealer. Rollins understood the central role the KeyOp account played in Roth's advising of his Plan clients. As such, Rollins knew that client assets were transferred to the KeyOp account at the Custodial Broker-Dealer and sold, with the proceeds remaining in the account until transferred to the proper recipient.

[2] The Custodial Broker-Dealer sent account statements to these clients from 2003 through February 2011.

18. Rollins, on behalf of CCM, knew or should have known that Roth held or had access to client assets in the KeyOp account at the Custodial Broker-Dealer and the client assets within it. Rollins took no steps to ensure, consistent with CCM's policies, that neither Roth nor CCM held, directly or indirectly, client assets, or had access to them through the KeyOp account. Had Rollins taken such steps, he could have found substantial evidence that Roth was in control of the account and client assets in violation of firm policy. Evidence of Roth's control included: 1) Roth's use of a stamp of the nominal owner's signatures; 2) the lack of communication between Roth and the nominal owner about KeyOp, client accounts, or distribution requests; 3) Roth's failure to obtain the nominal owner's written authorization to transfer funds from the KeyOp account; 4) CCM's continued status as the investment adviser of record for the KeyOp account at the Custodial Broker-Dealer; and 5) Roth's children becoming the KeyOp owners in 2007.

19. From approximately December 2008 through February 2011, CCM and Rollins also failed to reasonably implement CCM's custody policy which prohibited the firm's advisers, including Roth, from having standing authority over client accounts. Rollins failed to investigate whether the firm's advisers, including Roth, had been granted such authority. Instead, Rollins relied on the advisers to self-report.

20. Had CCM and Rollins reasonably implemented CCM's custody policy, they could have prevented or detected Roth's fraud.

21. **Failure to implement policy requiring daily review of transactions.** CCM and Rollins failed to reasonably implement CCM's policy requiring the daily review of transactions in client accounts. Rollins was responsible for these reviews. Rollins only reviewed purchases and sales within accounts. He did not review transfers of assets into or out of CCM's client accounts, including those of Roth's victims with KeyOp.

22. If Rollins had reviewed such transfers from client accounts to a KeyOp account, he could have discovered at least 15 transfers of cash totaling approximately $1.1 million between 2004 and 2008 from the accounts of Roth's individual clients to the KeyOp account at the Custodial Broker-Dealer and bank accounts in the name of KeyOp. Rollins knew or should have known that there was no legitimate reason for Roth's individual clients to transfer cash or securities to the KeyOp account. In addition, Rollins could have discovered that mutual fund shares were transferred back and forth between the client accounts and the KeyOp account. Such transfers could have reasonably caused Rollins to take additional steps to determine the legitimacy of such back-and-forth transfers.

23. Rollins also failed to review all transactions in the KeyOp account at the Custodial Broker-Dealer, including transfers from the account, on a daily basis.

24. If Rollins had reviewed the transactions in the KeyOp account at the Custodial Broker-Dealer starting in June 2003, he could have discovered numerous suspicious transactions, including: 1) significant securities trading on margin throughout 2009 and 2010 in the KeyOp account; 2) the transfer of approximately $14 million worth of mutual fund shares from Plan

client accounts to the KeyOp account from 2006 through 2011 in which there were no corresponding transfers of money out of the KeyOp account to the proper recipients; 3) the transfer of $733,000 from 2007 through February 2011 from the KeyOp account to a bank account in the name of a Roth-owned company which he had previously disclosed as an outside business activity; 4) transfers totaling approximately $1.1 million from individual clients' accounts to the KeyOp account; and 5) the transfers of approximately 1.1 million mutual fund shares from Plan clients to KeyOp from 2008 through February 2011 in which the shares were returned to the client accounts within two months. All of these transactions involved the misappropriation of client assets by Roth.

25. Had CCM and Rollins reasonably implemented CCM's daily review of transactions policy and procedures, they could have prevented or detected Roth's fraud.

26. **Failure to implement e-mail policy**. CCM and Rollins failed to reasonably implement the firm's written policies and procedures requiring that associated personnel only use their CCM-issued e-mail address for e-mail communications related to firm and client matters. Specifically, CCM and Rollins permitted Roth to use non-CCM e-mail accounts for such communications. Rollins knew that Roth used non-CCM e-mail accounts after 2006 and rarely used his CCM e-mail account. Rollins frequently sent e-mails to Roth's non-CCM e-mail accounts about Roth's clients and other firm business.

27. CCM and Rollins failed to reasonably implement CCM's written policy requiring that e-mails relating to firm and client matters be maintained and monitored. Rollins permitted Roth and other associated personnel to use non-CCM e-mail accounts if they agreed to forward the required e-mails to their CCM e-mail account. Roth did not forward any e-mails to his CCM account after 2007. As a result, the firm did not have possession of all of Roth's e-mails that it was supposed to maintain or monitor.

28. CCM's and Rollins' failure to reasonably implement the firm's e-mail policy allowed Roth to communicate about client matters via e-mail with virtually no oversight for over three years. Had Rollins properly retained and monitored Roth's e-mails, he could have discovered e-mails showing Roth's control of the KeyOp account and other e-mails questioning the legitimacy of transfers that Roth had ordered.

29. Had CCM and Rollins reasonably implemented CCM's e-mail policy and procedures, they could have prevented or detected Roth's fraud.

30. **Failure to implement office audit policies and procedures**. CCM and Rollins failed to reasonably implement policies and procedures for conducting audits of offices of associated persons ("compliance audits"). CCM's written policies and procedures required annual audits of associated personnel's offices. Between at least 2002 and 2008, CCM assigned Rollins the overall responsibility for administering the compliance audits. With respect to Roth's office, CCM and Rollins failed to reasonably implement the procedures for annual compliance audits.

31. From at least 2004 through January 2010, the compliance audits of Roth's office were perfunctory and were not designed to prevent or detect fraud. There was no meaningful discussion or review of Roth's business advising the Plans or of his outside business activities. There was no review of transactions in Roth's client accounts, including the KeyOp account. There were no surprise compliance audits. No one audited Roth's office in 2009. Roth was last audited in January 2010. Thus, Roth was audited only once between December 2008 through his termination in February 2011.

32. Had CCM and Rollins reasonably implemented CCM's office compliance audit policy and procedures, they could have prevented or detected Roth's fraud.

Violations

33. As a result of the conduct described above, Rollins failed reasonably to supervise Roth, within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing Roth's violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Roth's aiding and abetting violations of Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-2 thereunder.

34. As a result of the conduct described above, Rollins willfully aided and abetted and caused CCM's violations of Section 206(4) of the Advisers Act, which prohibits fraudulent conduct by an investment adviser, and Rule 206(4)-2 thereunder, which, among other things, imposes on investment advisers that have custody of client funds or securities certain requirements with respect to the preparation and dissemination of client account statements and surprise annual examinations.

35. As a result of the conduct described above, Rollins willfully aided and abetted and caused CCM's violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which requires registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act.

36. As a result of the conduct described above, Rollins willfully aided and abetted and caused CCM's violations of Section 204 of the Advisers Act and Rules 204-2(a)(7) and 204-2(e)(1) thereunder. Section 204 of the Advisers Act requires every registered investment adviser to make and keep such reports as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. Such records are subject to periodic examinations by the Commission. Rule 204-2 promulgated thereunder requires that an investment adviser "make and keep, true, accurate and current" books and records relating to its advisory business. Rule 204-2(a)(7) generally requires a registered adviser to maintain records relating to "(i) any recommendation made or proposed to be made and any advice given or proposed to be given, (ii) any receipt, disbursement or delivery of funds or securities, or (iii) the placing or execution of any order to purchase or sell any security." Rule 204-2(e)(1) generally requires records required by Rule 204-2(a) to be "maintained and preserved in an easily

accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such records, the first two years in an appropriate office of the investment adviser."

Undertakings

37. In connection with this public administrative proceeding and any related judicial or administrative proceedings or investigation commenced by the Commission or to which the Commission is a party, Rollins: (i) agrees to appear and be interviewed by Commission staff at such times and places as the staff requests upon reasonable notice; (ii) will accept service by mail or facsimile transmission of notices or subpoenas issued by the Commission for documents or testimony at depositions, hearings, or trials, or in connection with any related investigation by Commission staff; (iii) appoints Rollins' undersigned attorney as agent to receive service of such notices and subpoenas; (iv) with respect to such notices and subpoenas, waives the territorial limits on service contained in Rule 45 of the Federal Rules of Civil Procedure and any applicable local rules, provided that the party requesting the testimony reimburses Rollins' travel, lodging, and subsistence expenses at the then-prevailing U.S. Government per diem rates; and v) consents to personal jurisdiction over him in any United States District Court or administrative court for the purposes of enforcing any such subpoena.

Civil Penalties

38. Rollins has submitted sworn Statements of Financial Condition dated April 3, 2013 and April 24, 2013 and other evidence and has asserted his inability to pay a civil penalty.

IV.

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

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

A. Respondent Rollins cease and desist from committing or causing any violations and any future violations of Sections 204 and 206(4) of the Advisers Act and Rules 204-2(a)(7), 204-2(e)(1), 206(4)-2, and 206(4)-7 thereunder.

B. Respondent Rollins be, and hereby is:

1. suspended from associating with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization for a period of twelve (12) months, effective on the second Monday following the entry this Order;

2. prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter for a period of twelve (12) months, effective on the second Monday following the entry this Order;

3. suspended from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock for a period of twelve (12) months, effective on the second Monday following the entry of this Order; and

4. barred from associating in a supervisory capacity with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization, effective on the second Monday following the entry of this Order, with the right to reapply for association after three years.

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

C. Based upon Respondent's sworn representations in his Statement of Financial Condition dated April 3, 2013 and April 24, 2013 and other evidence submitted to the Commission, the Commission is not imposing a civil penalty against Respondent.

D. The Division of Enforcement may, at any time following the entry of this Order, petition the Commission to: (1) reopen this matter to consider whether Respondent 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 was fraudulent, misleading, inaccurate, or incomplete in any material respect. Respondent 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.

E. Respondent shall comply with the undertakings enumerated in Section III above.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Gallagher not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3636 / July 29, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15393

In the Matter of **COMPREHENSIVE CAPITAL MANAGEMENT, INC.** **Respondent.**	**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**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against Comprehensive Capital Management, Inc. ("Respondent" or "CCM").

II.

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

III.

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

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

Summary

These proceedings arise out of the fraudulent activities of Timothy J. Roth ("Roth") who misappropriated over $16 million from investment advisory accounts managed by Comprehensive Capital Management, Inc. From June 2003 until February 2011, while an associated person of CCM, Roth transferred mutual fund shares and cash from client accounts at a custodial broker-dealer to a nominee account he controlled in the name of KeyOp Exercise, Inc. ("KeyOp account"). The KeyOp account was held at CCM's clearing broker-dealer which served as the custodian of CCM's clients' assets (the "Custodial Broker-Dealer"). Roth began making unauthorized transfers from these client accounts in May 2004. Roth accomplished this by using falsified transfer authorization forms and by abusing the standing authority several clients gave him over their advisory accounts. Roth used the stolen shares and cash to fund several companies he owned or controlled and to trade securities on margin in the KeyOp account for his own benefit.

CCM failed reasonably to supervise Roth with a view to preventing his violations and committed violations of the Custody Rule and certain books and records provisions of the Advisers Act in connection with Roth's misconduct. From June 2003 through February 2011, CCM failed reasonably to supervise Roth through its failures to reasonably implement its policies governing custody, reviews of transactions, books and records, e-mail, and annual office audits. Further, CCM violated the Advisers Act's books and records provisions by failing to maintain certain required records such as advisory agreements, client lists, and e-mails. CCM also violated the Advisers Act's rules which require firms to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act.

Respondent

1. **Comprehensive Capital Management, Inc.** ("CCM") is a New Jersey corporation headquartered in Parsippany, New Jersey. CCM has been registered with the Commission as an investment adviser firm since 2004.

Other Relevant Persons and Entities

2. **Ronald S. Rollins**, age 62, is a resident of Plainfield, New Jersey. From September 2002 until he was demoted in January 2012, Rollins served as Chief Compliance Officer for CCM and a broker-dealer affiliated with CCM, and was Roth's direct supervisor at all relevant times. Rollins' employment was terminated in July 2012.

3. **Timothy J. Roth**, age 56, is a resident of Stonington, Illinois. Roth became an associated person of CCM in 2002 and a registered representative with a broker-dealer affiliated with CCM in 2005, with offices in Champaign County, Illinois. On February 28, 2011, immediately upon learning of certain of Roth's conduct, CCM terminated its relationship with Roth and reported his conduct to law enforcement authorities. On March 21, 2011, the Commission filed an emergency injunctive action against Roth, alleging that he stole millions from CCM advisory clients from October 2010 through February 2011. *See SEC v. Timothy J.*

Roth, et al., 11-cv-02079 (C.D. Ill.). In October 2011, the U.S. Attorney's Office for the Central District of Illinois charged Roth with one count each of mail fraud and money laundering in connection with the same conduct alleged by the Commission. On October 25, 2011, Roth pled guilty to one count each of mail fraud and money laundering in connection with the conduct described in this Order. On January 31, 2013, Roth was sentenced to 151 months in prison and ordered to pay $16,151,964 in restitution. *See U.S. v. Timothy J. Roth*, 11-cr-20048 (C.D. Ill.).

4. **KeyOp Exercise, Inc.** was an Illinois corporation headquartered in Champaign, Illinois. KeyOp Exercise's only purpose was to serve as the name on the KeyOp account at the Custodial Broker-Dealer. Roth used the KeyOp account as a pass-through account for distributions from deferred compensation plans that he advised. Roth controlled the company and its accounts at all times.

Background

5. From 2003 through February 2011, while associated with CCM, Roth advised individual clients and small business employers which offered non-qualified compensation plans to certain high-level employees through what were known as mutual fund option benefit plans ("Plans"). During that period, Roth misappropriated millions of dollars from several clients. These individuals and Plans were advisory clients of CCM. Cash and securities belonging to the individual and Plan clients were held in accounts at the Custodial Broker-Dealer in the clients' names. Roth advised the employer in selecting which mutual funds to offer. The mutual fund shares were then purchased by the employer and held in its account at the Custodial Broker-Dealer. Generally, when an employee wanted a distribution of funds from the Plan, the employer or a trustee overseeing the Plan would send to Roth's office a signed letter of authorization which granted Roth the authority to order a transfer of a specific number of mutual fund shares from the Plan account to the KeyOp account at the Custodial Broker-Dealer. Shortly after the shares had been transferred to the KeyOp account, Roth would place an order redeeming the shares and would send the proceeds to the employee or another party for the benefit of the employee.

6. KeyOp was a company Roth incorporated in March 2003 to serve as the name of the nominee account at the Custodial Broker-Dealer used in connection with Roth's business of advising the Plans. In June 2003, Roth opened an account at the Custodial Broker-Dealer in the name of KeyOp with CCM's predecessor firm named as the investment adviser.

7. In June 2003 and at other times thereafter, Roth explained to Rollins what the Plans were, how they operated, how the distribution process was supposed to work, and the purpose of the KeyOp account. Roth explained that the only securities or cash that were supposed to be present in the KeyOp account were client mutual fund shares that were about to be sold and the proceeds from those sales. Roth further explained that neither the securities nor the cash were to remain in the KeyOp account for more than the few days it typically took to transfer the assets to the requesting employee. Roth also explained that no trading was supposed to occur in the KeyOp account other than the sale of client mutual fund shares. Rollins and CCM gave Roth their approval to operate the Plan business in the manner he described.

8. In July 2003, Rollins realized that CCM had custody over client assets held in the KeyOp account, which was in violation of firm policy. In an effort to avoid having custody of these assets, Rollins directed Roth to find a new owner for KeyOp Exercise. Rollins informed Roth that neither Roth nor a family member could be the owner. In response, Roth transferred nominal ownership of KeyOp Exercise to a friend. Rollins never communicated with the new owner and took no steps to learn about the new owner's background, qualifications, or relationship with Roth.

9. Despite the nominal change in ownership, Rollins recognized that the use of the KeyOp account could still present custody-related issues for the firm. Rollins drafted a memo in 2004 in which he wrote that "Compliance will continue to monitor this activity and will focus on this matter during the on-site visit of this location in 2004." As KeyOp's investment adviser, CCM had complete access to all KeyOp account information through the Custodial Broker-Dealer's website at all times. Rollins and CCM, however, never monitored the KeyOp account or the activity within it, despite knowing that the account held CCM client assets.

10. Roth continued to control the activities within the KeyOp account through February 2011, despite the nominal change in ownership. The new owner did not play any role in KeyOp's operation. Roth created a stamp of the nominal owner's signature and used it on checks, letters of authorizations, and wire transfer requests. Roth never told the nominal owner of any distribution requests or sought his authorization before conducting any activity within the account. In 2007, Roth installed his adult children as the KeyOp owners, replacing his friend, but Roth continued to maintain sole control and use of the KeyOp account. Rollins and CCM did not learn about this second change of ownership until February 2011.

11. Between May 2004 and February 2011, Roth stole approximately $16 million from certain of his KeyOp Exercise Plan clients and individual clients. Roth used the stolen shares and cash to form and support several companies he owned or controlled, to trade in ETFs on margin in the KeyOp account for his own benefit, and to serve as collateral for this margin trading.

12. Roth used several methods to carry out his thefts, all of which made it appear that the fraudulent transfers had been authorized by the client or trustee:

a. starting in at least 2004, Roth convinced several individual clients to sign blank letters of authorization and wire transfer requests, which permitted him to have client securities and cash transferred from the client accounts at the Custodial Broker-Dealer to the KeyOp account and bank accounts Roth controlled. From May 2004 through February 2011, Roth stole more than $1.85 million from these individual clients.

b. from August 2006 through February 2011, Roth falsely told the trustee for several Plan clients that employees had requested distributions, and presented fabricated letters of authorization, which the trustee signed. Roth stole more than $2 million from Plan clients in this way.

c. beginning in 2008, Roth convinced several Plan clients to give Roth standing authority to transfer assets from the Plan clients' accounts to the KeyOp account without a signed letter of authorization. Roth did not tell his clients that his control of the KeyOp account allowed him to use the shares as he wished once they were in the KeyOp account. From late 2008 until February 2011, Roth used his standing authority to steal more than $12.1 million from these clients.

d. from December 2008 through February 2011, Roth also made at least 16 unauthorized transfers totaling over 1.1 million shares from Plan clients to the KeyOp account. Roth moved these shares to the KeyOp account to serve as collateral to support his margin trading. He returned the shares to the clients' accounts within two months. When a third-party record administrator e-mailed Roth in 2010 and questioned their legitimacy, Roth claimed the transfers were mistakes.

CCM Had Custody of Client Assets

13. From 2003 through February 2011, CCM had custody of client assets when the assets were held in the KeyOp account at the Custodial Broker-Dealer because Roth held or had access to client accounts through his control over the KeyOp Exercise entity and the KeyOp account. From December 2008 through February 2011, CCM also had custody of several clients' assets, which were held by the Custodial Broker-Dealer because of the standing authority Roth had over these clients' accounts.

14. From 2003 through February 2011, when CCM's clients' assets were held in the KeyOp account at the Custodial Broker-Dealer, CCM failed to maintain client assets with a qualified custodian either (1) in a separate account for each client under that client's name; or (2) in accounts that contained only the client's funds and securities under the adviser's name as agent or trustee for the client. The KeyOp account at the Custodial Broker-Dealer was neither an account in the client's name nor an account under CCM's name as agent or trustee for the clients. Second, CCM also failed to ensure that clients whose assets were held in the KeyOp account at the Custodial Broker-Dealer received a copy of the KeyOp account statements from either the Custodial Broker-Dealer.[2] Prior to March 2010, it alternatively would have been permissible for CCM to send the account statements, provided CCM also arranged for the account to undergo an annual surprise examination. Third, from 2003 through February 2011, CCM did not arrange for surprise examinations of the KeyOp account at the Custodial Broker-Dealer or of those client accounts over which Roth (and thus CCM) had standing authority.

[2] The Custodial Broker-Dealer sent account statements to these clients from 2003 through February 2011.

CCM Failed Reasonably to Supervise Roth

15. Under CCM's written policies and procedures, Rollins was responsible for implementing CCM's policy prohibiting the firm from having custody of client assets. With respect to Roth, Rollins failed to reasonably implement this prohibition. Rollins knew that client assets were transferred to the KeyOp account at the Custodial Broker-Dealer as part of Roth's advisory business. However, after 2003, Rollins took no action to ensure, consistent with CCM's policies, that neither Roth nor CCM held, directly or indirectly, client assets, or had access to them through the KeyOp account. Likewise, Rollins took no action to determine whether Roth had standing authority over client accounts at the Custodial Broker-Dealer. Roth continued to hold or had access to client assets, which was in violation of CCM's custody policy. Because of Rollins' failure to reasonably implement CCM's policies, CCM continued to retain custody of client assets held at the Custodial Broker Dealer. CCM did not arrange for Roth's clients to receive copies of the KeyOp account statements nor arranged for annual surprise examinations of the KeyOp account or client accounts.

16. The CCM Investment Adviser Policies and Procedures Manual stated that Rollins was responsible for developing, adopting, implementing, and enforcing all of the firms' supervisory and compliance policies and procedures. Rollins was also the direct supervisor for all of the registered personnel, including Roth, from 2002 through at least February 2011.

17. **Failure to implement custody policy**. From March 2003 through February 2011, CCM and Rollins failed to reasonably implement CCM's custody policy that prohibited the firm from having custody of client assets by permitting client assets to be held in the KeyOp account at the Custodial Broker-Dealer. Rollins understood the central role the KeyOp account played in Roth's advising of his Plan clients. As such, Rollins knew that client assets were transferred to the KeyOp account at the Custodial Broker-Dealer and sold, with the proceeds remaining in the account until transferred to the proper recipient.

18. Rollins, on behalf of CCM, knew or should have known that Roth held or had access to client assets in the KeyOp account at the Custodial Broker-Dealer and the client assets within it. Rollins took no steps to ensure, consistent with CCM's policies, that neither Roth nor CCM held, directly or indirectly, client assets, or had access to them through the KeyOp account. Had Rollins taken such steps, he could have found substantial evidence that Roth was in control of the account and client assets in violation of firm policy. Evidence of Roth's control included: 1) Roth's use of a stamp of the nominal owner's signatures; 2) the lack of communication between Roth and the nominal owner about KeyOp, client accounts, or distribution requests; 3) Roth's failure to obtain the nominal owner's written authorization to transfer funds from the KeyOp account; 4) CCM's continued status as the investment adviser of record for the KeyOp account at the Custodial Broker-Dealer; and 5) Roth's children becoming the KeyOp owners in 2007.

19. From approximately December 2008 through February 2011, CCM and Rollins also failed to reasonably implement CCM's custody policy which prohibited the firm's advisers, including Roth, from having standing authority over client accounts. Rollins failed to investigate

whether the firm's advisers, including Roth, had been granted such authority. Instead, Rollins relied on the advisers to self-report.

20. Had CCM and Rollins reasonably implemented CCM's custody policy, they could have prevented or detected Roth's fraud.

21. **Failure to implement policy requiring daily review of transactions**. CCM and Rollins failed to reasonably implement CCM's policy requiring the daily review of transactions in client accounts. Rollins was responsible for these reviews. Rollins only reviewed purchases and sales within accounts. He did not review transfers of assets into or out of CCM's client accounts, including those of Roth's victims with KeyOp.

22. If Rollins had reviewed such transfers from client accounts to a KeyOp account, he could have discovered at least 15 transfers of cash totaling approximately $1.1 million between 2004 and 2008 from the accounts of Roth's individual clients to the KeyOp account at the Custodial Broker-Dealer and bank accounts in the name of KeyOp. Rollins knew or should have known that there was no legitimate reason for Roth's individual clients to transfer cash or securities to the KeyOp account. In addition, Rollins could have discovered that mutual fund shares were transferred back and forth between the client accounts and the KeyOp account. Such transfers could have reasonably caused Rollins to take additional steps to determine the legitimacy of such back-and-forth transfers.

23. Rollins also failed to review all transactions in the KeyOp account at the Custodial Broker-Dealer, including transfers from the account, on a daily basis.

24. If Rollins had reviewed the transactions in the KeyOp account at the Custodial Broker-Dealer starting in June 2003, he could have discovered numerous suspicious transactions, including: 1) significant securities trading on margin throughout 2009 and 2010 in the KeyOp account; 2) the transfer of approximately $14 million worth of mutual fund shares from Plan client accounts to the KeyOp account from 2006 through 2011 in which there were no corresponding transfers of money out of the KeyOp account to the proper recipients; 3) the transfer of $733,000 from 2007 through February 2011 from the KeyOp account to a bank account in the name of a Roth-owned company which he had previously disclosed as an outside business activity; 4) transfers totaling approximately $1.1 million from individual clients' accounts to the KeyOp account; and 5) the transfers of approximately 1.1 million mutual fund shares from Plan clients to KeyOp from 2008 through February 2011 in which the shares were returned to the client accounts within two months. All of these transactions involved the misappropriation of client assets by Roth.

25. Had CCM and Rollins reasonably implemented CCM's daily review of transactions policy and procedures, they could have prevented or detected Roth's fraud.

26. **Failure to implement e-mail policy**. CCM and Rollins failed to reasonably implement the firm's written policies and procedures requiring that associated personnel only use their CCM-issued e-mail address for e-mail communications related to firm and client matters.

Specifically, CCM and Rollins permitted Roth to use non-CCM e-mail accounts for such communications. Rollins knew that Roth used non-CCM e-mail accounts after 2006 and rarely used his CCM e-mail account. Rollins frequently sent e-mails to Roth's non-CCM e-mail accounts about Roth's clients and other firm business.

27. CCM and Rollins failed to reasonably implement CCM's written policy requiring that e-mails relating to firm and client matters be maintained and monitored. Rollins permitted Roth and other associated personnel to use non-CCM e-mail accounts if they agreed to forward the required e-mails to their CCM e-mail account. Roth did not forward any e-mails to his CCM account after 2007. As a result, the firm did not have possession of all of Roth's e-mails that it was supposed to maintain or monitor.

28. CCM's and Rollins' failure to reasonably implement the firm's e-mail policy allowed Roth to communicate about client matters via e-mail with virtually no oversight for over three years. Had Rollins properly retained and monitored Roth's e-mails, he could have discovered e-mails showing Roth's control of the KeyOp account and other e-mails questioning the legitimacy of transfers that Roth had ordered.

29. Had CCM and Rollins reasonably implemented CCM's e-mail policy and procedures, they could have prevented or detected Roth's fraud.

30. **Failure to implement office audit policies and procedures**. CCM and Rollins failed to reasonably implement policies and procedures for conducting audits of offices of associated persons ("compliance audits"). CCM's written policies and procedures required annual compliance audits of associated personnel's offices. Between at least 2002 and 2008, CCM assigned Rollins the overall responsibility for administering the compliance audits. With respect to Roth's office, CCM and Rollins failed to reasonably implement the procedures for annual compliance audits.

31. From at least 2004 through January 2010, the compliance audits of Roth's office were perfunctory and were not designed to prevent or detect fraud. There was no meaningful discussion or review of Roth's business advising the Plans or of his outside business activities. There was no review of transactions in Roth's client accounts, including the KeyOp account. There were no surprise compliance audits. No one audited Roth's office in 2009. Roth was last audited in January 2010. Thus, Roth was audited only once between December 2008 through his termination in February 2011.

32. Had CCM and Rollins reasonably implemented CCM's office compliance audit policy and procedures, they could have prevented or detected Roth's fraud.

33. **Failure to implement books and records policies**. CCM failed to reasonably implement its books and records policies and procedures with respect to two of Roth's Plan clients which executed written advisory agreements with CCM's predecessor firm. These Plan clients paid advisory fees to a company affiliated with Roth, and after most of the advisory business of CCM's predecessor firm was transferred to CCM, these Plan clients continued to pay

fees to Roth's affiliated company. CCM failed to enter or properly maintain investment adviser agreements with either of these Plan clients from whom Roth misappropriated over $9.2 million. As a result, these two clients were not listed as clients on CCM's books and records and the transactions in their accounts were not reviewed.

34. Had CCM reasonably implemented CCM's books and records policies and procedures, it could have prevented or detected Roth's fraud.

Violations

35. As a result of the conduct described above, CCM willfully[3] violated Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder, which provide that custody of client funds or securities by an adviser is a fraudulent act, unless the adviser, among other things, complies with certain requirements with respect to the preparation and dissemination of client account statements and surprise annual examinations.

36. As a result of the conduct described above, CCM failed reasonably to supervise Roth, within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing Roth's violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Roth's aiding and abetting violations of Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-2 thereunder.

37. As a result of the conduct described above, CCM willfully violated Rule 206(4)-7 thereunder, which requires registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act.

38. As a result of the conduct described above, CCM willfully violated Section 204 of the Advisers Act and Rules 204-2(a)(7), 204-2(a)(8), 204-2(a)(9), 204-2(a)(10), 204-2(e)(1) thereunder. Section 204 of the Advisers Act requires every registered investment adviser to make and keep such reports as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. Such records are subject to periodic examinations by the Commission. Rule 204-2 promulgated thereunder requires that an investment adviser "make and keep, true, accurate and current" books and records relating to its advisory business. Rule 204-2(a)(7) generally requires a registered adviser to maintain records relating to "(i) any recommendation made or proposed to be made and any advice given or proposed to be given, (ii) any receipt, disbursement or delivery of funds or securities, or (iii) the placing or execution of any order to purchase or sell any security." Rule 204-2(e)(1) generally requires records required by Rule 204-2(a) to be "maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such records, the first two years in an appropriate office of the investment adviser." Rule 204-2(a)(8) requires an investment adviser to keep a "list or other

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[3] 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)).

record of all accounts in which the investment adviser is vested with any discretionary power with respect to the funds, securities or transactions of any client." Rule 204-2(a)(9) requires that registered investment advisers to keep "powers of attorney and other evidences of the granting of any discretionary authority by the client to the investment adviser." Rule 204-2(a)(10) requires that registered investment advisers keep "all written agreements . . . entered into by the investment adviser with any client or otherwise relating to the business of such investment adviser as such."

CCM's Remedial Efforts

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

Undertakings

40. Respondent has undertaken to:

a. Independent Compliance Consultant. CCM shall retain, within 30 days of the date of the issuance of this Order, the services of an Independent Compliance Consultant not unacceptable to the staff of the Commission. The Independent Compliance Consultant's compensation and expenses shall be borne exclusively by CCM. CCM shall require the Independent Compliance Consultant to conduct a review of the CCM compliance policies and procedures that the Independent Compliance Consultant deems relevant with respect to 1) custody of client assets, daily review of transactions (including transfers), books and records, and electronic communications, and; 2) the supervision of its registered personnel.

b. At the end of the review, which in no event shall be more than three months after the date of the issuance of this Order, CCM shall require the Independent Compliance Consultant to submit an Initial Report to CCM and to the Commission staff. The Initial Report shall describe the review performed, the conclusions reached, and shall include any recommendations deemed necessary to make the policies and procedures adequate. CCM may suggest an alternative procedure designed to achieve the same objective or purpose as that of the recommendation of the Independent Compliance Consultant. The Independent Compliance Consultant shall evaluate any alternative procedure proposed by CCM. However, CCM shall abide by the Independent Compliance Consultant's final recommendation.

c. Within six months after the date of issuance of this Order, CCM shall, in writing, advise the Independent Compliance Consultant and the Commission staff of the recommendations it is adopting.

d. Within nine months after the date of issuance of this Order, CCM shall require the Independent Compliance Consultant to complete its review and submit a written final report to Commission staff. The Final Report shall describe the review made of CCM's compliance policies and procedures; set forth the conclusions reached and the recommendations made by the Independent Compliance Consultant, as well as any proposals made by CCM; and describe how CCM is implementing the Independent Compliance Consultant's final recommendations.

e. CCM shall take all necessary and appropriate steps to adopt and implement all recommendations contained in the Independent Compliance Consultant's Final Report to the extent it has not already done so.

f. For good cause shown and upon timely application by the Independent Compliance Consultant or CCM, the Commission's staff may extend any of the deadlines set forth in these undertakings.

g. CCM shall require the Independent Compliance Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Independent Compliance Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with CCM, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity, other than the agreement relating to the Independent Compliance Consultant's previous retention by CCM in connection with the findings set forth herein. The agreement will also provide that the Independent Compliance Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Independent Compliance Consultant in performance of his/her duties under this Order shall not, without prior written consent of the Commission staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with CCM, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

41. CCM shall certify, in writing, compliance with the undertaking(s) set forth above. The certification shall identify the undertaking(s), provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Respondent agrees to provide such evidence. The certification and supporting material shall be submitted to Timothy J. Warren, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than sixty days from the date of the completion of the undertakings.

IV.

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

Accordingly, pursuant to Sections 203(e) and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondent shall cease and desist from committing or causing any violations and any future violations of Sections 204 and 206(4) of the Advisers Act and Rules 204-2(a)(7), 204-2(a)(8), 204-2(a)(9), 204-2(a)(10), 204-2(e)(1), 206(4)-2, and 206(4)-7 thereunder.

B. Respondent is censured.

C. Respondent shall pay a civil money penalty in the amount of $120,000 to the Securities and Exchange Commission pursuant to a payment plan under which Respondent shall $40,000 within 10 days of the entry of this Order, $40,000 within 180 days of the entry, and $40,000 within 360 days of the entry. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in one of the following ways:

(1) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or

(2) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Comprehensive Capital Management, Inc. as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Timothy J. Warren, Associate Regional Director, Chicago Regional Office, Division of Enforcement, Securities and Exchange Commission, 175 W. Jackson Boulevard Suite 900, Chicago, Illinois 60604.

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

E. Respondent shall comply with the undertakings enumerated in Section III above.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Paredes not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9434 / July 29, 2013

SECURITIES EXCHANGE ACT OF 1934
Release No. 70056 / July 29, 2013

INVESTMENT COMPANY ACT OF 1940
Release No. 30632 / July 29, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15390

In the Matter of

City Securities Corporation and Randy G. Ruhl

Respondents.

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTIONS 15(b), 15B(c) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), and Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against City Securities Corporation ("City Securities"), and that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act, and Sections 15(b), 15B(c)(4) and 21C of the Exchange Act, and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Randy G. Ruhl ("Ruhl").

II.

In anticipation of the institution of these proceedings, City Securities and Ruhl 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, City Securities and Ruhl consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Sections 15(b), 15B(c) and 21C of the Securities Exchange Act of 1934, and Section 9(b) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and City Securities's and Ruhl's Offers, the Commission finds[1] that:

Summary

1. This matter involves multiple violations of the antifraud and other provisions of the federal securities laws by City Securities, a registered broker-dealer, while acting as underwriter for various municipal bond offerings by Indiana municipalities. City Securities conducted inadequate due diligence and, as a result, failed to form a reasonable basis for believing the truthfulness of material statements in an issuer's official statement, which resulted in City Securities offering and selling municipal securities on the basis of a materially misleading disclosure document. In addition, City Securities failed to enact procedures, and did not take reasonable steps to ensure it would receive prompt notice of certain submissions by municipal issuers, or notice of an issuer's failure to make required submissions. Further, City Securities fraudulently mischaracterized expenses for entertainment, charitable donations and gratuities as expenses for "Printing, Preparation and Distribution of Official Statement," so as to obtain reimbursement from bond proceeds without the knowledge of various municipal securities issuers. Finally, City Securities approved and provided improper entertainment and gratuities to representatives of issuers of municipal bonds.

2. In December 2007, City Securities acted as sole underwriter for a $31 million negotiated municipal bond offering on behalf of the West Clark Community Schools ("West Clark" or the "School District"). In that capacity, City Securities assisted in compiling information for the Official Statement, and reviewed a near-final version of the Official Statement used in connection with the School District's offering. Ultimately, the final Official Statement contained materially false statements to the effect that the School District had substantially complied with its prior continuing disclosure undertakings pursuant to Rule 15c2-12,[2] when in fact it had not.

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

[2] Rule 15c2-12 prohibits, among other things and subject to certain exemptions, any underwriter from purchasing or selling municipal securities unless it has reasonably determined that the issuer of municipal securities, or an obligated person, has undertaken in a written agreement or contract, sometimes referred to as a Continuing Disclosure Agreement ("CDA"), to provide annual financial information and notices of certain material events ("Event Notices") to certain information repositories. An "obligated person" generally means any person or entity that is committed by contract or other arrangement to support payment of all or part of the obligations on the

3. City Securities, in its role as underwriter, conducted inadequate due diligence and, as a result, failed to form a reasonable basis for believing the truthfulness of material statements in the School District's Official Statement, and in particular the School District's assertion that it had complied with its prior continuing disclosure undertakings; a fact that City Securities could have easily verified through a review of public repositories. As a result, City Securities disseminated the materially false Official Statement to its customers in connection with the School District's 2007 municipal bond offering.

4. In addition, City Securities recommended the purchase and sale of municipal securities without implementing adequate procedures, and without taking steps required by Rule 15c2-12(c), as promulgated under Section 15(c)(2) of the Exchange Act, to reasonably ensure prompt receipt of notice of issuers' disclosure submissions.

5. Further, between at least 2007 and 2010 (the "relevant time period"), City Securities mischaracterized expenses such as charitable donations and entertainment expenses, and then billed these expenses and other purported "miscellaneous" costs back to various municipal securities issuers as costs of the "Printing, Preparation and Distribution of Official Statements," without the issuers' knowledge.

6. Finally, during the relevant time period, City Securities provided improper gifts and gratuities to personnel of certain municipal securities issuers, including multi-day, out-of-state golf trips and tickets to multiple sporting events in violation of Municipal Securities Rulemaking Board ("MSRB") Rule G-20.[3]

7. As a result of the conduct described above, City Securities willfully violated Section 17(a)(2) of the Securities Act, Sections 10(b), 15(c)(2) and 15B(c)(1) of the Exchange Act and Rules 10b-5(b) and 15c2-12 thereunder, and willfully violated MSRB Rules G-17 and G-20.

8. In addition, during the relevant time period, Ruhl was an executive vice president and supervisor of City Securities's Public Finance & Municipal Bond Department (the "Department"). As such, Ruhl oversaw public finance banking, municipal underwriting and municipal bond trading and was responsible for the Department's day-to-day operations. Ruhl, in his capacity as supervisor, approved of and substantially assisted in the conduct described above and, as a result, willfully aided and abetted and caused City Securities's violations of Sections 10(b), 15(c)(2) and 15B(c)(1) of the Exchange Act and Rules 10b-5(b) and 15c2-12 thereunder, and MSRB Rules G-17 and G-20, and caused City Securities's violation of Section 17(a)(2) of the Securities Act.

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municipal securities being offered. The School District was an obligated person, and not the issuer, in the 2007 Offering. Additionally, Rule 15c2-12(f)(3) defines what information must be included in a final Official Statement. Among other things, this definition requires a description of the issuer's or obligated person's disclosure undertakings, as well as a description of any instances in the previous five years in which an issuer or obligated person failed to comply in all material respects with any previous disclosure undertakings.

[3] West Clark was not one of the issuers whose personnel received such gifts and gratuities.

Respondents

9. City Securities Corporation is a broker-dealer headquartered in Indianapolis, Indiana, with approximately 200 employees and seven branch offices throughout Indiana. City Securities has been a registered broker-dealer with the Commission since 1936 and conducts a general securities business with an emphasis on the underwriting and sale of municipal securities by issuers located in the State of Indiana.

10. Randy G. Ruhl, age 56, is a resident of Indianapolis, Indiana. Ruhl joined City Securities in May 1988 as an assistant vice president. In January 2007, Ruhl became an executive vice president and supervisor of City Securities's Public Finance & Municipal Bond Department, reporting directly to the president. From January 2007 to April 2010, Ruhl was responsible for supervising the Department, which consisted of approximately 15 individuals located in Indianapolis and Fort Wayne.

Related Entity

11. West Clark Community Schools is a corporate entity and political subdivision, located in Clark County, Indiana, and formed under Indiana law. It employs approximately 400 staff at eight different schools to teach approximately 4,500 students. An elected, five member Board of School Trustees governs the School District.[4]

City Securities, With Ruhl's Substantial Assistance, Made Recommendations Without Forming a Reasonable Basis Regarding the Accuracy of Disclosures Because of a Lack of Due Diligence, Resulting in the Public Dissemination of a Materially False Official Statement

12. In March 2005, City Securities acted as sole underwriter for the School District's $52 million municipal bond offering ("2005 Offering").

13. Pursuant to the requirements of Rule 15c2-12, City Securities obtained an executed Continuing Disclosure Agreement ("CDA") from the School District in connection with the 2005 Offering. As part of the CDA, the School District covenanted and agreed to, among other things, submit an annual report containing certain financial information and operating data to the appropriate national and state repositories, as well as timely notice of certain specified events

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[4] The Indiana State Constitution restricts the amount of debt Indiana school districts are allowed to incur. As a result, the Indiana legislature allows school districts to create distinct legal entities called "school building corporations," through which school districts can issue debt. These school building corporations are essentially shells, created and controlled by the school district for the limited purpose of providing funding for the benefit of the school district. In this matter, the West Clark School District offered bonds through its shell conduit issuer, the West Clark 2000 School Building Corporation. Consequently, under Rule 15c2-12, the School District constitutes an obligated person with respect to the West Clark 2000 School Building Corporation municipal bond offerings.

pertaining to the bonds at issue.[5] Further, the School District contracted to submit notices to each repository in the event it was unable to provide the required annual report.

14. As the underwriter of the School District's 2005 Offering, City Securities assisted in compiling a draft 2005 Official Statement using City Securities's boilerplate language and provided the draft to the School District.

15. After the School District received and reviewed various drafts of both the preliminary, and what ultimately became the final, Official Statement for the 2005 Offering, City Securities reviewed a near-final version of the 2005 Official Statement. As required by Rule 15c2-12, the final 2005 Official Statement included a summary description of the provisions of the CDA.[6]

16. After the School District authorized and approved the Official Statement for the 2005 Offering, City Securities publicly disseminated the 2005 Official Statement in connection with its offer and sale of the bonds.

17. In December 2007, City Securities again acted as the sole underwriter for the School District, this time for a $31 million municipal bond offering ("2007 Offering").

18. As the underwriter of the School District's 2007 Offering, City Securities again assisted in compiling a draft 2007 Official Statement using City Securities's boilerplate language and provided the draft to the School District.

19. After the School District reviewed various drafts of both the preliminary and final Official Statement for the 2007 Offering, City Securities reviewed a near-final version of the 2007 Official Statement.

20. Rule 15c2-12(f)(3) requires that a final Official Statement set forth any instances in the previous five years in which an issuer of municipal securities, or obligated person, failed to comply in all material respects with any previous continuing disclosure undertakings.

21. The final 2007 Official Statement used in connection with the School District's 2007 Offering included a section titled "Compliance with Previous Undertakings" which read: "[i]n the previous five years, the School [District] has never failed to comply, in all material respects, with any previous undertakings . . . ." After various School District officials reviewed the 2007 Official Statement, the School District authorized and approved the Official Statement for the 2007 Offering.

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[5] In December 2008, Rule 15c2-12 was amended to designate the Electronic Municipal Market Access system ("EMMA") as the central repository for ongoing disclosures by municipal issuers effective July 1, 2009.

[6] Rule 15c2-12(f)(3) delineates what information must be included in a final Official Statement. Among other things, this definition requires a description of the issuer's disclosure undertakings.

22. In addition, at the closing for the 2007 Offering, the School District executed a Certificate and Affidavit, attesting that the 2007 Official Statement did not "contain any untrue statements of a material fact or omit to state a material fact required to be stated therein or necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." Under the terms of the Bond Purchase Contract with City Securities, execution of the Certificate and Affidavit by the School District was a prerequisite to City Securities's obligation to purchase the 2007 Offering.

23. City Securities then publicly disseminated the 2007 Official Statement in connection with its offer and sale of the School District's 2007 Offering.

24. The School District's assertion of compliance with previous disclosure undertakings in its 2007 Official Statement was materially false. Between 2005 and 2010, the School District never submitted any annual reports, or any notices of its failure to submit annual reports, as required under the terms of its CDAs.

25. City Securities failed to form a reasonable basis through adequate due diligence for believing the truthfulness of the School District's assertions regarding compliance with its prior continuing disclosure undertakings pursuant to Rule 15c2-12. Instead, City Securities relied solely on the representations of the issuer, which came in the form of the language included in the 2007 Official Statement and the School District's Certification and Affidavit that the 2007 Official Statement did not contain any untrue statements of material fact.

26. City Securities's Written Supervisory Procedures ("Compliance Manual") designated Ruhl, as supervisor of the Department beginning in January 2007, as responsible for monitoring and ensuring compliance in the Department. Ruhl was familiar with City Securities's Compliance Manual, had input into its policies, and annually certified that he had received, and understood it.

27. Ruhl failed to take reasonable steps to ensure that Department employees comported with even their most basic due diligence requirements when City Securities acted as underwriter. Specifically, the Compliance Manual required Department employees, as part of City Securities's due diligence activities, to review designated public repositories to ensure that issuers had submitted their required public disclosures. In practice however, certain Department employees were unaware of this requirement, and instead, with Ruhl's approval and knowledge, relied solely on the assertions of the issuer that it had complied with its prior continuing disclosure undertakings.

Legal Discussion Regarding City Securities's and Ruhl's Violations of the Federal Securities Laws As a Result of Recommendations made Without Forming a Reasonable Basis for Believing the School District's Representations, Because of a Lack of Due Diligence

28. Section 17(a)(2) of the Securities Act prohibits any person from, directly or indirectly, "obtain[ing] money or property by means of any untrue statement of a material fact" or misleading omissions. Section 10(b) and Rule 10b-5(b) of the Exchange Act prohibit the making of (1) a false statement or omission; (2) of material fact; (3) with scienter; (4) in connection with the purchase or

sale of any security. *See* SEC v. McConville, 465 F.3d 780, 786 (7th Cir. 2006). A fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. *See* Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988). The Supreme Court has previously defined scienter as "a mental state embracing intent to deceive, manipulate or defraud." *Id.* Recklessness is sufficient to establish scienter under Section 10(b) and Rule 10b-5. Miller v. Champion Enter., Inc., 346 F.3d 660, 672 (6th Cir. 2003). "Recklessness" has been defined for purposes of liability under Section 10(b) of the Exchange Act as an "extreme departure from the standards of ordinary care, which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." McConville v. SEC, 465 F.3d 780, 788 (7th Cir. 2006), 2007 U.S. App. LEXIS 926 (Jan. 17, 2007). Section 17(a)(2) violations do not require proof of scienter. Aaron v. SEC, 446 U.S. 680, 697 (1980). There is a substantial likelihood that a reasonable investor determining whether to purchase the municipal securities would attach importance to the School District's failure to comply with its prior continuing disclosure undertakings.

29. "By participating in an offering, an underwriter makes an implied recommendation about the securities [that it] . . . *has a reasonable basis for belief in the truthfulness and completeness* of the key representations made in any disclosure documents used in the offerings." Dolphin and Bradbury, Inc. v. SEC, 512 F.3d 634, 641 (D.C. Cir. 2008) (emphasis added). An underwriter "occupies a vital position" in a securities offering because investors rely on its reputation, integrity, independence, and expertise.[7] An underwriter must investigate and disclose material facts that are known or "reasonably ascertainable."[8] While broker-dealers must have a reasonable basis for recommending securities to customers, underwriters have a "heightened obligation" to take steps to ensure adequate disclosure.[9] Thus, an underwriter may violate the antifraud provisions of the federal securities laws if it does not have a reasonable basis for believing the truthfulness of material statements in offering documents in connection with a security offering as a result of inadequate due diligence.

30. In negotiated municipal offerings, where the underwriter is involved in the preparation of the official statement, as is the case in this matter, development of a reasonable basis for belief in the accuracy and completeness of the statements therein should involve an inquiry into the key representations in the official statement. The Commission has expressly stated that "sole reliance on the representations of the issuer [will] not suffice."[10]

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[7] *See* Securities Exchange Act Release No. 26100 (Sept. 22, 1988), 53 FR 37778, 37787 (Sept. 28, 1988) ("1988 Proposed Rule").

[8] *See* 1988 Proposed Rule, 53 FR at 37787.

[9] *See* 1988 Proposed Rule, 53 FR at 37788, n.74.

[10] *See* 1988 Proposed Rule, at 37789.

31. The Commission has further provided under Rule 15c2-12 that an issuer's failure to submit annual financial information is an event that requires notice pursuant to an undertaking entered into by the issuer, and is a significant factor to be taken into account when the underwriter formulates its basis for recommending securities.[11]

32. Rule 15c2-12 was adopted in an effort to improve the quality and timeliness of disclosures to investors in municipal securities. In recognition of the fact that disclosure of sound financial information is critical to the integrity of not just the primary market, but also the secondary markets for municipal securities,[12] Rule 15c2-12 requires an underwriter to obtain a written agreement, for the benefit of the holders of the securities, in which the issuer undertakes (among other things) to annually submit certain financial information. Rule 15c2-12 prohibits an underwriter such as City Securities from underwriting a municipal securities offering unless the issuer contractually agrees to make such annual disclosures.

33. In addition, Section 15B(c)(1) of the Exchange Act prohibits a broker, dealer or municipal securities dealer from using the mails or any instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in violation of any MSRB rule. City Securities was subject to Section 15B(c)(1) of the Exchange Act and the MSRB rules. MSRB Rule G-17 requires brokers, dealers and municipal securities dealers to deal fairly with all persons and not to engage in any deceptive, dishonest, or unfair practice.

34. Based on the conduct described above, City Securities willfully violated Section 17(a)(2) of the Securities Act, Sections 10(b) and 15B(c)(1) of the Exchange Act and Rule 10b-5(b) thereunder, and willfully violated MSRB Rule G-17. Ruhl willfully aided and abetted and caused City Securities's violations of Sections 10(b) and 15B(c)(1) of the Exchange Act and Rule 10b-5(b) thereunder, and MSRB Rule G-17, and caused City Securities's violation of Section 17(a)(2) of the Securities Act.

<u>City Securities Failed to Institute Procedures Pursuant to Rule 15c2-12(c) with Substantial Assistance from Ruhl</u>

35. In addition, Rule 15c2-12(c) provides that it is unlawful for a broker, dealer, or municipal securities dealer to recommend the purchase or sale of a municipal security unless such broker, dealer or municipal security dealer has procedures in place that provide reasonable assurance it will receive prompt notice of certain required disclosure submissions by an issuer, or notice of an issuer's failure to make certain required submissions.

36. During the relevant time period, City Securities did not have procedures and policies relating to Rule 15c2-12(c) and did not take reasonable steps to ensure it would receive prompt notice of required disclosure submissions by an issuer, or notice of an issuer's failure to make

[11] *See* Exchange Act Rel. No. 34961 (Nov. 10, 1994), 59 FR 59590, 59602-03 (Nov. 17, 1994).

[12] *See* Securities Exchange Act Release No. 33741 (March 9, 1994), 59 FR 12748, 12752 (March 17, 1994).

required submissions. City Securities relied solely on the assertions of the issuer as to its compliance with continuing disclosure obligations.

37. Ruhl was aware of Rule 15c2-12(c), yet as supervisor of the Department he failed to take reasonable steps to ensure that City Securities had reasonable compliance procedures and failed to provide any training to Department employees regarding Rule 15c2-12. Certain Department employees, with Ruhl's approval and knowledge, relied solely on the assertions of the issuer that it had complied with its prior continuing disclosure undertakings.

38. Based on the conduct described above, City Securities willfully violated Section 15(c)(2) of the Exchange Act and Rule 15c2-12 thereunder, and Ruhl willfully aided and abetted and caused City Securities's violation.

City Securities Fraudulently Billed Issuers for Mischaracterized Expenses with Substantial Assistance from Ruhl

39. During the relevant time period, City Securities employed standardized Bond Purchase Contracts for use with issuers when acting as an underwriter for municipal bond offerings. The Bond Purchase Contracts permitted City Securities to obtain reimbursement from bond proceeds for only certain expenses. These expenses included, among others, costs for the printing, preparation and distribution of official statements, fees of bond counsel and ratings agencies, and costs of verification services and CUSIP numbers.

40. City Securities's Compliance Manual also addressed this issue and specifically cautioned employees that "expenses which are reimbursed from bond proceeds must be reasonable and related to the municipal bond issuance process." Beginning in January 2007, the Compliance Manual designated Ruhl, as supervisor of the Department, as responsible for confirming that only those expenses "reasonably related to the offering" were reimbursed from bond proceeds.

41. In practice however, City Securities fostered a long standing and pervasive culture of lax supervision and loose internal controls as it related to expense reimbursement. As a result, City Securities, and Ruhl beginning in January 2007, routinely approved and reimbursed its employees for expenses not related to municipal bond offerings. City Securities later billed these expenses to issuers.

42. When billing expenses to issuers, City Securities's expense letters included only three categories of reimbursable expenses: (1) Printing, Preparation and Distribution of Official Statement, (2) CUSIP Fees, and (3) DTC Fees.[13]

[13] The Committee on Uniform Securities Identification Procedures ("CUSIP") numbers are the universally-recognized means of identification which, among other things, identifies the issuer of the security and the type of security to which it has been assigned. The Depository Trust Company ("DTC") is a securities depository that acts as a clearinghouse to settle trades in corporate and municipal securities.

43. However, regardless of whether expenses other than CUSIP and DTC fees in fact related to "Printing, Preparation and Distribution of Official Statement," City Securities billed them as such, thereby mischaracterizing the expense to the issuer. In doing so, City Securities billed expenses that were unrelated to the offering, and therefore not reimbursable from bond proceeds, by reallocating these costs into one of the limited categories for which it was allowed to receive reimbursement under the Bond Purchase Contract.

44. For example, during the relevant time period, various Department employees requested, and Ruhl approved reimbursement from City Securities, for expenses relating to charitable donations, entertainment and travel. Examples include the following:

a. Numerous reimbursements for mileage, hotels and entertainment relating to issuers;

b. A donation of $2,500 to a charity favored by an issuer;

c. A donation of $1,500 to an educational scholarship favored by an issuer;

d. $1,000 to sponsor of a golf outing hosted by an issuer;

e. $2,500 to sponsor an education foundation event hosted by an issuer which featured a "Colts Town Hall" breakfast with high profile professional football players from the Indianapolis Colts; and

f. Reimbursement for 12 Chicago White Sox tickets.

45. City Securities later billed these expenses back to the issuers, mischaracterized as costs of "Printing, Preparation and Distribution of Official Statement." Issuers were therefore unaware they were paying for expenses unrelated to the offering from bond proceeds.

46. During the relevant time period, Ruhl approved of the practice of mischaracterizing unrelated expenses and billing them back to issuers. Certain Department employees believed Ruhl was making an individual determination to bill expenses back to an issuer at the time he approved the expense. Ruhl however, disregarded his responsibility to determine which expenses reasonably related to the offering, resulting in the improper billing practices of Department employees.

47. In addition, City Securities, with Ruhl's knowledge and participation, regularly added purported "miscellaneous" expenses to issuers' expense letters without requiring any documentation from its bankers, or providing any documentation to the issuers, to support those expenses. In at least two instances, City Securities added $10,000 in purported "miscellaneous" expenses to issuers' expense letters, again categorizing the expenses as costs of "Printing, Preparation and Distribution of Official Statement."

48. Finally, in certain instances Ruhl, when determining the amount of charitable and entertainment expenses he would approve for particular issuers, considered the amount of revenue

he expected City Securities to receive for underwriting future bond offerings of that issuer. For example, in response to a Department employee's email request to sponsor a foursome at a charity golf outing (which Ruhl was informed would not be attended by any representatives from City Securities), Ruhl responded: "due to our 'slowing down' we are in a slowdown in approving expenses unless it is directly tied to future business."

Legal Discussion Regarding City Securities's Mischaracterization of Expenses and Ruhl's Substantial Assistance

49. The issuers were not aware they were subsidizing City Securities "charitable donations" or that City Securities was billing them for entertainment, travel and purported "miscellaneous" expenses, all of which were mischaracterized as the cost of "Printing, Preparation and Distribution of Official Statement." The issuers' payments to City Securities were made in connection with the sale of the bonds from the issuers to City Securities, in accordance with the terms of the Bond Purchase Contracts, and were material to the issuers who, had they been aware of the mischaracterized expenses, likely would not have engaged or retained City Securities as underwriter.

50. Based on the conduct described above, City Securities made materially false statements to the issuers in connection with the purchase and sale of securities and therefore willfully violated Sections 10(b) and 15B(c)(1) of the Exchange Act and Rule 10b-5(b) thereunder, and MSRB Rule G-17.[14] Ruhl willfully aided and abetted and caused City Securities's violations.

City Securities Provided Improper Gifts and Gratuities to Issuers in Violation of MSRB Rule G-20 with Substantial Assistance from Ruhl

51. During the relevant time period, City Securities provided improper entertainment, gifts and gratuities to various municipal securities issuers. For example, City Securities authorized:

a. Frequent and excessive gifts and gratuities to representatives of one school district within a four-month period in 2007, including approximately $1,500 in catering expenses for a lunch and an evening dinner reception at an event to celebrate the installation of a new superintendent; approximately $800 for travel expenses for a multi-day out-of-state golf trip, including airfare, car rental and meals; and another $140 for an overnight golf trip including hotel stays;

b. Approximately $1,250 for a group outing to a Chicago Cubs baseball game for six issuer officials and their guests which was not attended by representatives from City Securities; and

[14] MSRB Rule G-17 requires dealers to deal fairly with issuers in connection with all aspects of the underwriting of their municipal securities. The MSRB has noted that Rule G-17 may apply in connection with certain payments made and expenses reimbursed during the municipal bond issuance process for excessive or lavish travel or entertainment expenses. *See* MSRB Interpretive Notice Regarding Dealer Payments in Connection with the Municipal Securities Issuance Process (January 29, 2007).

c. In excess of $200 for two issuer officials and their guests to attend a Notre Dame football game, which again was not attended by representatives from City Securities.

52. City Securities's Compliance Manual addressed "Gifts, Gratuities and Entertainment," "Charitable Contributions," and applicable MSRB Rules including but not limited to MSRB Rule G-20. The Compliance Manual designated Ruhl, as supervisor of the Department, as the individual responsible for ensuring compliance with policies and procedures. In that capacity, Ruhl reviewed reimbursement requests for entertainment, gifts and gratuities from City Securities Department employees.

53. Ruhl approved these reimbursement requests as a matter of course, without regard to limitations addressed in the Compliance Manual and without regard to the prohibitions of MSRB Rule G-20. Further, once Ruhl approved an expense, it was almost always billed back to issuers, often times mischaracterized, without the issuers' knowledge.

Legal Discussion Regarding City Securities's and Ruhl's Violations of MSRB Rule G-20

54. In general and with certain exceptions, MSRB Rule G-20 prohibits any broker, dealer, or municipal securities dealer from, directly or indirectly, giving or permitting to be given any thing or service of value, including gratuities, in excess of $100 per year to a person other than an employee or partner of such broker, dealer, or municipal securities dealer, if such payments or services are in relation to the municipal securities activities of the recipient's employer.[15]

55. Based on the conduct described above, City Securities willfully violated MSRB Rule G-20 and Section 15B(c)(1) of the Exchange Act. Ruhl willfully aided and abetted and caused City Securities's violations.

City Securities Enhances Its Disclosure and Expense Reimbursement Policies

56. With the assistance of counsel, City Securities has:

a. Reviewed and amended the firm's written supervisory policies and procedures as it relates to SEC Rule 15c2-12, and has developed a certification process to ensure compliance with Rule 15c2-12. Also, the relevant City Securities's investment banker or underwriter, as well as a City Securities manager, must certify that the process has been followed and that each issuer is current in its submissions prior to the closing of an underwriting.

b. Hired a dedicated, nonproducing manager with the title of executive vice president to head a newly created Fixed Income Capital Markets Department. This new Department is

[15] MRSB Rule G-20(b) provides exceptions for "occasional gifts of meals or tickets to theatrical, sporting, and other entertainments hosted by the broker, dealer or municipal securities dealer; the sponsoring by the broker, dealer or municipal securities dealer of legitimate business functions that are recognized by the Internal Revenue Service as deductible business expenses; or gifts of reminder advertising; provided, that such gifts shall not be so frequent or so extensive as to raise any question of propriety."

comprised of the firm's Public Finance Department, Municipal Trading and Underwriting Department, Taxable Fixed Income and Trading Department, and Institutional Sales Department. In turn, registered principals were named as designated supervisors of the firm's Municipal Trading and Underwriting and Taxable Fixed Income Trading departments reporting up to the executive vice president of Fixed Income Capital Markets.

c. Reviewed and amended the firm's written supervisory policies and procedures to require the executive vice president of Fixed Income Capital Markets to review and approve all municipal underwriting expense letters and supporting documents prior to billing to ensure only appropriate expenses are billed to issuers.

d. Automated the firm's expense process and amended the expense report form to require bankers and other employees to note whether or not they accompany customers to events designated as "[customer] entertainment."

e. Reviewed and amended the firm's expense report to require the names and employers of those in attendance at business functions for which an employee seeks reimbursement (to include a firm employee, if present) and to more readily identify expenses which constitute gifts.

f. Reviewed and amended the firm's written supervisory policies and procedures to ensure all municipal underwriting expense reports are reviewed and approved not only by the employee's direct manager, but also by Compliance personnel who review for evidence of gifts not previously reported to Compliance and excessive customer entertainment.

g. Reviewed and amended the firm's bond purchase agreements (based on the SIFMA model BPA) and invoices to more clearly identify expenses for which City Securities will seek reimbursement.

h. Conducted approximately seven training sessions to discuss City Securities's gift and expense policy as well as its Rule 15c2-12 compliance procedures with firm personnel in general and Public Finance & Municipal Bond Department personnel in particular. Monthly compliance meetings are scheduled with the executive vice president of Fixed Income Capital Markets and designated supervisors. Attendance at these meetings will be documented and, on an annual basis, all employees are required to certify that they have received and are familiar with the firm's policies and procedures.

i. Performed an internal audit of the Public Finance & Municipal Bond Department to assess compliance with the firm's amended policies and procedures.

j. Retained independent counsel to review numerous agreements employed by City Securities to conduct its municipal finance and underwriting business for the purpose of ensuring these documents are in accord with current industry practices and standards.

k. Completed an internal audit of municipal engagements for the period January 2005 through June 2010 for the purpose of identifying instances where the firm inappropriately billed a municipal bond issuer expenses in amounts over $25, and reimbursed issuers for such amounts.

l. Engaged an Independent Compliance Consultant, not unacceptable to the Commission, to conduct a comprehensive review of the newly created Municipal Trading & Underwriting and Public Finance Departments to ensure compliance with the federal securities laws.

Violations

57. As a result of the conduct described above, City Securities willfully violated Section 17(a)(2) of the Securities Act, Sections 10(b), 15(c)(2) and 15B(c)(1) of the Exchange Act and Rules 10b-5(b) and 15c2-12 thereunder, which prohibit fraudulent conduct in the offer or sale of securities and in connection with the purchase or sale of securities, and violated MSRB Rules G-17 and G-20.

58. As a result of the conduct described above, Ruhl willfully aided and abetted and caused City Securities's violations of Sections 10(b), 15(c)(2) and 15B(c)(1) of the Exchange Act and Rules 10b-5(b) and 15c2-12 thereunder, and MSRB Rules G-17 and G-20, and caused City Securities's violation of Section 17(a)(2) of the Securities Act.

City Securities's Remedial Efforts

59. In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by City Securities.

Undertakings

City Securities has undertaken to:

60. Within ninety (90) days of the entry of this Order, require the Independent Compliance Consultant to recommend any changes necessary to ensure City Securities's future compliance with the federal securities laws. Within one hundred and eighty (180) days of the entry of this Order, City Securities shall implement any such changes.

61. Require the Independent Compliance Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Independent Compliance Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with City Securities, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the Independent Compliance Consultant will require that any firm with which he/she/it is affiliated or of which he/she/it is a member, and any person engaged to assist the Independent Compliance Consultant in performance of his/her/its duties under this Order shall not, without prior

written consent of the Assistant Director of the Municipal Securities and Public Pensions Unit in the Chicago Regional Office of the U.S. Securities and Exchange Commission, enter into any employment, consultant, attorney-client, auditing or other professional relationship with City Securities, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

IV.

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 City Securities's and Randy G. Ruhl's Offers.

Accordingly, pursuant to Section 8A of the Securities Act, Sections 15(b), 15B(c) and 21C of the Exchange Act, and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

City Securities

A. City Securities shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, and Sections 10(b), 15(c)(2) and 15B(c)(1) of the Exchange Act and Rules 10b-5 and 15c2-12 thereunder, and violations and any future violations of MSRB Rules G-17 and G-20 that would cause it to violate Section 15B(c)(1) of the Exchange Act.

B. City Securities is censured.

C. City Securities shall, within ten (10) days of the entry of this Order, pay disgorgement of $238,000, prejudgment interest of $41,446 and a civil money penalty in the amount of $300,000 to the United States Treasury, of which $60,000 shall be paid to the MSRB in accordance with Section 15B(c)(9) of the Exchange Act, representing its share of the portion of the penalty attributable to violations of MSRB rules. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 and/or 31 U.S.C. 3717. Payment must be made in one of the following ways:

(1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
(2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or
(3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center

Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying City Securities as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Elaine C. Greenberg, Chief, Municipal Securities and Public Pensions Unit, Division of Enforcement, Securities and Exchange Commission, The Mellon Independence Center, 701 Market Street, Philadelphia, PA 19106-1532.

D. City Securities shall comply with the undertakings enumerated in Section III above.

Randy G. Ruhl

E. Randy G. Ruhl shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Sections 10(b), 15(c)(2) and 15B(c)(1) of the Exchange Act and Rules 10b-5 and 15c2-12 thereunder, and violations and any future violations of MSRB Rules G-17 and G-20 that would cause him to violate Section 15B(c)(1) of the Exchange Act.

F. Randy G. Ruhl hereby is:

> barred, with the right to apply for reentry after one (1) year to the appropriate self-regulatory organization, or if there is none, to the Commission, from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter; and from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock; and
>
> barred from association in a supervisory capacity with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

G. Any reapplication for association by Randy G. Ruhl 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 Randy G. Ruhl, whether or not the Commission has fully or partially to SEC Rule of Practice 600 and/or 31 U.S.C. 3717. Payment must be made in one of the following ways:

(1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
(2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or
(3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Randy G. Ruhl as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Elaine C. Greenberg, Chief, Municipal Securities and Public Pensions Unit, Division of Enforcement, Securities and Exchange Commission, The Mellon Independence Center, 701 Market Street, Philadelphia, PA 19106-1532.

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. 70074 / July 30, 2013

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3473 / July 30, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15395

In the Matter of **Subramanian Krishnan (CPA),** **Respondent.**	**CORRECTED 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 Subramanian Krishnan ("Krishnan" 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

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

> The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . suspend from appearing or practicing before it any . . . accountant . . . who has been by name . . . permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.3 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Krishnan, age 58, is and has been a certified public accountant licensed to practice in the State of Minnesota since 1983. He served as Chief Financial Officer and Senior Vice President of Digi International, Inc. ("Digi" or the "Company"), from February 1999 until his resignation in May 2010.

2. Digi was, at all relevant times, a Delaware corporation headquartered in Minnesota. At all relevant times, Digi manufactured device networking products for businesses. At all relevant times, Digi's common stock was registered with the Commission pursuant to Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act"), and traded on the NASDAQ Global Select Market.

3. On September 28, 2012, the Commission filed a complaint against Krishnan in SEC v. Subramanian Krishnan (Civil Action No. 0:12-cv-02495-PAM-JJG) in the United States District Court for the District of Minnesota. On October 17, 2012, the court entered an order permanently enjoining Krishnan, by consent, from future violations of Section 17(a) of the Securities Act of 1933 ("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 aiding and abetting violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder; and from acting as an officer or director of a public company for a period of time to be determined by stipulation or subsequent motion by the Commission. On July 15, 2013, Krishnan was also ordered to pay a $60,000 civil money penalty and is prohibited from acting as an officer or director of a public company for a period of five years from the date of the Commission's complaint.

4. The Commission's complaint alleged that Krishnan engaged in a course of conduct which resulted in Digi filing inaccurate reports and accompanying certifications in Digi's annual reports on Form 10-K and Digi's quarterly reports on Form 10-Q for the period from March 2005 through May 2010. The complaint also alleged that Krishnan engaged in certain actions and inactions: a result of which corporate funds were used to pay for unauthorized expenses. The complaint further alleged that Krishnan aided and abetted Digi's violations by making and keeping inaccurate books and records, failing to maintain a system of adequate internal controls and making inaccurate representations to auditors.

IV.

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

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

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

B. After five years (or 60 months) 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

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

Release No. 34-70072; File No. S7-08-07

RIN 3235-AJ85

Financial Responsibility Rules for Broker-Dealers

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is adopting amendments to the net capital, customer protection, books and records, and notification rules for broker-dealers promulgated under the Securities Exchange Act of 1934 ("Exchange Act"). These amendments are designed to address several areas of concern regarding the financial responsibility requirements for broker-dealers. The amendments also update certain financial responsibility requirements and make certain technical amendments.

DATES: Effective Date: [insert date 60 days after publication in the Federal Register].

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director, at (202) 551-5525; Thomas K. McGowan, Deputy Associate Director, at (202) 551-5521; Randall Roy, Assistant Director, at (202) 551-5522; Raymond Lombardo, Branch Chief, at (202) 551-5755; Sheila Dombal Swartz, Special Counsel, (202) 551-5545; Carrie A. O'Brien, Special Counsel, (202) 551-5640; or Kimberly N. Chehardy, Attorney Advisor, (202) 551-5791; Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

SUPPLEMENTARY INFORMATION:

Table of Contents

I. BACKGROUND

The Commission is adopting amendments to the broker-dealer net capital rule (Rule 15c3-1),[1] customer protection rule (Rule 15c3-3),[2] books and records rules (Rules 17a-3 and 17a-4), and notification rule (Rule 17a-11).[3] The Commission proposed these rule changes on March 9, 2007.[4] The Commission re-opened the public comment period on May 3, 2012.[5] The Commission received a total of 97 comment letters on the proposed amendments.[6] Sixty comment letters were received prior to the re-opening of

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1 17 CFR 240.15c3-1.

2 17 CFR 240.15c3-3.

3 17 CFR 240.17a-3; 17 CFR 240.17a-4; and 17 CFR 240.17a-11.

4 See Amendments to Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 55431 (Mar. 9, 2007), 72 FR 12862 (Mar. 19, 2007) ("Amendments to Financial Responsibility Rules"). As part of this release, the Commission also requested comment on three additional matters: reducing the Rule 17a-11 (17 CFR 240.17a-11) early warning level for broker-dealers that carry over $10 billion in debits; harmonization of the net capital deductions required by paragraph (c)(2)(iv)(B) of Rule 15c3-1 for securities lending and borrowing transactions with the deductions required under paragraph (c)(2)(iv)(F) for securities repurchase and reverse repurchase agreement transactions (17 CFR 240 240.15c3-1(c)(2)(iv)(B) and (c)(2)(iv)(F), respectively); and accounting for third-party liens on customer securities held at a broker-dealer. As discussed below in section III. of this release, the Commission received comments in response to these requests but has determined to defer consideration of actions with respect to these specific matters at this time.

5 Amendments to Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 66910 (May 3, 2012), 77 FR 27150 (May 9, 2012).

6 Comments on the amendments are available at http://www.sec.gov/comments/s7-08-07/s70807.shtml. See also letter dated April 22, 2007 from Peter G. Crane, President, Crane Data LLC ("Crane Data Letter"); letter dated April 22, 2007 from David Michael Bishop ("Bishop Letter"); letter dated April 27, 2007 from Ted Beer, Broker/Dealer Principal ("Beer Letter"); letter dated April 28, 2007 from Ted Beer, Broker/Dealer Principal ("Beer 2 Letter"); letter dated April 29, 2007 from R.A. Lowenstein, FinOps Compliance Consultant ("Lowenstein Letter"); letter dated April 29, 2007 from G. Kirk Ellis ("Ellis Letter"); letter dated May 1, 2007 from Stuart J. Kaswell and David J. Harris, Dechert LLP on behalf of Federated Investors ("Federated Letter"); letter dated May 2, 2007 from Daniel R. Levene, President, small NASD broker-dealer ("Levene Letter"); letter dated May 4, 2007 from Gerard J. Quinn, Vice President and Associate General Counsel, SIFMA ("SIFMA Letter"); letter dated May 7, 2007 from Michael Bell, President and CEO, Curian Clearing, LLC ("Curian Clearing Letter"); letter dated May 10, 2007 from Richard B. Franz II, Senior Vice-President, Treasurer and Chief Financial Officer, Raymond James & Associates ("Raymond James Letter"); letter dated May 16,

2007 from Steven R. Gerbel, Chicago Capital Management LP ("Chicago Capital Letter"); letter dated May 17, 2007 from Jeffrey L. Kiss, Principal, PackerKiss Securities, Inc. ("PackerKiss Letter"); letter dated May 17, 2007 from Josephine Wang, General Counsel, SIPC ("SIPC Letter"); letter dated May 18, 2007 from Kimberly Taylor, Managing Director and Clearing House President, Chicago Mercantile Exchange Inc. ("CME Letter"); letter dated May 18, 2007 from Diane V. Esheleman, Executive Vice President, JP Morgan Chase Bank, N.A. ("JP Morgan Letter"); letter dated May 21, 2007 from Faith Colish, Carter Ledyard Milburn LLP ("Colish Letter"); letter dated May 23, 2007 from Charles R. Manzoni, Jr., General Counsel, FAF Advisors, Inc. ("FAF Advisors Letter"); letter dated May 27, 2007 from Joyce Glenn ("Glenn Letter"); letter dated May 28, 2007 from William Bare ("Bare Letter"); letter dated May 29, 2007 from Robert Keenan, CEO, St. Bernard Financial Services, Inc. ("St. Bernard Financial Services Letter"); letter dated May 31, 2007 from John C. Melton, Sr., Executive Vice President, Coastal Securities ("Coastal Letter"); letter dated June 3, 2007 from Anonymous ("Anonymous Letter"); letter dated June 5, 2007 from Kelly S. McEntire, Executor, Retired State Administrator/Executor of Janus Capital Investments ("McEntire Letter"); letter dated June 13, 2007 from Bruce Bent, Chairman, The Reserve ("Reserve Letter"); letter dated June 14, 2007 from Amal El Said, Accounting and Regulatory, Abbey National ("Abbey National Letter"); letter dated June 14, 2007 from Frank A. Perrone, Senior Vice President, Brown Brothers Harriman & Co. ("Brown Brothers Harriman Letter"); letter dated June 15, 2007 from James J. Angel, Ph.D., CFA, Associate Professor of Finance, McDonough School of Business, Georgetown University ("Angel Letter"); letter dated June 15, 2007 from Matthew M. Hughey, Chief Financial Officer, First Clearing, LLC ("First Clearing Letter"); letter dated June 15, 2007 from Marshall J. Levinson, Senior Managing Director, Bear, Stearns & Co. Inc., Chair, SIFMA Capital Committee ("SIFMA 2 Letter"); letter dated June 15, 2007 from Christopher Williams, Director and Senior Counsel, and Barbara Brooks, Principal Financial Officer, Dresdner Kleinwort ("Dresdner Kleinwort Letter"); letter dated June 18, 2007 from Michael Dworkin ("Dworkin Letter"); letter dated June 18, 2007 from Keith Weller, Executive Director and Senior Associate General Counsel, UBS Global Asset Management (Americas) Inc. ("UBS Letter"); letter dated June 18, 2007 from Marcelo Riffaud, Managing Director, Legal Department, Deutsche Bank Securities Inc. ("Deutsche Bank Securities Letter"); letter dated June 18, 2007 from Jill Gross and Rahat Sarmast, Pace Investor Rights Project ("Pace Letter"); letter dated June 18, 2007 from Robert E. Putney, III, Director and Senior Counsel, BlackRock, Inc. ("BlackRock Letter"); letter dated June 18, 2007 from James S. Keller, Chief Regulatory, the PNC Financial Services Group, Inc. ("PNC Letter"); letter dated June 18, 2007 from Sarah A. Miller, General Counsel, American ABA Securities Association ("ABASA Letter"); letter dated June 18, 2007 from David Hirschmann, Executive Vice President, National Chamber Foundation of U.S. Chamber of Commerce ("National Chamber Foundation Letter"); letter dated June 18, 2007 from Michael W. Fields, Chief Fixed Income Officers, American Beacon Advisors ("American Beacon Letter"); letter dated June 18, 2007 from David Lonergan, Head of U.S. Cash Management, Barclays Global Investors ("Barclays Letter"); letter dated June 18, 2007 from Howard Spindel, Senior Managing Directors, Integrated Management Solutions ("Integrated Management Letter"); letter dated June 18, 2007 from Jane G. Heinrichs, Associate Counsel, Investment Company Institute ("ICI Letter"); letter dated June 18, 2007 from Jeffrey P. Neubert, CEO, Clearinghouse Association L.L.C. ("Clearing House Letter"); letter dated June 19, 2007 from James T. McHale, Associate General Counsel, E*Trade Brokerage Holdings, Inc. ("E*Trade Letter"); letter dated June 25, 2007 from Cliff Verron, Managing Director, Deputy Chief Financial Officers and John Ramsay, Managing Director, Deputy General Counsel, Citigroup Global Markets Inc. ("Citigroup Letter"); letter dated June 25, 2007 from AMEX, CBOE, ISE, OCC, and NYSE/ARCA ("AMEX Letter"); letter dated July 3, 2007 from Keith F. Higgins, Chair, Committee on Federal Regulation of Securities, American Bar Association ("American Bar Association Letter"); letter dated July 23, 2007 from Charles S. Morrison, Senior Vice President and Money Market Group Leader, Fidelity Management & Research Company, and John Valenti, Vice President, National Financial Securities LLC ("Fidelity/NFS Letter"); letter dated August 6, 2007 from Stuart Kaswell, Dechert LLP, on behalf of Federated Investors, Inc. ("Federated 2 Letter"); letter dated October 9, 2007 from Stuart Kaswell, Dechert LLP on behalf of Federated Investors, Inc. ("Federated 3 Letter"); letter dated November 16, 2007 from Marshall J. Levinson, Chair, Capital Committee, SIFMA ("SIFMA 3 Letter"); letter dated January 7, 2008 from Stuart J. Kaswell, Dechert LLP, on behalf of Federated Investors, Inc. ("Federated 4 Letter"); letter dated August 7, 2008 from Stuart J. Kaswell, Bryan Cave LLP, on behalf of Federated Investors, Inc. ("Federated 5 Letter"); letter dated November 10, 2008 from Lee A. Pickard, Pickard & Djinis LLP on behalf of Federated Investors ("Federated 6 Letter"); letter dated November 25, 2008 from Lee A. Pickard, Pickard & Djinis LLP on behalf of Federated Investors ("Federated 7 Letter"); letter dated December 18, 2008 from Lee A. Pickard, Pickard & Djinis LLP on behalf of Federated Investors ("Federated 8 Letter"); letter dated July 28, 2009 from Richard J. McDonald, Chief Regulatory Counsel, Susquehanna International Group LLP ("SIG Letter"); letter dated June 8, 2010 from The Honorable Gregory W. Meeks ("Meeks Letter"); letter dated October 14, 2011 from The Honorable Gregory W. Meeks ("Meeks 2 Letter"); letter dated May 5, 2012 from Edward P. Cernocky ("Cernocky Letter"); letter dated May 11, 2012 from Chris Barnard ("Barnard Letter"); letter dated May 15, 2012 from Helen M. Saarinen ("Saarinen Letter"); letter dated May 18, 2012 from Laura H. Hearne ("Hearne Letter"); letter dated May 24, 2012 from Dick Fuld ("Fuld Letter"); letter dated May 30, 2012 from Bruce J. Womack ("Womack Letter"); letter dated June 1, 2012 from Lee A. Pickard, Pickard & Djinis LLP, on behalf of Federated Investors ("Federated 9 Letter"); letter dated June 4, 2012 from Michael Scillia, Director, National Investment Banking Association ("NIBA Letter"); letter dated June 7, 2012 from Anthony Fitzgerald ("Fitzgerald Letter"); letter dated June 7, 2012 from Tom Vincent, Senior V.P., Corporate Governance and Wealth Management Compliance, BOK Financial Corporation ("BOK Letter"); letter dated June 8, 2012 from Denise Dolphin ("Dolphin Letter"); letter dated June 8, 2012 from Colin W. McKechnie, Managing Director, JP Morgan Chase Bank, N. A ("JP Morgan 2 Letter"); letter dated June 8, 2012 from William A. Jacobson, Associate Clinical Professor, Cornell Law School, and Director, Cornell Securities Law Clinic, Ithaca, New York ("Cornell Letter"); letter dated June 8, 2012 from Ryan K. Bakhtiari, Aidikoff, Uhl & Bakhtiari, on behalf of the Public Investors Arbitration Bar Association ("PIABA Letter"); letter dated June 8, 2012 from Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA ("SIFMA 4 Letter"); letter dated June 8, 2012 from Sarah A. Miller, Chief Executive Officer, Institute of International Bankers ("IIB Letter"); letter dated June 8, 2012 from James T. McHale, Global Head of Compliance, E*TRADE Financial Corporation ("E*Trade 2 Letter"); letter dated June 11, 2012 from Steve M. Brewer, Sr., ASG Securities, LLC, Houston, Texas ("ASG Securities Letter"); letter dated June 25, 2012 from Gene L. Finn ("Finn Letter"); letter dated June 26, 2012 from Cindy Walsh ("Walsh Letter"); letter dated July 12, 2012 from Michael Scillia, Director, National Investment Banking Association ("NIBA 2 Letter"); letter dated July 18, 2012 from Gene L. Finn ("Finn 2 Letter"); letter dated July 30, 2012 from David Waddell ("Waddell Letter"); letter dated August 6, 2012 from Gene Finn ("Finn 3 Letter"); letter dated August 15, 2012 from Echeal R. Sigan ("Sigan Letter"); letter dated August 26, 2012 from Mark Irwin ("Irwin Letter"); letter dated September 17, 2012 from Gene L. Finn ("Finn 4 Letter"); letter dated September 27, 2012 from Jeff S. Clark ("Clark Letter"); letter dated September 28, 2012 from Robert LaPlante, M.P.A.

the comment period, and 37 were received after it. The Commission carefully considered all of the comment letters, and as discussed in detail below, modified the amendments in certain respects in light of the comments received. In addition, the Commission has determined to defer consideration of action at this time with respect to certain of the proposed amendments.

II. AMENDMENTS

A. Amendments to the Customer Protection Rule

1. Background

The Commission adopted Rule 15c3-3 in 1972 in response to a congressional directive to strengthen the financial responsibility requirements for broker-dealers that hold securities and cash for customers.[7] In particular, Rule 15c3-3 is designed "to give more specific protection to customer funds and securities, in effect forbidding brokers and dealers from using customer assets to finance any part of their businesses unrelated to servicing securities customers; e.g., a firm is virtually precluded from using customer funds to buy securities for its own account."[8] To meet this objective, Rule 15c3-3 requires a broker-dealer that maintains custody of customer securities and cash (a

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("LaPlante Letter"); letter dated October 19, 2012 from Rick Louderbough ("Louderbough Letter"); letter dated October 24, 2012 from Paul L. Matecki, Senior Vice President, General Counsel, Raymond James Financial, Inc. ("Raymond James 2 Letter"); letter dated October 25, 2012 from Eric Gamble, Ph.D. ("Gamble Letter"); letter dated November 1, 2012 from Percy R. Moorman, Esq. ("Moorman Letter"); letter dated January 4, 2013 from Marquis Wilkins ("Wilkins Letter"); letter dated January 5, 2013 from Anonymous SEC Fan ("Anonymous SEC Letter"); letter dated January 24, 2013 from Robert Fournier ("Fournier Letter"); and letter dated January 28, 2013 from Scott E. Shjefte ("Shjefte Letter"). Comment letters and specific comments outside the scope of this rulemaking are not addressed in this release.

7 See Broker-dealers; Maintenance of Certain Basic Reserves, Exchange Act Release No. 9856 (Nov. 10, 1972), 37 FR 25224 (Nov. 29, 1972).

8 See Net Capital Requirements for Brokers and Dealers, Exchange Act Release No. 21651 (Jan. 11, 1985), 50 FR 2690, 2690 (Jan. 18, 1985). See also Broker-Dealers; Maintenance of Certain Basic Reserves, Exchange Act Release No. 9856 (Nov. 10, 1972), 37 FR 25224, 25224 (Nov. 29, 1972).

"carrying broker-dealer") to take two primary steps to safeguard these assets. The steps are designed to protect customers[9] by segregating their securities and cash from the broker-dealer's proprietary business activities. If the broker-dealer fails financially, the securities and cash should be readily available to be returned to the customers. In addition, if the failed broker-dealer is liquidated in a formal proceeding under the Securities Investor Protection Act of 1970 ("SIPA"), the securities and cash would be isolated and readily identifiable as "customer property" and, consequently, available to be distributed to customers ahead of other creditors.[10]

The first step required by Rule 15c3-3 is that a carrying broker-dealer must maintain physical possession or control over customers' fully paid and excess margin securities.[11] Physical possession or control means the broker-dealer must hold these

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9 Rule 15c3-3 defines customer as "any person from whom or on whose behalf a broker or dealer has received or acquired or holds funds or securities for the account of that person." The rule excludes certain categories of persons from the definition, including broker-dealers, municipal securities dealers, and government securities broker-dealers. It also excludes general partners, directors, and principal officers of the broker-dealer and any other person to the extent that the person has a claim for property or funds which by contract, agreement or understanding, or by operation of law, is part of the capital of the broker-dealer or is subordinated to the claims of creditors of the broker-dealer. 17 CFR 240.15c3-3(a)(1).

10 See 15 U.S.C. 78aaa et seq.

11 See 17 CFR 240.15c3-3(b) and (d). The term fully paid securities includes all securities carried for the account of a customer in a special cash account as defined in Regulation T promulgated by the Board of Governors of the Federal Reserve System, as well as margin equity securities within the meaning of Regulation T which are carried for the account of a customer in a general account or any special account under Regulation T during any period when section 8 of Regulation T (12 CFR 220.8) specifies that margin equity securities shall have no loan value in a general account or special convertible debt security account, and all such margin equity securities in such account if they are fully paid: provided, however, that the term fully paid securities shall not apply to any securities which are purchased in transactions for which the customer has not made full payment. 17 CFR 240.15c3-3(a)(3). The term margin securities means those securities carried for the account of a customer in a general account as defined in Regulation T, as well as securities carried in any special account other than the securities referred to in paragraph (a)(3) of Rule 15c3-3. 17 CFR 240.15c3-3(a)(4). The term excess margin securities means those securities referred to in paragraph (a)(4) of Rule 15c3-3 carried for the account of a customer having a market value in excess of 140 percent of the total of the debit balances in the customer's account or accounts encompassed by paragraph

securities in one of several locations specified in Rule 15c3-3 and free of liens or any other interest that could be exercised by a third party to secure an obligation of the broker-dealer.[12] Permissible locations include a bank, as defined in section 3(a)(6) of the Exchange Act, and a clearing agency.[13]

The second step is that a carrying broker-dealer must maintain a reserve of cash or qualified securities in an account at a bank that is at least equal in value to the net cash owed to customers, including cash obtained from the use of customer securities.[14] The account must be titled "Special Reserve Bank Account for the Exclusive Benefit of Customers."[15] The amount of net cash owed to customers is computed pursuant to a formula set forth in Exhibit A to Rule 15c3-3.[16] Under the customer reserve formula, the broker-dealer adds up customer credit items (e.g., cash in customer securities accounts and cash obtained through the use of customer margin securities) and then subtracts from that amount customer debit items (e.g., margin loans).[17] If credit items exceed debit items, the net amount must be on deposit in the customer reserve account in the form of

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(a)(4) of Rule 15c3-3 which the broker-dealer identifies as not constituting margin securities. 17 CFR 240.15c3-3(a)(5). As discussed in section II.F. of this release, the Commission is adopting technical amendments to the definitions of the terms fully paid securities and margin securities under Rule 15c3-3. See paragraphs (a)(3) and (4) of Rule 15c3-3, as adopted.

12 See 17 CFR 240.15c3-3(c). Customer securities held by the carrying broker-dealer are not assets of the firm. Rather, the carrying broker-dealer holds them in a custodial capacity and the possession and control requirement is designed to ensure that the carrying broker-dealer treats them in a manner that allows for their prompt return.

13 Id.

14 17 CFR 240.15c3-3(e). The term qualified security is defined in Rule 15c3-3 to mean a security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States. See 17 CFR 240.15c3-3(a)(6).

15 See 17 CFR 240.15c3-3(e)(1). The purpose of giving the account this title is to alert the bank and creditors of the broker-dealer that this account is to be used to meet the broker-dealer's obligations to customers (and not the claims of general creditors) in the event the broker-dealer must be liquidated in a formal proceeding.

16 17 CFR 240.15c3-3a.

17 Id.

cash and/or qualified securities.[18] A broker-dealer cannot make a withdrawal from the customer reserve account until the next computation and even then only if the computation shows that the reserve requirement has decreased.[19] The broker-dealer must make a deposit into the customer reserve account if the computation shows an increase in the reserve requirement.

In addition, the customer reserve formula permits the broker-dealer to offset customer credit items only with customer debit items.[20] This means the broker-dealer can use customer cash to facilitate customer transactions such as financing customer margin loans and borrowing securities to make deliveries of securities that customers have sold short.[21] Broker-dealer margin rules require securities customers to maintain a minimum

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18 17 CFR 240.15c3-3(e). Customer cash is a balance sheet item of the carrying broker-dealer (i.e., the amount of cash received from a customer increases the amount of the carrying broker-dealer's assets and creates a corresponding liability to the customer). The customer reserve formula is designed to isolate these broker-dealer assets so that an amount equal to the net liabilities to customers is held as a reserve in the form of cash or qualified securities. The requirement to establish this reserve is designed to effectively prevent the carrying broker-dealer from using customer funds for proprietary business activities such as investing in securities. The goal is to put the carrying broker-dealer in a position to be able to readily meet its cash obligations to customers by requiring the firm to make deposits of cash and/or qualified securities into the customer reserve account in the amount of the net cash owed to customers. Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071 (Oct. 18, 2012), 77 FR 70213, 70277 n.671 (Nov. 23, 2012).

19 See 17 CFR 240.15c3-3(e). Under paragraph (e), broker-dealers are generally required to perform the customer reserve computation as of the close of business on the last business day of the week. Broker-dealers from time to time may perform a mid-week computation if it would permit them to make a withdrawal. 17 CFR 240.15c3-3(g).

20 See 17 CFR 240.15c3-3a.

21 For example, if a broker-dealer holds $100 for customer A, the broker-dealer can use that $100 to finance a security purchase of customer B. The $100 the broker-dealer owes customer A is a credit in the formula and the $100 customer B owes the broker-dealer is a debit in the formula. Therefore, under the customer reserve formula there would be no requirement to maintain cash and/or U.S. government securities in the customer reserve account. However, if the broker-dealer did not use the $100 held in customer A's account for this purpose, there would be no offsetting debit and, consequently, the broker-dealer would need to have on deposit in the customer reserve account cash and/or qualified securities in an amount at least equal to $100.

level of equity in their securities accounts.[22] In addition to protecting the broker-dealer from the consequences of a customer default, this equity serves to over-collateralize the customers' obligations to the broker-dealer and thereby protect customers whose cash was used to facilitate the broker-dealer's financing of securities purchases and short sales by other customers. For example, if the broker-dealer fails, the customer debits, because they generally are over-collateralized, should be attractive assets for another broker-dealer to purchase or, if not purchased by another broker-dealer, they should be able to be liquidated to a net positive equity.[23] The proceeds of the debits sale or liquidation can be used to repay the customer cash used to finance the customer obligations. This cash plus the funds and/or qualified securities held in the customer reserve account should equal or exceed the total amount of customer credit items (i.e., the total amount owed by the broker-dealer to its customers).[24]

2. Proprietary Accounts of Broker-Dealers

A carrying broker-dealer may carry accounts that hold proprietary securities and cash of other broker-dealers ("PAB accounts"). As noted above, broker-dealers are not within the definition of customer for purposes of Rule 15c3-3.[25] Accordingly, a carrying broker-dealer that carries PAB accounts is not required to treat these accounts as

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22 Broker-dealers are subject to margin requirements in Regulation T promulgated by the Federal Reserve (see 12 CFR 220.1, et seq.), in rules promulgated by the self-regulatory organizations ("SROs") (see, e.g., FINRA Rules 4210–4240), and with respect to security futures, in rules jointly promulgated by the Commission and the CFTC (see 17 CFR 242.400–406).

23 The attractiveness of the over-collateralized debits facilitates the bulk transfer of customer accounts from a failing or failed broker-dealer to another broker-dealer.

24 See Net Capital Requirements for Broker-Dealers; Amended Rules, Exchange Act Release No. 18417 (Jan. 13, 1982), 47 FR 3512, 3513 (Jan. 25, 1982) ("The alternative method is founded on the concept that if the debit items in the Reserve Formula can be liquidated at or near their contract values, these assets, along with any cash required to be on deposit under the [customer protection] rule, will be sufficient to satisfy all customer-related liabilities (which are represented as credit items in the Reserve Formula").

25 17 CFR 240.15c3-3(a)(1).

customer accounts for the purposes of Rule 15c3-3. This means the carrying broker-dealer is not required to maintain possession or control of the securities of PAB account holders that are not securing margin loans to the account holders ("non-margin securities") or include credit and debit items associated with those accounts in its customer reserve computation. The definition of customer in SIPA, however, is broader than the definition in Rule 15c3-3 in that the SIPA definition does not exclude broker-dealers.[26] Customers under SIPA ("SIPA customers") generally are entitled to a number of protections, including the right to share pro rata with other SIPA customers in the customer property held by the broker-dealer and, if the customer property is insufficient to make each SIPA customer whole, the entitlement to receive an advance from the Securities Investor Protection Corporation ("SIPC") of up to $500,000 (of which $250,000 currently can be used to cover cash claims).[27] Broker-dealers as SIPA customers have the right to a pro rata share of the customer property, but are not entitled to receive an advance from the SIPC fund.[28] Consequently, when a carrying broker-dealer is liquidated in a SIPA proceeding, each customer (including a SIPA customer that is a broker-dealer) has a claim on the customer property. Because the possession and control and customer reserve account provisions of Rule 15c3-3 do not apply to PAB account holders by virtue of the definition of customer in the rule, the carrying broker-

26 See 15 U.S.C. 78lll(2).

27 See 15 U.S.C. 78fff-2(c) and 15 U.S.C. 78fff-3(a), respectively. Under SIPA, customer property includes "cash and securities (except customer name securities delivered to the customer) at any time received, acquired, or held by or for the account of the debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted." 15 U.S.C. 78lll(4). Therefore, customer property includes those securities positions that are held for customers and the cash that is owed to customers.

28 See 15 U.S.C. 78fff-2(c); see also 15 U.S.C. 78fff-3(a).

dealer is not restricted by Rule 15c3-3 from using the securities and cash in these accounts for its own business purposes.

The treatment of PAB account holders as SIPA customers but not as customers for the purposes of Rule 15c3-3 increases the risk that, in the event a carrying broker-dealer is liquidated under SIPA, the claims of SIPA customers (i.e., customers and PAB account holders) will exceed the amount of customer property available and, thereby, expose the SIPC fund and potentially SIPA customers to losses. In addition, if the customer property is insufficient to fully satisfy all SIPA customer claims and losses are incurred, the PAB account holders could be placed in financial distress causing adverse impacts to the securities markets beyond those resulting from the failure of the carrying broker-dealer.[29]

To address the disparity in treatment between customers and PAB account holders, the Commission proposed amendments to Rules 15c3-3 and 15c3-3a that would have required a broker-dealer that carries PAB accounts to perform a PAB reserve computation with respect to those accounts, generally as of the close of business on the last business day of the week.[30] The amendments, as proposed, would have required the carrying broker-dealer to add up the debits and credits relating to PAB accounts – including credits arising from the use of securities held in PAB accounts – and maintain cash or qualified securities in a PAB reserve account in an amount equal to or greater than the amount that the credits exceed the debits.

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[29] As noted above, while broker-dealers are customers for the purposes of SIPA, they are not entitled to the advances from the SIPC fund to make up for shortfalls after the pro rata distribution of customer property. 15 U.S.C. 78fff-3(a)(5).

[30] See Amendments to Financial Responsibility Rules, 72 FR at 12863. A broker-dealer that does not carry an account of a customer as defined under Rule 15c3-3 or conduct a proprietary trading business would be permitted to make the computation monthly rather than weekly. See paragraph (e)(3)(iii) of Rule 15c3-3, as adopted.

Seven commenters responded to the Commission's request for comment on the proposed amendments.[31] As discussed below, the Commission has modified the final rule in certain respects to address, among other things, issues raised by commenters. As adopted, the Commission's amendments to Rules 15c3-3 and 15c3-3a require carrying broker-dealers to: (1) perform a separate reserve computation for PAB accounts (in addition to the customer reserve computation currently required for Rule 15c3-3 customer accounts); (2) establish and fund a separate reserve account for the benefit of PAB account holders; and (3) obtain and maintain physical possession or control of non-margin securities carried for PAB accounts unless the carrying broker has provided written notice to the PAB account holders that it will use those securities in the ordinary course of its securities business, and has provided opportunity for the PAB account holder to object to such use.[32]

These amendments, in part, incorporate many of the provisions of a no-action letter regarding PAB accounts issued by Commission staff in 1998.[33] The PAIB Letter stated that the staff would not recommend enforcement action to the Commission if a broker-dealer did not take a net capital deduction under Rule 15c3-1 for cash held in a securities account at another broker-dealer,[34] provided the other broker-dealer agrees to:

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31 See SIFMA 2 Letter; SIFMA 4 Letter; Dresdner Kleinwort Letter; Deutsche Bank Securities Letter; SIPC Letter; Abbey National Letter; First Clearing Letter; Cornell Letter.

32 See infra section II.A.2.ii. of this release for a discussion of the Commission's rationale for the change in the final rule to require a carrying broker-dealer provide notice to, rather than obtain written permission from, a PAB account holder in order for its securities to be used in the ordinary course of the carrying firm's securities business.

33 See Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Raymond J. Hennessy, Vice President, NYSE, and Thomas Cassella, Vice President, NASD Regulation, Inc. (Nov. 3, 1998) ("PAIB Letter").

34 Under Rule 15c3-1, broker-dealers are generally required to deduct unsecured receivables from their net worth when computing their net capital.

(1) perform a reserve computation for PAB accounts;[35] (2) establish a separate special reserve bank account; and (3) maintain cash or qualified securities in the reserve account equal to the computed reserve requirement ("PAIB agreement"). Broker-dealers that carry PAB accounts have the incentive to enter into PAIB agreements to prevent their PAB account holders from choosing to open an account or enter into a clearing agreement with another broker-dealer. Because many of the provisions in the PAIB Letter are being incorporated in this rulemaking, the Commission is directing the Commission staff to withdraw the PAIB Letter as of the effective date of these rule amendments.

i. Definition of "PAB account" under Rule 15c3-3(a)(16)

The Commission proposed, among other things, to add paragraph (a)(16) to Rule 15c3-3 that would have defined the term PAB account as "a proprietary securities account of a broker or dealer (which includes a foreign broker or dealer, or a foreign bank acting as a broker or dealer), but shall not include an account where the account owner is a guaranteed subsidiary of the carrying broker or dealer, the account owner guarantees all liabilities and obligations of the carrying broker or dealer, or the account is a delivery-versus-payment account or receipt-versus-payment account."[36] Two commenters raised concerns about the proposed definition because – by including proprietary accounts of foreign broker-dealers and foreign banks acting as broker-dealers within the term PAB account – it differed from provisions in the PAIB Letter, which excluded such accounts

35 Under new paragraph (e)(3), broker-dealers will be required to perform the PAB reserve account computation (and its customer reserve account computation, if applicable) on a weekly basis, as of the close of business on the last business day of the week. With regard to PAB accounts, a broker-dealer that does not carry an account of a customer as defined under Rule 15c3-3 or conduct a proprietary trading business may make the PAB reserve account computation monthly rather than weekly. See new paragraph (e)(3)(iii) of Rule 15c3-3.

36 See Amendments to Financial Responsibility Rules, 72 FR at 12895.

from a PAIB computation.[37] One of these commenters stated that broker-dealers (including foreign banks acting as broker-dealers) should be allowed to opt-out of PAB account treatment because they do not require the same protections as customers as defined in Rule 15c3-3.[38] The commenter stated that broker-dealers are able to understand the insolvency risk of the broker-dealers at which they maintain proprietary accounts.[39] This commenter noted that broker-dealer customers often self-insure or otherwise account for such exposure regardless of their status under SIPA.[40] The second commenter stated that foreign broker-dealers and foreign banks acting as broker-dealers should be allowed to subordinate their claims to customers and creditors of the broker-dealer in order to remove their accounts from PAB account treatment because under SIPA foreign broker-dealers and foreign banks acting as broker-dealers, under certain circumstances, will not be deemed customers and, therefore, would not be entitled to a pro rata share of the estate of customer property in a SIPA liquidation.[41] More specifically, the commenter suggested that the Commission modify the definition of PAB account, to exclude "any foreign broker-dealer and foreign bank to the extent that such entity has a claim for cash or securities that is subordinated to the claims of creditors of the carrying broker-dealer" in order to parallel the language in SIPA.[42] This commenter

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37 See Dresdner Kleinwort Letter; Deutsche Bank Securities Letter. Though SIFMA initially raised concerns about the proposed definition, it later withdrew its recommendation that proprietary accounts of affiliated non-U.S. broker-dealers and non-U.S. banks be excluded from the PAB account definition. See SIFMA 2 Letter; SIFMA 4 Letter.

38 See Dresdner Kleinwort Letter.

39 Id.

40 See Dresdner Kleinwort Letter.

41 See Deutsche Bank Securities Letter.

42 The definition of customer in SIPA excludes any person, to the extent that "such person has a claim for cash or securities which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor, or is subordinated to the claims of

also recommended requiring the "subordinating" broker-dealer to follow the requirements for non-conforming subordinated loans to remove an account from PAB account treatment.[43]

Another commenter stated that the Commission's desire to close the gap between Rule 15c3-3 and SIPA must be balanced against the potentially significant practical issues the Commission's proposal would raise in the case of accounts carried for affiliated entities operating in non-U.S. jurisdictions.[44] In a subsequent letter, this commenter stated that while it would prefer a more flexible solution that would allow broker-dealers and non-U.S. banks acting as broker-dealers (especially non-U.S. affiliates) to opt to have their accounts treated as neither customer accounts under SIPA nor PAB accounts, the commenter recognized that there is a clear need for an immediate solution that cannot be delayed until appropriate amendments to SIPA are adopted.[45] Consequently, the commenter withdrew its recommendation that the proprietary accounts of affiliated non-U.S. broker-dealers and affiliated non-U.S. banks be excluded from the "PAB account" definition, but continued to endorse its previous comments to achieve the

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any and all creditors of the debtor, notwithstanding that some grounds exist for declaring such contract, agreement, or understanding void or voidable in a suit between the claimant and the debtor." See 15 U.S.C. 78lll(2)(C)(iii).

43 See Deutsche Bank Securities Letter. See also SIFMA 4 Letter. Under Rule 15c3-1, a broker-dealer can exclude liabilities that are subordinated to the claims of creditors pursuant to a satisfactory subordination agreement, as defined in Appendix D to Rule 15c3-1, for purposes determining its net capital. See 17 CFR 240.15c3-1(c)(2)(ii) and 17 CFR 240.15c3-1d. See also 17 CFR 240.15c3-1(c)(i)(x). A non-conforming subordination agreement generally would not meet all the requirements of Appendix D to Rule 15c3-1, and, therefore, a broker-dealer could not exclude the liability resulting from the loan agreement in computing its net capital. See 17 CFR 240.15c3-1(c)(2)(ii).

44 See SIFMA 2 Letter. This commenter specifically raised concerns that it would be cumbersome to subject transactions between a carrying broker-dealer and its foreign affiliates to the proposed PAB requirements because of the integrated securities processing and settlement activities of these entities, which would limit the ability of the group as a whole to provide competitive services to U.S. investors.

45 See SIFMA 4 Letter.

goal of correcting the gap between Rule 15c3-3 and SIPA without creating undue or unintended burdens.[46]

The goal of the proposed amendments is to create a process that protects Rule 15c3-3 customers and PAB account holders of a failed carrying broker-dealer. The amendments are designed to provide such protection by mitigating the risk that there will be insufficient customer property to fully satisfy all customer claims in a SIPA liquidation. The entitlement of PAB account holders to a pro rata share of the fund of customer property places all SIPA customers at risk if the carrying firm does not establish a PAB reserve account for excess credits owed to PAB account holders.

At the same time, the Commission appreciates the need to consider both the practical issues raised by commenters and its objective to eliminate the inconsistency between Rule 15c3-3 and SIPA.[47] Accordingly, in response to commenters, the final rule adopted by the Commission excludes from the definition of PAB account in paragraph (a)(16) of Rule 15c3-3 "an account that has been subordinated to the claims of creditors of the carrying broker or dealer."[48] A PAB account holder that has subordinated its claims with respect to that account to claims of creditors of the carrying broker-dealer will not be entitled to SIPA protection for that account.[49] Consequently, this provision will provide flexibility to carrying broker-dealers and their broker-dealer affiliates to structure their PAB account relationships in a manner that permits operational

46 See SIFMA 4 Letter. Among other things, the commenter suggested that the Commission modify the proposed definition of PAB account to exclude any customer as defined in Rule 15c3-3 and also to exclude the other types of persons who are specifically excluded from the definition of customer. This suggestion included excluding accounts whose claims are subordinated to the claims of other creditors of the carrying broker-dealer. Id.

47 See Amendments to Financial Responsibility Rules, 72 FR at 12863.

48 The agreement would not need to be conforming for purposes of Exchange Act Rule 15c3-1d (Satisfactory Subordination Agreements).

49 See 15 U.S.C. 78lll(2).

efficiencies (i.e., the ability to exclude these accounts from the PAB reserve computation) while still promoting the goal of the amendments to have a consistent treatment of these accounts under Rule 15c3-3 and SIPA, and thereby protect accounts holders that are "customers" under SIPA.[50] If a U.S. broker-dealer, however, chooses to subordinate its claims to assets in that account to the claims of other creditors of the carrying broker-dealer, it will not be able to include those assets as allowable for its own net capital computation.[51]

Further, as was proposed, the definition of PAB account in the final rule excludes accounts that operate on a delivery-versus-payment or a receipt-versus-payment basis, or "DVP/RVP" basis, because these accounts generally hold securities and cash for short durations.[52] The provision relating to DVP/RVP accounts is being adopted substantially as proposed, though paragraph (a)(16), as adopted, has been modified by splitting the text into two sentences. As adopted, the reference to the DVP/RVP accounts provision was moved to the first sentence. The Commission is not adopting the proposed exclusions from the PAB reserve computation requirement related to accounts established by a PAB account holder that fully guarantee the obligations of, or whose accounts are fully guaranteed by, the carrying broker-dealer. Rather than create a specific exemption for such account holders, the Commission believes the better approach is to allow these accounts to enter into subordination agreements with the carrying broker-dealer, in order

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50 See 17 CFR 240.15c3-3(a)(1) and 15 U.S.C. 78lll(2)(C)(ii). These accounts will be excluded from both the definition of PAB account, as well from the definition of customer under SIPA. See Amendments to Financial Responsibility Rules, 72 FR at 12863. Consequently, these account holders will not be entitled to the protections in SIPA applicable to customers.

51 See 17 CFR 240.15c3-1(c)(2)(iv)(E).

52 See Amendments to Financial Responsibility Rules, 72 FR at 12863, n.17 ("[T]he amendment would exclude delivery-versus-payment and receipt-versus-payment accounts. These types of accounts pose little risk of reducing the estate of customer property in a SIPA liquidation since they only hold assets for short periods of time.").

for these accounts to be excluded from the definition of PAB account. This approach simplifies the final rule, while continuing to provide a means for these account holders to be excluded from its scope. Consequently, as adopted, paragraph (a)(16) to Rule 15c3-3 defines the term PAB account to mean "a proprietary securities account of a broker or dealer (which includes a foreign broker or dealer, or a foreign bank acting as a broker or dealer) other than a delivery-versus-payment account or a receipt-versus-payment account."[53] The definition of PAB Account does not include accounts that have been subordinated to the claims of a carrying broker-dealer's creditors.[54]

ii. Written Permission to Use PAB Account Securities

Because PAB account holders are not customers for purposes of Rule 15c3-3, a carrying broker-dealer is not required to maintain possession or control of their non-margin securities. Consequently, it has been a long-standing industry practice for carrying broker-dealers to use these PAB securities in their business activities. Under the final rule, a carrying broker-dealer that uses these PAB securities will need to include the market value of the securities as a credit in the formula when performing the PAB reserve computation. Thus, the amount that the carrying broker-dealer must maintain in its PAB reserve account will increase by the amount of these credits because there would be no corresponding debit item.[55]

Using non-margin securities of PAB account holders presents the risk that securities may increase in market value between PAB reserve computations and, therefore, the amount of the credit items in the formula may be less than the value of the securities for a short period of time. To accommodate industry practice, however, the

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53 See paragraph (a)(16) to Rule 15c3-3, as adopted.

54 Id.

55 17 CFR 240.15c-3-3a.

Commission did not propose amending Rule 15c3-3 to apply the possession or control requirements to PAB accounts. The Commission proposed adding paragraph (b)(5) to Rule 15c3-3 that would have required the carrying broker-dealer to obtain written permission from a PAB account holder before it could use the PAB account holder's securities in the ordinary course of its securities business. In this way, the Commission proposed increasing the protections for PAB account holders without interfering with long-standing industry practice of carrying broker-dealers using the securities of their broker-dealer account holders. However, securities not being used by the broker-dealer must be maintained in accordance with the possession or control requirements of Rule 15c3-3.

One commenter stated that this provision should be eliminated from the proposed amendments, arguing that "[t]he proposal interferes unnecessarily in the contractual arrangements between broker-dealers, which are capable of understanding the terms of standard industry custodial relationships."[56] The commenter also noted that the PAIB Letter did not contain any such requirement.[57] The Commission agrees with the commenter that broker-dealers should be able to understand the implications of granting another broker-dealer the ability to use their non-margin securities and, therefore, the final rule requires written notice rather than written permission. An appropriate level of protection for the PAB account holder may be achieved without requiring the carrying broker-dealer to maintain possession or control of securities carried for a PAB account,

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56 See SIFMA 2 Letter.

57 Id.

provided that the carrying broker-dealer gives written notice to its PAB account holders that it may use their non-margin securities.[58]

The Commission acknowledges that this change, as compared to the proposed rule, will shift the burden to the PAB account holder to proactively object to the carrying broker-dealer using the account holder's securities. However, the new written notice requirement increases the protections for PAB account holders from the status quo without imposing substantial burdens on existing account relationships. The revised rule is intended to provide to the PAB account holders the opportunity to negotiate different terms if they do not want their securities used, while eliminating the need for, and the costs that would result from, carrying broker-dealers reworking existing contracts.

As adopted, the Commission is modifying the final rule to add the phrase "and has provided an opportunity for the account holder to object" following the phrase "ordinary course of its securities business."[59] This language was added to the final rule to impose a requirement that the carrying broker-dealer provide the PAB account holders an opportunity to object to the use of their non-margin securities after they receive the written notice from the carrying broker-dealer. The rule does not prescribe the form in which a PAB account holder must provide notice to the carrying broker-dealer of its objection. This will provide the PAB account holder with flexibility to communicate the objection in a manner the account holder determines is most effective in terms of conveying such objection to the carrying broker-dealer. If the PAB account holder objects, the carrying broker-dealer could not use the securities. Further, the PAB account

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58 The Commission has deleted the phrase "obtained the written permission of the account owner to use the securities in the ordinary course of its securities business" from paragraph (b)(5) of the final rule and replaced it with "provided written notice to the account holder that the securities may be used in the ordinary course of its securities business, and has provided an opportunity for the account holder to object."

59 See paragraph (b)(5) of Rule 15c3-3, as adopted.

holder could seek to move the account to another carrying broker-dealer or negotiate different terms with the carrying broker-dealer with regard to the use of its securities.

Finally, the Commission has modified proposed paragraph (b)(5) to clarify in the final rule that a broker-dealer is affirmatively required to maintain possession and control of non-margin securities unless the broker-dealer has provided written notice to the PAB account holder.[60] As modified, paragraph (b)(5) reads: "A broker or dealer is required to obtain and thereafter maintain the physical possession or control of securities carried for a PAB account, unless the broker or dealer has provided written notice to the account holder that the securities may be used in the ordinary course of its securities business, and has provided an opportunity for the account holder to object."[61]

iii. PAB Reserve Bank Accounts

The Commission proposed amendments to paragraph (e) of Rule 15c3-3 to require a carrying broker with PAB accounts to establish and maintain a PAB reserve account for PAB accounts, perform a separate PAB reserve computation for PAB accounts, and maintain cash or qualified securities in the PAB reserve account in an amount equal to the PAB reserve requirement.[62] The Commission also proposed amendments to paragraph (f) of Rule 15c3-3 to require carrying broker-dealers with PAB accounts to notify the bank about the status of the PAB reserve account and obtain an agreement and notification from the bank that the PAB reserve account will be maintained for the benefit of the PAB account holders.[63] The Commission is adopting

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60 The modifications replaced the phrase "shall not be required" with the phrase "is required" and replaced the phrase "provided that" with the word "unless."

61 See paragraph (b)(5) of Rule 15c3-3, as adopted.

62 See section II.A.3. of this release for a discussion of changes to paragraph (e)(5) of Rule 15c3-3 with respect to banks where customer or PAB reserve accounts may be held.

63 17 CFR 240.15c3-3(f).

these amendments to paragraphs (e) and (f) of Rule 15c3-3 substantially as proposed, with some technical modifications suggested by one commenter, including making terminology consistent throughout the paragraphs.[64] In addition, the Commission is adopting substantially as proposed the amendments to paragraph (g) of Rule 15c3-3 which specifies when the carrying broker-dealer can make withdrawals from a PAB reserve account.[65] Finally, the Commission is adopting, as proposed, new paragraph (e)(4) to Rule 15c3-3, which allows a carrying broker-dealer to use credits related to PAB accounts to finance Rule 15c3-3 customer debits, but does not allow a carrying broker-dealer to use Rule 15c3-3 customer credits to finance PAB debits.

iv. Other PAB Issues Raised by Commenters

In addition to specific comments on the proposed rule language, one commenter had other interpretive questions and comments about the proposed PAB requirements.[66] The commenter requested that the Commission clarify whether PAB account holders must obtain from their carrying broker-dealers a written agreement to perform the calculation as required by the PAIB Letter.[67] Under the amendments, there is no requirement that PAB account holders obtain a written agreement from the carrying firm that it will perform the PAB reserve computation. Rule 15c3-3, as amended, requires the carrying firm to perform the PAB reserve computation. As stated above, Rule 15c3-3

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64 See SIFMA 2 Letter.

65 17 CFR 240.15c3-3(g). In this paragraph, the Commission deleted the phrase "his Reserve Bank Accounts" and replaced it with the phrase "a Customer Reserve Bank Account and PAB Reserve Bank Account." The Commission also deleted the phrase "each Reserve Bank Account" and replaced it with the phrase "the Customer Reserve Bank Account and PAB Reserve Bank Account." These were the only changes made to the final rule in paragraph (g) of Rule 15c3-3.

66 See SIMFA 2 Letter.

67 Id.

prescribes the requirements for carrying firms with respect to PAB accounts, and the PAIB Letter is being withdrawn.[68]

In addition, the commenter requested the Commission to clarify that existing PAIB reserve accounts need not be re-titled to comply with the proposed amendments.[69] Item 4 of the PAIB Letter required that a carrying broker-dealer, "establish and maintain a separate 'Special Reserve Account for the Exclusive Benefit of Customers' with a bank in conformity with the standards of paragraph (f) of Rule 15c3-3." Paragraph (e)(1) of Rule 15c3-3, however, requires that a carrying broker-dealer establish and maintain a "Special Reserve Bank Account for Brokers and Dealers." Given the small differences in nomenclature and the time and expense associated with broker-dealers re-titling these accounts, a carrying broker-dealer that has properly established PAB reserve account in the manner described in Item 4 of the PAIB Letter need not re-title the account and obtain a new notification from the bank.[70] However, all PAB reserve accounts established on or after the effective date of these amendments must title the account in accordance with paragraph (e)(1) of Rule 15c3-3.

Finally, the commenter urged the Commission to clarify whether, for purposes of Rule 15c3-1, the term aggregate debit items means total aggregate debit items computed in accordance with the customer reserve formula or the total aggregate debit items computed in accordance with both the customer reserve formula and the PAB reserve formula.[71] Aggregate debit items are used in the net capital rule to determine the minimum net capital requirement for broker-dealers that elect to use the alternative

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68 As discussed above in this section II.A.2., the Commission is directing the staff to withdraw the PAIB Letter as of the effective date of these rules.

69 See SIFMA 2 Letter.

70 See PAIB Letter.

71 See SIFMA 2 Letter; SIFMA 4 Letter.

standard in computing their minimum net capital requirement. Specifically, the net capital rule requires broker-dealers using the alternative standard to maintain net capital of at least the greater of $250,000 or 2% of aggregate debit items.[72] Including PAB aggregate debit items in this computation would significantly increase net capital requirements for broker-dealers that use the alternative method. The intended purpose of this rule change is to address the inconsistencies between Rule 15c3-3 and SIPA – not to increase net capital requirements. Consequently, the requirements in Rules 15c3-1, 15c3-1d, and 17a-11 that refer to aggregate debit items continue to be based only on aggregate debit items computed in accordance with the customer reserve computation, and do not include aggregate debit items computed in accordance with the PAB reserve computation.[73]

v. Amendment to Rule 15c3-1(c)(2)(iv)(E) Related to PAB Accounts

Finally, the Commission proposed an amendment to Rule 15c3-1[74] that would have required a broker-dealer, when calculating net capital, to deduct from net worth cash and securities held in a securities account at another broker-dealer if the other broker-dealer does not treat the account, and the assets therein, in compliance with the applicable

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72 17 CFR 240.15c3-1(a)(1)(ii). In addition, certain other financial responsibility rules require that a broker-dealer that computes net capital pursuant to the alternative method either report to the Commission, limit its ability to obtain, pre-pay, or repay subordinated debt, or limit its business if its net capital falls below a certain level based on a percentage of aggregate debit items (see, e.g., Rules 15c3-1(e)(2)(vi), 15c3-1d(b)(6)(iii), 15c3-1d(b)(7), 15c3-1d(b)(8)(i)(A), 15c3-1d(b)(10)(ii)(B), 15c3-1d(c)(2), 15c3-1d(c)(5)(ii)(A), and 17a-11(c)(2)).

73 Under paragraph (e)(4) to Rule 15c3-3, a carrying broker-dealer will be permitted to use credits related to PAB accounts to finance Rule 15c3-3 customer debits. This rule, however, does not affect the use of aggregate debit items in computing a broker-dealer's net capital under the alternative standard pursuant to paragraph (a)(1)(ii) of Rule 15c3-1.

74 17 CFR 240.15c3-1(c)(2)(iv)(E).

PAB reserve account requirements of Rules 15c3-3 and 15c3-3a.[75] A commenter suggested modifying this proposed amendment,[76] arguing that "[a]lthough the Proposing Release states that the Commission 'would not expect broker-dealers to audit or examine their carrying broker-dealers to determine whether the carrying broker-dealer is in compliance with [the proposed rules],' the text of the proposed amendment suggests that they in fact would have such an obligation."[77] The commenter also stated that a broker-dealer should not be deemed to have violated Rule 15c3-1 merely because its carrying firm fails to properly perform requirements solely applicable to the carrying firm and that paragraph (c)(2)(iv)(E) under Rule 15c3-1 should be explicitly modified to clarify that cash and securities held in a securities account at another broker-dealer are not subject to the deduction specified in that paragraph.[78]

While the Commission did not intend to impose any monitoring requirement on the PAB account holder, the Commission recognizes that the language, as proposed, could have implied such a requirement and agrees with the commenter that a broker-dealer should not be deemed to have violated Rule 15c3-1 with respect to requirements that are solely applicable to the carrying broker-dealer. To address this concern, the Commission has modified the language in paragraph (c)(2)(iv)(E) under Rule 15c3-1 to eliminate the proposed capital charge of Rule 15c3-1 that would have resulted from a failure of a carrying broker-dealer to comply with the PAB requirements in Rule 15c3-3.[79]

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75 See Amendments to Financial Responsibility Rules, 72 FR at 12864.

76 See SIFMA 2 Letter.

77 Id.

78 Id.

79 More specifically, the Commission has deleted the proposed language referring to "cash and securities held in a securities account at another broker-dealer if the other broker-

Instead, the Commission has adopted amendments to Rule 15c3-1 providing that a broker-dealer need not deduct cash and securities held in a securities account at a carrying broker-dealer except where the account has been subordinated to the claims of creditors of the carrying broker-dealer.[80] This provision is intended to prevent broker-dealers from including assets in their net capital that may not be readily available to be returned because they would not be subject to the PAB account provisions discussed above. Accordingly, the amendments to paragraph (c)(2)(iv)(E) of Rule 15c3-1 are consistent with the exclusions from the definition of PAB account in paragraph (a)(16) of Rule 15c3-3.[81]

3. Banks Where Special Reserve Deposits May Be Held

As amended, paragraph (e) of Rule 15c3-3 requires a broker-dealer to deposit cash or qualified securities into the customer or PAB reserve account,[82] which must be maintained at a bank.[83] While cash deposits at a bank are fungible and may be used by the bank in its lending and investment activities, paragraph (f) of Rule 15c3-3 requires that a broker-dealer obtain a written contract from the bank wherein the bank agrees not to re-lend or hypothecate securities deposited into the reserve account.[84] This means the bank cannot use the securities in its business, which provides a measure of protection by requiring that the securities will be available to the broker-dealer if the bank falls into

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dealer does not treat the account, and the assets therein in compliance with paragraphs (b)(5) and (e) of § 240.15c3-3 . . . ."

80 17 CFR 240.15c3-1(c)(2)(iv)(E).

81 17 CFR 15c3-3(a)(16).

82 The PAB reserve account and the customer reserve account are collectively referred to as the "reserve accounts" or a "reserve account."

83 The term bank is defined in paragraph (a)(7) of Rule 15c3-3 as a "bank as defined in section 3(a)(6) of the Exchange Act and will also mean any building and loan, savings and loan or similar banking institution subject to the supervision by a Federal banking authority." See paragraph (a)(7) to Rule 15c3-3, as adopted.

84 See 17 CFR 240.15c3-3(f).

financial difficulty. Cash deposits, however, may be freely used in the course of the bank's commercial activities.[85] Therefore, to the extent a broker-dealer deposits cash in a reserve account, there is a risk the cash could become inaccessible if the bank experiences financial difficulties.[86] This could adversely impact the broker-dealer and its customers.[87] To limit these risks, the Commission proposed amendments to Rule 15c3-3 that would have: (1) prohibited a broker-dealer from maintaining cash deposits in the reserve accounts for customers and PAB account holders if the bank was affiliated; and (2) limited the amount of cash that could be deposited in both types of reserve accounts at non-affiliated banks.[88] These restrictions would not have applied to securities held in the reserve accounts because, as noted above, the bank must agree not to use the securities in its business. The goal of the proposals was to limit cash reserve account deposits to reasonably safe amounts as measured against the capitalization of the broker-dealer and the bank.[89]

Specifically, as proposed, paragraph (e)(5) of 15c3-3 provided that a carrying broker-dealer would have been required to exclude the amount of cash deposited into reserve accounts at affiliated banks when determining whether it maintained the minimum amount required to be on deposit in the reserve accounts for its customers and PAB account holders. In addition, the proposed amendment would have required a carrying broker-dealer to exclude cash deposited in a reserve account at an unaffiliated bank to the extent the amount of the cash deposited exceeded: (1) 50% of the broker-dealer's excess net capital (based on the broker-dealer's most recently filed FOCUS

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85 See Amendments to Financial Responsibility Rules, 72 FR at 12864.

86 Id.

87 Id.

88 Id.

89 Id.

Report);[90] or (2) 10% of the bank's equity capital (based on the bank's most recently filed Call Report or Thrift Financial Report).[91]

The Commission is adopting the amendments with modifications designed to address issues identified by commenters. Twenty-three commenters addressed the proposed amendments.[92] Fifteen commenters urged the Commission not to adopt the proposed prohibition on broker-dealers maintaining cash in reserve accounts at affiliated banks.[93] These commenters generally stated that, with regard to cash in reserve accounts, affiliated banks should be treated the same as unaffiliated banks because both groups are subject to the same financial regulation.[94] These commenters noted that banks are subject to safety and soundness requirements of their respective banking regulators and,

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90 Under Rule 17a-5, broker-dealers must file periodic reports on Form X-17a-5 (Financial and Operational Combined Uniform Single Reports) ("FOCUS Reports"). See 17 CFR 240.17a-5(a). The FOCUS Report requires, among other financial information, a balance sheet, income statement, and net capital and customer reserve computations. Excess net capital is the amount that a broker-dealer's net capital exceeds its minimum requirement.

91 See Amendments to Financial Responsibility Rules, 72 FR at 12864. On July 21, 2011, supervisory responsibility for federal savings associations was transferred from the Office of Thrift Supervision ("OTS") to the Office of the Comptroller of the Currency ("OCC"). As of the quarter ending March 31, 2012, savings associations were required to file a Call Report in lieu of a Thrift Financial Report. See Proposed Agency Information Collection Activities; Comment Request, 76 FR 7082 (Feb. 8, 2011). The Call Report includes a line item for total bank equity capital. A report for a specific institution is available at https://cdr.ffiec.gov/public/. See also, FINRA, Interpretations of Financial and Operational Rules, Interpretations 15c3-3(e)(1)/01 and /011 (establishing similar threshold restrictions on using money market deposit accounts or time deposits, respectively, to meet customer reserve account requirements), and Interpretation 15c3-3(e)(3)/051 (establishing similar threshold restrictions with respect to meeting the customer reserve requirement by depositing cash at an affiliated bank).

92 See Federated Letter; Curian Clearing Letter; Raymond James Letter; JP Morgan Letter; Reserve Letter; Dresdner Kleinwort Letter; SIFMA 2 Letter; SIFMA 4 Letter; First Clearing Letter; Clearing House Letter; ICI Letter; Barclays Letter; ABASA Letter; PNC Letter; BlackRock Letter; Deutsche Bank Securities Letter; E*Trade Letter; Citigroup Letter; American Bar Association Letter; Fidelity/NFS Letter; BOK Letter; JP Morgan 3 Letter; IIB Letter; Raymond James 2 Letter.

93 See Federated Letter; JP Morgan Letter; Dresdner Kleinwort Letter; SIFMA 4 Letter; First Clearing Letter; ICI Letter; ABASA Letter; E*Trade Letter; Citigroup Letter; American Bar Association Letter; Fidelity/NFS Letter; Curian Letter; BOK Letter; JP Morgan 2 Letter; IIB Letter.

94 Id.

therefore, the commenters argued that the proposed restriction with respect to affiliated banks is unwarranted.

One commenter also stated that the Commission's distinction between affiliated and unaffiliated banks was not sufficiently supported in the proposing release.[95] More specifically, this commenter stated that the Commission's "bare statement that a broker-dealer 'may not exercise due diligence with the same degree of impartiality when assessing the soundness of an affiliate bank as it would with a non-affiliate...' does not suffice to justify the disparate treatment" with regard to the treatment of affiliated banks under the proposed rule.[96] This commenter also stated that it is just as easy to argue that broker-dealers are in a much better position to know about the soundness of an affiliated bank then to learn about the soundness of a unaffiliated bank, which may not be willing to provide complete and accurate information.[97] In addition, another commenter stated that the Commission cited no empirical or anecdotal evidence to support its reasons for prohibiting cash reserve deposits at an affiliated bank.[98] This commenter also stated that the Commission's concerns discount the operational efficiencies to be gained between an affiliated broker-dealer and its bank, including: commonality between certain policies and procedures; greater ease in communication internally; and greater operational efficiencies leading to reduced operational risk in the transfer of funds to and from the bank.[99]

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95 See Dresdner Kleinwort Letter.

96 Id.

97 Id.

98 See Citigroup Letter.

99 Id.

One commenter stated that it took no issue with the proposed restriction on affiliated banks.[100] Another commenter noted that the financial industry has seen a remarkable consolidation of the banking and securities industries, and, as a result, the number of broker dealers affiliated with banks has increased, along with the number of those broker-dealers maintaining deposits at affiliated banks.[101] This commenter stated that broker-dealers would be required to move deposits from one institution and divide that amount among several banks, resulting in credit risk to the broker-dealer, as well as an increase in operational risk.[102] Finally, the commenter observed that the Commission did not provide any specific examples of bank failures impacting affiliated broker-dealers, which led the commenter to question whether there is any realistic benefit to offset the increased risk that broker-dealers would be required to take on as a result of the proposal to place restrictions on cash deposits in reserve accounts at affiliated and unaffiliated banks.[103]

The Commission recognizes that all banks, whether or not affiliated with a broker-dealer, are subject to regulation by their respective banking regulators. The Commission's continuing concern, however, is that a carrying broker-dealer may not exercise due diligence with the same degree of impartiality and care when assessing the financial soundness of an affiliated bank as it would with an unaffiliated bank.[104] Moreover, the goal of protecting the carrying broker-dealer's customers through the Rule

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100 See Raymond James Letter. In a subsequent comment letter, this commenter stated that if this proposal is adopted, registered broker-dealers holding customer funds may be required to move their reserve accounts if those accounts are currently held at affiliated banks, which would increase costs. See Raymond James 2 Letter.

101 See BOK Letter.

102 Id.

103 Id.

104 See Amendments to Financial Responsibility Rules, 72 FR at 12864.

15c3-3 reserve requirement may be undermined in the event a holding company becomes insolvent, with corresponding adverse consequences to both the bank and broker-dealer subsidiaries.

In some cases, a broker-dealer may have access to more information about an affiliated bank in comparison to an unaffiliated bank for purposes of conducting due diligence. However, having more information would not be of benefit if the individuals making the decision on where to maintain the reserve account are not objective in their decision making. The Commission is concerned that a broker-dealer's decision to hold cash in a reserve account at an affiliated bank may be driven in part by profit or reasons based on the affiliation, regardless of any due diligence it may conduct or the overall safety and soundness of the bank.

In addition, in response to the comments regarding affiliated banks, the Commission notes that substantial numbers of banks have failed or required government assistance in recent years.[105] While a particular bank failure may not have materially impacted an affiliated broker-dealer to date,[106] the risk remains that the financial difficulty of an entity that is part of a holding company structure may adversely impact other affiliated entities, including affiliated broker-dealers and banks.[107] Therefore, the final rule retains the prohibition on maintaining customer reserve cash deposits at an affiliated bank.[108]

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105 According to the FDIC, the number of FDIC-insured institutions that failed in the U.S. over the last four years are: (1) 140 in 2009; (2) 157 in 2010; (3) 92 in 2011; and (4) 51 in 2012. A complete list of failed banks since October 1, 2000, is available at www.fdic.gov/bank/individual/failed/banklist.html.

106 See BOK Letter; Dresdner Kleinwort Letter.

107 See, e.g., Lehman Brothers Inc. – Trustee's Preliminary Investigation Report and Recommendations (Case No. 08-01420 (JMP) SIPA), available at http://bankrupt.com/misc/sipareport0904.pdf.

108 Id.

This prohibition does not apply to securities on deposit at an affiliated bank, but only cash deposits because, as noted above, the latter are fungible with other deposits carried by the bank and may be freely used in the course of the bank's commercial activities.[109] Consequently, to the extent that operational or other efficiencies can be achieved through the use of an affiliated bank, the carrying broker-dealer can use qualified securities held at an affiliated bank to meet its reserve deposit requirements.[110] The ability to use qualified securities alleviates concerns that a broker-dealer would be required to take deposits from one institution and divide that amount among several banks, resulting in credit risk to the broker-dealer, as well as an increase in operational risk.[111]

In summary, while the Commission acknowledges concerns raised by commenters, the Commission continues to believe that it is appropriate to exclude cash deposited in affiliated banks from the calculation to determine whether a broker-dealer has met its reserve account requirements. Therefore, the final rule excludes the amount of any cash on deposit in an affiliated bank of the broker-dealer from being used to meet the reserve requirements.[112] Broker-dealers that use affiliated banks for holding cash

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109 See Federal Reserve, Division of Banking Supervision and Regulation, Commercial Bank Examination Manual, Section 3000.1, Deposit Accounts (stating that deposits are the primary funding source for most banks and that banks use deposits in a variety of ways, primarily to fund loans and investments), available at http://www.federalreserve.gov/boarddocs/supmanual/cbem/3000.pdf. See also OCC Banking Circular (BC-196), Securities Lending (May 7, 1985) (stating securities should be lent only pursuant to a written agreement between the lender institution and the owner of the securities specifically authorizing the institution to offer the securities for loan), available at http://www.occ.gov/static/news-issuances/bulletins/pre-1994/banking-circulars/bc-1985-196.pdf.

110 See Citigroup Letter.

111 See BOK Letter. Based on FOCUS Report data, as of December 31, 2011, 79% of the total customer reserve requirement across all carrying broker-dealers was met using qualified securities.

112 See paragraph (e)(5) of Rule 15c3-3, as adopted.

customer reserve accounts will need to either deposit qualified securities into the accounts or move their accounts to non-affiliated banks.

As for the limits on the amounts of cash that could be deposited in one unaffiliated bank, some commenters argued that the proposed thresholds were too restrictive. One commenter urged the Commission to reconsider the proposed limits, noting that the proposed amendment will impose significant costs on broker-dealers and potentially adversely impact the broker-dealers' customers.[113] Several commenters suggested that the Commission allow cash reserve deposits without the percentage restrictions at unaffiliated banks that are well-capitalized or for which the broker-dealer has performed due diligence.[114] One commenter suggested that the Commission consider higher percentages for cash deposits at large money-center banks.[115] This commenter stated that this would strike a better balance between the Commission's concerns regarding the safety of cash deposits and the costs imposed on broker-dealers arising from having to use qualified securities (as opposed to cash) to meet deposit requirements or having to maintain reserve accounts at multiple banks.[116] This commenter also stated that the percentage thresholds would negatively impact smaller broker-dealers because they would exceed the 50% of excess net capital threshold at lower deposit levels.[117] Two commenters noted that the proposed 10% bank equity capital limitation appears to be derived from a 1988 NYSE staff interpretation, which stated that customer reserve accounts may be maintained in money market deposit accounts if the total of such

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113 See Raymond James 2 Letter.

114 See Raymond James Letter; JP Morgan Letter; Clearing House Letter; ABASA Letter; PNC Letter; Deutsche Bank Securities Letter; E*Trade Letter; JP Morgan 2 Letter.

115 See SIFMA 2 Letter; SIFMA 4 Letter.

116 See SIFMA 2 Letter.

117 Id.

deposits in any one bank does not exceed 50% of the broker-dealer's excess net capital or 10% of the bank's equity capital.[118] These commenters pointed out that significant changes have taken place with respect to federal bank regulatory agency oversight of the safety and soundness of banks since 1988, including the imposition of prompt corrective action provisions.[119] These commenters stated that the concerns that gave rise to the 1988 interpretation have been mitigated by current statutes and regulations requiring prompt corrective action in the event that a bank's capital position deteriorates.[120]

As stated above, substantial numbers of banks have failed or required government assistance in recent years.[121] Consequently, the rule, as adopted, establishes requirements designed to avoid the situation where a carrying broker-dealer's cash deposits constitute a substantial portion of the bank's deposits. At the same time, the proposal has been modified to mitigate concerns raised by commenters that broker-dealers would have to maintain reserve accounts at multiple banks. First, the Commission has eliminated the provision that would have excluded the amount of a cash deposit that exceeds 50% of the broker-dealer's excess net capital. As noted by comments, this provision likely would have disproportionately impacted small and mid-size broker-dealers when they deposited cash into large commercial banks since they would exceed the excess net capital threshold well before exceeding the bank equity capital threshold.[122] Also, based on staff experience monitoring larger broker-dealers, firms that maintain large amounts of cash in their customer reserve accounts generally use more than one non-affiliated bank to maintain these accounts.

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118 See PNC Letter; ABASA Letter.

119 See PNC Letter; ABASA Letter.

120 Id.

121 See www.fdic.gov/bank/individual/failed/banklist.html.

122 See SIFMA 2 Letter; JP Morgan 2 Letter.

The bank equity capital threshold is the more important metric since it relates directly to the financial strength of the bank, which is the entity holding the account. Thus, this metric more directly addresses the risk at issue: the potential impairment of the bank's ability to quickly return the customer reserve deposit to the broker-dealer.

Second, with respect to the bank equity capital threshold, in response to comments, the Commission has increased the threshold from 10% to 15% of the bank's equity capital. The increase of the threshold to 15% is designed to address concerns raised by commenters that the proposed percentage tests were unduly restrictive in certain respects and should be modified, particularly with respect to large broker-dealers with large deposit requirements. Consequently, the increase from 10% to 15% is designed to mitigate commenters' concerns that the 10% threshold would require broker-dealers to spread out cash deposits over a number of banks, while still providing adequate protection against the risk that arises when a bank's deposit base is overly reliant on a single depositor.

The elimination of the 50% of excess net capital threshold and increase in the bank capital threshold from 10% to 15% is intended to address concerns raised by commenters that they would have to substantially alter their current cash deposit practices in light of the goal of the rule to promote the broker-dealer's ability to have quick access to the deposit.

As proposed, the equity capital threshold would have been based on equity capital "as reported by the bank in its most recent Call Report or Thrift Financial Report." Under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"),[123] the supervision of savings associations was transferred from the OTS to the

123 Pub. L. No. 111–203, 124 Stat. 1376 (2010).

OCC (for federal savings associations) and the FDIC (for state savings associations).[124] Also, beginning in the period ending March 31, 2012, savings associations began to file a Call Report in lieu of a Thrift Financial Report, thereby ending the use of the Thrift Financial Report.[125] Therefore, due to the passage of the Dodd-Frank Act and the elimination of the Thrift Financial Report, as well as to provide more flexibility with regard to any successor reports that may be required to be filed by a bank, the Commission is modifying the phrase "Call Report or Thrift Financial Report" to read "Call Report or any successor form the bank is required to file by its appropriate Federal banking agency (as defined by section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813))".

Two commenters expressed concern about the use of a Call Report to determine a bank's "equity capital" under the rule.[126] These commenters noted that there is no equity capital line item in the Call Reports of U.S. branches of foreign banks due to these branches not being separately incorporated legal entities.[127] Therefore, the proposed Call Report provision potentially excluded U.S. branches of foreign banks from holding reserve accounts. The commenters stated that for foreign banks, the equity capital can be found in other forms, such as Form FR Y-7, Form FR Y-70, Form 6-K, and Form F-20, among other financial statements filed with U.S. regulators.[128] One commenter suggested the Commission revise the proposed provision to read: "The amount of the deposit

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124 Id. at §§ 300–378. See also List of OTS Regulations to be Enforced by the OCC and the FDIC Pursuant to the Dodd-Frank Act, OCC, FDIC, (June 14, 2011), 76 FR 39246 (July 6, 2011). Supervision of savings and loan holding companies and their subsidiaries (other than depository institutions) was transferred from the OTS to the Federal Reserve.

125 See Proposed Agency Information Collection Activities; Comment Request, 76 FR 7082 (Feb. 8, 2011).

126 See IIB Letter; SIFMA 4 Letter.

127 Id.

128 Id.

exceeds 10% of the bank's equity capital (as reported by the bank in its most recent Call Report or Thrift Financial Report if such report includes a line item for 'equity capital')."[129] Alternatively, these commenters suggested that in lieu of a Call Report a U.S. branch of a foreign bank could periodically obtain a certificate from the bank stating its equity capital (or stating that its equity capital exceeds a specified level).[130]

The Commission recognizes that the U.S. branches of some foreign banks may meet the definition of bank under section (3)(a)(6) of the Exchange Act and, therefore, also under paragraph (a)(7) of Rule 15c3-3.[131] However, the Commission is retaining the requirement that the bank's equity be determined using its most recent Call Report because U.S. branches of foreign banks generally are not FDIC-insured.[132] Consequently, deposits at these institutions would not receive the protections of FDIC

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129 See IIB Letter.

130 See IIB Letter; SIFMA 4 Letter.

131 The term bank as defined in section 3(a)(6) of the Exchange Act is limited to banks directly regulated by U.S. state or federal bank regulators. The determination whether any particular financial institution meets the requirements of section 3(a)(6) is the responsibility of the financial institution and its counsel. See 15 U.S.C. 78c(a)(6); cf. Securities Issued Or Guaranteed By United States Branches Or Agencies of Foreign Banks; Interpretive Release, Securities Act Release No. 6661 (Sept. 23, 1986), 51 FR 34460 (Sept. 29, 1986) (determination as to whether branch or agency of foreign bank falls within the definition of bank under section 3(a)(2) of Securities Act of 1933, 15 U.S.C. 77c(a)(2), is responsibility of issuers and their counsel). However, section 4(d) of the International Banking Act, 12 U.S.C. 3102(d), expressly prohibits agencies of foreign banks established under federal law from receiving deposits or exercising fiduciary powers, criteria necessary for qualification as a bank under section 3(a)(6)(C) of the Exchange Act. See 12 U.S.C. 3102(d); see also Conference of State Bank Supervisors v. Conover, 715 F.2d 604 (D.C. Cir. 1983), cert. denied, 466 U.S. 927 (1984) (stating that federally-chartered agencies of foreign banks are prohibited from receiving deposits from foreign, as well as domestic, sources).

132 The FDIC protects depositors' funds in the event of the financial failure of their bank or savings institution. FDIC deposit insurance covers the balance of each depositor's account, dollar-for-dollar, up to the insurance limit, including principal and any accrued interest through the date of the insured bank's closing. No depositor has suffered a loss of insured deposits since the FDIC was created in 1933. See FDIC, When a Bank Fails – Facts for Depositors, Creditors, and Borrowers, available at http://fdic.gov/consumers/banking/facts/index.html. See also Federal Reserve, Structure and Share Data for U.S. Offices of Foreign Banks, available at http://www.federalreserve.gov/releases/iba/.

insurance in the event of a bank failure. FDIC insurance provides additional protections to cash deposited in a reserve account at a bank in the event of a bank failure that would not be available at an uninsured bank.[133] The Commission, however, will consider requests for exemptive relief from broker-dealers that wish to hold a reserve account at a U.S. branch of a foreign bank.

For these reasons, the Commission is adopting the final rule to exclude, when determining whether a broker-dealer maintains the minimum deposits required under paragraph (e) of Rule 15c3-3, cash deposited with an affiliated bank as well as cash deposited with an unaffiliated bank "to the extent that the amount of the deposit exceeds 15% of the bank's equity capital as reported by the bank in its most recent Call Report or any successor form the bank is required to file by its appropriate Federal banking agency (as defined by section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813))."[134] As discussed above, the Commission is deleting from the final rule the provision that would have excluded the amount of cash on deposit that exceeds 50% of the broker-dealer's excess net capital.

4. Allocation of Customers' Fully Paid and Excess Margin Securities to Short Positions

Paragraph (d) of Rule 15c3-3 currently sets forth steps a broker-dealer must take to retrieve securities from non-control locations if there is a shortfall in the fully paid or excess margin securities it is required to hold for its customers. The actions prescribed in the rule do not include a requirement that the broker-dealer obtain possession or control

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133 Id. Therefore, the availability of FDIC insurance could also be a contributing factor to mitigating the risk that an impairment of the reserve deposit at an unaffiliated bank will have a material negative impact on the broker-dealer's ability to meet its obligations to customers and PAB account holders. See Amendments to Financial Responsibility Rules, 72 FR at 12864.

134 See paragraph (e)(5) of Rule 15c3-3, as adopted.

of a fully paid or excess margin security that is reflected on the broker-dealer's stock record as a long position of a customer that allocates to a broker-dealer or non-customer short position. In the simplest case, this occurs when the carrying broker-dealer as principal sells short a security to its own customer. Currently, in such a case, the broker-dealer is not required to have possession or control of the security even though its customer has paid for the security in full. Rather, the broker-dealer must include the mark-to-market value of the security as a credit item in the reserve formula. The broker-dealer can use the cash paid by the customer to purchase the security to make any increased deposit requirement caused by the credit item.[135] As the Commission stated in the proposing release, this permits the broker-dealer, in effect, to partially monetize the customer's security.[136] This result is contrary to the customer protection goals of Rule 15c3-3, which seek to ensure that broker-dealers do not use customer assets for proprietary purposes.[137]

To address these concerns, the Commission proposed an amendment to Rule 15c3-3 that would have required a broker-dealer to obtain physical possession or control of customer fully paid and excess margin securities that allocate to a broker-dealer short position.[138] Specifically, the proposed amendment would have added a fifth step to take when a deficit arose in the amount of securities the broker-dealer was required to maintain in possession or control; namely that for "[s]ecurities included on [the broker-dealer's] books or records as a proprietary short position or as a short position for another

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135 In effect, the broker-dealer has monetized the customer's security and has to purchase or borrow it, at a future date, to return the customer's fully paid securities.

136 See Amendments to Financial Responsibility Rules, 72 FR at 12865.

137 See, e.g., Customer Protection Rule, Exchange Act Release No. 22499 (Oct. 3, 1985), 50 FR 41337 (Oct. 10, 1985).

138 See Amendments to Financial Responsibility Rules, 72 FR at 12865.

person, excluding positions covered by paragraph (m) of this section, for more than 10 business days (or more than 30 calendar days if the broker or dealer is a market maker in the securities), [...] the broker or dealer shall, not later than the business day following the day on which the determination is made, take prompt steps to obtain physical possession or control of such securities."[139]

Eleven commenters addressed this proposed amendment.[140] Three commenters urged the Commission to disallow naked short selling of securities and one argued that the Commission should force short sellers to pre-borrow.[141] Three commenters generally opposed the proposed rule. They argued that the credit item added to the reserve formula computation when a customer's fully paid or excess margin security allocates to a short position provides the customer with adequate protection.[142] Two of these commenters requested that the 30 calendar days allowed for a broker-dealer acting as a market maker to obtain possession or control over securities allocating to a short position be expanded to include all situations where a broker-dealer must act pursuant to the rule (i.e., not be limited to market maker positions).[143] These commenters argued that it would be

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139 Id. at 12895.

140 See Glenn Letter; Bare Letter; Anonymous Letter; SIFMA 2 Letter; First Clearing Letter; Hearne Letter; Deutsche Bank Securities Letter; Citigroup Letter; AMEX Letter; SIFMA 4 Letter; Federated 6 Letter; Raymond James 2 Letter.

141 See Glenn Letter; Bare Letter; Anonymous Letter; Hearne Letter. The Commission has taken a number of measures to strengthen investor protections against potentially abusive "naked" short selling, including adopting rules requiring that fails to deliver resulting from short sales immediately be closed-out and expressly targeting fraud in short selling transactions. See Amendments to Regulation SHO, Exchange Act Release No. 60388 (July 27, 2009), 74 FR 38266 (July 31, 2009); "Naked" Short Selling Antifraud Rule, Exchange Act Release No. 58774 (Oct. 14, 2008), 73 FR 61666 (Oct. 17, 2008). In addition, the Commission adopted a short sale-related price test that, if triggered, imposes a restriction on the prices at which securities may be sold short. See Amendments to Regulation SHO, Exchange Act Release No. 61595 (Feb. 26, 2010), 75 FR 11232 (Mar. 10, 2010).

142 See First Clearing Letter; Deutsche Bank Securities Letter; Citigroup Letter.

143 See Citigroup Letter; Deutsche Bank Securities Letter.

difficult to distinguish between market maker and non-market maker positions in complying with the proposed rule. Another commenter requested that the Commission reevaluate the proposed amendment because of its potential effects on investment and hedging strategies in addition to the heavy burden it will impose on short sales.[144] One commenter supported the amendments noting that it had "come to believe . . . that the Commission's proposal is consistent with the direction of the Commission's other short sale regulations . . . ."[145]

As discussed above in section II.A.2.ii. of this release, the Commission has determined that a credit item is sufficient to protect PAB account holders if the carrying broker-dealer provides them with notice that it may be using their non-margin securities, as well as the opportunity to object to such use. The use of the non-margin securities of PAB account holders is a long-standing industry practice. In contrast, customers under Rule 15c3-3, which include the carrying broker-dealer's retail customers, have an expectation that the fully paid and excess margin securities reflected on their account statements are, in fact, in the possession or control of the carrying broker-dealer. However, as described above, this expectation may be frustrated where the securities are allocated to a short position carried by the broker-dealer, as the securities are not in the possession or control of the broker-dealer.

This gap in the existing rule, in effect, permits the broker-dealer to partially monetize the customer's security. Also, under some circumstances (e.g., a change in the market value of the securities), the amount the broker-dealer may have on deposit in the customer reserve account as a consequence of the credit item may be less than the value

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144 See Raymond James 2 Letter.

145 See SIFMA 4 Letter. SIFMA originally opposed the proposed amendments. See SIFMA 2 Letter.

of the securities. Consequently, if the broker-dealer fails, sufficient funds may not be readily available to purchase the securities to return them to customers. The use of customer securities in this manner is contrary to the customer protection goals of Rule 15c3-3 and the expectations of a broker-dealer's customers.[146] For these reasons, the Commission is adopting the amendment.[147] The Commission agrees, however, that the proposed distinction based upon a broker-dealer's market maker status could present operational challenges and, consequently, the final rule has been modified to allow a uniform period of 30 calendar days before the possession and control requirement is triggered.

Specifically, as adopted, paragraph (d)(4) of Rule 15c3-3 requires a broker-dealer to take prompt steps to obtain physical possession or control over securities of the same issue and class as those included "on the broker's or dealer's books or records that allocate to a short position of the broker or dealer or a short position for another person, excluding positions covered by paragraph (m) of this section, for more than 30 calendar days . . . ."[148] The Commission does not believe that lengthening the time from 10 business days to 30 calendar days for non-market maker positions will significantly diminish the protections provided by the new rule.[149] Therefore, the Commission is adopting a uniform 30 calendar day time period in the final rule.

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146 See supra notes 12 and 18, and accompanying text.

147 Current paragraph (d)(4) of Rule 15c3-3 is being re-designated paragraph (d)(5), as proposed.

148 See Amendments to Financial Responsibility Rules, 72 FR at 12865–12866. The amendment will not apply to securities that are sold long for a customer but not obtained from the customer within ten days after the settlement date. This circumstance is addressed by paragraph (m) of Rule 15c3-3, which requires the broker-dealer to close the transaction by purchasing securities of like kind and quantity. 17 CFR 240.15c3-3(m).

149 For example, the rule currently has a thirty calendar day time period for securities failed to receive and a forty-five calendar day time period for securities receivable as a result of

Three commenters requested that the Commission clarify that the aging process begins when the Rule 15c3-3 possession and control deficit arises and not when the short transaction is executed.[150] The proposed amendment was designed to require that the aging process commence at the time a deficit in securities allocating to a short position arises. One commenter[151] also requested that the Commission modify the proposed amendment to specifically exclude an underwriter's short position created in connection with a distribution of securities until after the later of the completion of such underwriter's participation in the distribution (as defined in Rule 100 of Regulation M)[152] or the delivery date for securities acquired in the exercise of any overallotment option (or "Green Shoe").[153] The Commission agrees with the commenter that there should be

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corporate actions (e.g., stock splits) before the broker-dealer must take prompt steps to obtain possession or control of such securities. See 17 CFR 240.15c3-3(d)(2)-(3).

150 See Deutsche Bank Securities Letter; Citigroup Letter; SIFMA 2 Letter.

151 See SIFMA 2 Letter. The commenter stated: "Regulation M embodies a carefully crafted scheme for the regulation of secondary market transactions by underwriters and other distribution participants, including the regulation of 'syndicate covering transactions,' which should not be disrupted by proposed paragraph (d)(4)." Id. In addition, SIFMA commented that where an underwriter sells short to a customer in anticipation of obtaining the securities through the exercise of an overallotment option, paragraph (d)(4) should not require the premature exercise of the overallotment option or the use of secondary market purchases instead of the overallotment option. Id.

152 17 CFR 242.100 through 242.105. More specifically, Rule 100 of Regulation M provides: "For purposes of regulation M . . . the following definitions shall apply: . . . Completion of participation in a distribution. . . . A person shall be deemed to have completed its participation in a distribution as follows: . . . (2) [a]n underwriter, when such person's participation has been distributed, including all other securities of the same class that are acquired in connection with the distribution, and any stabilization arrangements and trading restrictions in connection with the distribution have been terminated; Provided, however, that an underwriter's participation will not be deemed to have been completed if a syndicate overallotment option is exercised in an amount that exceeds the net syndicate short position at the time of such exercise . . . ." 17 CFR 242.100(b).

153 A green shoe or overallotment option is a provision contained in an underwriting agreement that gives the underwriting syndicate the right to purchase additional shares from the issuer or selling security holders (in addition to those initially underwritten by the syndicate) for the purpose of covering any overallotments that are made on behalf of the syndicate in connection with an offering of securities.

consistency between the final rule and Regulation M.[154] Consequently, the Commission has added a sentence to the final rule to clarify that the 30 calendar day period with respect to a syndicate short position established in connection with an offering does not begin to run until the underwriter's participation in the distribution is complete as determined pursuant to Rule 100(b) of Regulation M.[155] Finally, the Commission is adopting the revision to paragraph (n) as proposed to permit broker-dealers to apply to their designated examining authority ("DEA") for extensions of time related to paragraph (d)(4).[156]

5. Importation of Rule 15c3-2 Requirements into Rule 15c3-3 and Treatment of Free Credit Balances

i. Importation of Rule 15c3-2

Rule 15c3-2 requires a broker-dealer holding free credit balances to provide its customers (defined as any person other than a broker-dealer) at least once every three months with a statement of the amount due the customer and a notice that: (1) the funds are not being segregated, but rather are being used in the broker-dealer's business; and (2) the funds are payable on demand. The rule was adopted in 1964, before the adoption of Rule 15c3-3 in 1972.[157] Since the adoption of Rule 15c3-3, broker-dealers have been limited in their use of customer free credit balances. The Commission proposed

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154 Rule 100 of Regulation M also provides that an underwriter's participation will not be deemed to have been completed if a syndicate overallotment option is exercised in an amount that exceeds the net syndicate short position at the time of exercise. 17 CFR 242.100(b).

155 17 CFR 242.100(b).

156 SROs generally have procedures in place for broker-dealers to apply for extensions of time under paragraph (n) of Rule 15c3-3. See, e.g., FINRA Rule 4230.

157 See Customers' Free Credit Balances, Exchange Act Release No. 7266 (Mar. 12, 1964), 29 FR 7239 (June 3, 1964).

importing requirements in Rule 15c3-2[158] into Rule 15c3-3 and eliminating Rule 15c3-2 as a separate rule in the Code of Federal Regulations.[159] The Commission received two comments supporting the proposal.[160]

The Commission is adopting the amendments substantially as proposed – deleting Rule 15c3-2 and adding paragraph (j)(1) to Rule 15c3-3. The Commission believes it is appropriate to eliminate Rule 15c3-2 as a separate rule because it is largely irrelevant in light of the requirements in Rule 15c3-3. Further, the provisions in Rule 15c3-2 that the Commission wishes to retain are being re-codified in Rule 15c3-3. These provisions include the requirement that broker-dealers inform customers of the amounts due to them and that such amounts are payable on demand.[161] Consequently, the Commission is amending Rule 15c3-3 to add new paragraph (j)(1), which provides that "[a] broker or dealer must not accept or use any free credit balance carried for the account of any customer of the broker or dealer unless such broker or dealer has established adequate procedures pursuant to which each customer for whom a free credit balance is carried will be given or sent, together with or as part of the customer's statement of account, whenever sent but not less frequently than once every three months, a written statement informing the customer of the amount due to the customer by the broker or dealer on the date of the statement, and that the funds are payable on demand of the customer."[162]

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158 17 CFR 240.15c3-2.

159 See Amendments to Financial Responsibility Rules, 72 FR at 12867.

160 See SIFMA 2 Letter; SIFMA 4 Letter.

161 Rule 15c3-2 contains an exemption for broker-dealers that also are banking institutions supervised by a Federal authority. This exemption will not be imported into Rule 15c3-3 because there are no broker-dealers left that fit within the exemption. Further, the definition of customer for purposes of the imported 15c3-2 requirements will be the definition of customer in Rule 15c3-3, which is somewhat narrower than the definition in Rule 15c3-2.

162 See paragraph (j)(1) of Rule 15c3-3, as adopted. The Commission also modified the phrase "[i]t shall be unlawful for a broker or dealer to" to the phrase "[a] broker or dealer

ii. Treatment of Free Credit Balances

Free credit balances are funds payable by a broker-dealer to its customers on demand.[163] They may result from cash deposited by the customer to purchase securities, proceeds from the sale of securities or other assets held in the customer's account, or earnings from dividends and interest on securities and other assets held in the customer's account. Broker-dealers may, among other things, pay interest to customers on their free credit balances or offer to routinely transfer ("sweep") them to a money market fund or bank account. On occasion, broker-dealers have changed the product to which a customer's free credit balances are swept – in recent years, most frequently from a money market fund to an interest bearing bank account. Because of differences in these two types of products, including the type of protection afforded the customer in the event of insolvency, there may be investment consequences to the customer when changing from one product to the other. The money market shares – as securities – would receive up to $500,000 in SIPA protection in the event the broker-dealer failed. The bank deposits – as cash – would receive up to $250,000 in protection from the FDIC in the event the bank failed. On the other hand, the money market fund shares may incur market losses; whereas, the full amount of the bank deposit would be guaranteed up to the FDIC's $250,000 limit. There also may be differences in the amount of interest earned from the two products. In short, there may be consequences to moving a customer's free credit balances from one product to another, and, accordingly, customers should have a sufficient opportunity to make an informed decision.[164]

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must not" in order to avoid using the term "unlawful." Any violation of the rules and regulations promulgated under the Exchange Act is unlawful and therefore it is unnecessary to use this phrase in the final rule.

163 See 17 CFR 240.15c3-3(a)(8).

164 See Amendments to Financial Responsibility Rules, 72 FR at 12866.

The Commission proposed amendments to Rule 15c3-3 that would have established conditions required to be met in order for a broker-dealer to use or transfer free credit balances in a customer's securities account.[165] More specifically, as initially proposed, the amendments would have structured the new rule to make it unlawful for a broker-dealer to convert, invest, or otherwise transfer to another account or institution free credit balances held in a customer's account except as provided in the proposed rule.[166] The proposed rule then prescribed three conditions to address three different scenarios involving the use or transfer of customer free credit balances. The first scenario involved the use or transfer of free credit balances outside the context of a routine sweep to a money market fund or bank. As discussed below, proposed paragraph (j)(2)(i) would have prohibited the use or transfer of free credit balances in this scenario unless the customer had specifically ordered or authorized the transaction. The second and third scenarios involved the use or transfer of free credit balances in the context of a program to routinely sweep them to a money market fund or bank account (a "sweep program"). As discussed below, proposed paragraph (j)(2)(ii) would have addressed sweep program requirements for accounts opened after the effective date of the rule ("new accounts") and proposed paragraph (j)(2)(iii) would have addressed sweep program requirements for accounts existing as of the effective date of the rule (existing accounts). The Commission is adopting new paragraph (j)(2) to Rule 15c3-3 with substantial modifications from the proposed rule in response to comments and to clarify certain portions of the rule.[167]

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165 Id. at 12866–12867.

166 Id. at 12866.

167 In 2005, the NYSE addressed the issue of disclosure in a sweep program context by issuing an information memo to its members discussing, among other things, the disclosure responsibilities of a broker-dealer offering a sweep program to its customers.

As proposed, the first sentence of paragraph (j)(2) of the rule would have established the prohibition with respect to the treatment of free credit balances by providing that "[i]t shall be unlawful for a broker or dealer to convert, invest, or otherwise transfer to another account or institution, free credit balances held in a customer's account except as provided in paragraphs (j)(2)(i), (ii) and (iii)."[168] The Commission received one comment in response to the proposed text of this first sentence.[169] The commenter expressed concern that the proposed text in the first sentence of paragraph (j)(2) could be construed broadly, in effect, to prohibit a broker-dealer from using, investing, or transferring cash deposits that are not swept to other investments or products (and are included as credits in the reserve formula) in the normal course of the broker-dealer's business, as is currently permitted by Rule 15c3-3. The commenter suggested that the text be revised to clarify the scope of the proposed rule by prohibiting a broker-dealer from deducting a free credit balance from the customer's account at the broker-dealer and transferring it to another institution and investing it in another instrument on behalf of the customer, except as permitted under paragraph (j)(2).[170]

In response to the comment, as a preliminary matter, cash balances in customer securities accounts must be included as credits in the customer reserve formula. Further, the net amount of the credits over debits must be deposited in a customer reserve account

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See Information Memo 05-11 (Feb. 15, 2005). The memo stated that broker-dealers should disclose material differences in interest rates between the different sweep products and, with respect to the bank sweep program, further disclose the terms and conditions, risks and features, conflicts of interest, current interest rates, manner by which future interest rates will be determined, and the nature and extent of FDIC and SIPC protection.

168 See Amendments to Financial Responsibility Rules, 72 FR at 12896.

169 See SIFMA 2 Letter.

170 Id.

in the form of cash or qualified securities. However, cash credit items that are net of debit items can be used by the broker-dealer for the limited purpose of facilitating transactions of its customers.[171] The commenter suggested that proposed paragraph (j)(2) of Rule 15c3-3 could be interpreted to impose new limits on a broker-dealer's ability to use cash that is an asset on the firm's balance sheet. In response to this concern, the Commission notes that the prohibition in the first sentence of proposed paragraph (j)(2) of Rule 15c3-3 is intended to place conditions only on the broker-dealer's ability to convert the cash asset of the customer (i.e., a receivable from the broker-dealer) into a different type of asset (e.g., a security or an obligation of another institution outside the context of a sweep program) or to transfer the customer's cash asset to another account.

The Commission is adopting paragraph (j)(2) of Rule 15c3-3 with certain technical modifications.[172] As adopted paragraph (j)(2) reads: "A broker or dealer must not convert, invest, or transfer to another account or institution, credit balances held in a customer's account except as provided in paragraphs (j)(2)(i) and (ii) of this section."[173]

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171 See 17 CFR 240.15c3-3(e)(2) ("It shall be unlawful for any broker or dealer to accept or use any of the amounts under items comprising Total Credits under the formula referred to in paragraph (e)(1) of this section except for the specified purposes indicated under items comprising Total Debits under the formula, and, to the extent Total Credits exceed Total Debits, at least the net amount thereof shall be maintained in the Reserve Bank Account pursuant to paragraph (e)(1) of this section.").

172 Specifically, the Commission is replacing the phrase "[i]t shall be unlawful for a broker or dealer to" with the phrase "[a] broker or dealer must not" because – as noted above – any violation of the rules and regulations promulgated under the Exchange Act is unlawful and therefore it is unnecessary to use this phrase in the final rule. The Commission also is replacing the phrase "free credit balance" with the phrase "credit balances" to clarify that this provision covers both free credit balances and other credit balances. See 17 CFR 240.15c3-3(a)(8)–(9) (defining free credit balances and other credit balances). The Commission is deleting the word "otherwise" because it would be redundant. Finally, the rule text does not include a reference to paragraph (j)(2)(iii), as proposed, because this paragraph was deleted from the final rule text.

173 See paragraph (j)(2) of Rule 15c3-3, as adopted.

a. **Treatment of Free Credit Balances Outside of a Sweep Program**

As proposed, paragraph (j)(2)(i) of Rule 15c3-3 would have permitted a broker-dealer to convert, invest or otherwise transfer to another account or institution free credit balances held in a customer's account only upon a specific order, authorization, or draft from the customer, and only in the manner, and under the terms and conditions, specified in the order, authorization, or draft.[174] This catchall provision would have applied to any use or transfer of customer free credit balances outside the context of a sweep program.

The Commission proposed paragraph (j)(2)(i) in order to comprehensively cover the range of possibilities with respect to the disposition of free credit balances in a customer account other than pursuant to a sweep program. The Commission received two comments recommending that proposed paragraph (j)(2)(i) be clarified to permit a broker-dealer to obtain a one-time consent to ongoing transfers of any free credit balances to a customer to another account, entity or product (outside of a sweep program).[175] The commenters noted that customers, for example, may prefer that free credit balances be regularly transferred to a linked account in their name at another broker-dealer or bank that is not part of a sweep program, and that this clarification would enable a broker-dealer to efficiently handle such customer requests by eliminating the need to obtain individual "specific orders" for repeated transfers that are substantially identical.[176] The Commission agrees with the commenters that a customer may consent to ongoing routine transfers from the customer's account outside of a sweep program without obtaining the customer's specific consent for each individual transfer, provided

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[174] See Amendments to Financial Responsibility Rules, 72 FR at 12866.

[175] See SIFMA 2 Letter; E*Trade 2 Letter.

[176] Id.

the customer has consented to the ongoing transfers under paragraph (j)(2)(i) of Rule 15c3-3. This scenario would already be covered by the proposed rule, and, therefore, the Commission is adopting paragraph (j)(2)(i) substantially as proposed, with certain technical modifications.[177] As adopted, paragraph (j)(2)(i) of Rule 15c3-3 reads: "A broker or dealer is permitted to invest or transfer to another account or institution, free credit balances in a customer's account only upon a specific order, authorization, or draft from the customer, and only in the manner, and under the terms and conditions, specified in the order, authorization, or draft."[178]

Finally, one commenter stated that both regulators and firms need the flexibility to remove funds from a reserve account to cover extraordinary requests for payment of customer free credit balances.[179] However, the commenter noted that "in light of recent market events, we withdraw our earlier proposal to allow such withdrawals under specified conditions and instead recommend that such withdrawals be permitted only by approval of Commission staff or a broker-dealer's [DEA]."[180] Broker-dealers currently may make withdrawals under paragraph (g) of Rule 15c3-3.[181] In light of the risks that could arise to customer funds, the Commission does not believe it would be appropriate

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177 See paragraph (j)(2)(i) of Rule 15c3-3, as adopted. The technical changes delete the words "convert" and "otherwise" from the final rule because a broker-dealer would be prohibited from "converting" a customer's free credit balances and, therefore, it is not necessary to include the word in the final rule. The word "otherwise" is redundant.

178 Id.

179 See SIFMA 4 Letter.

180 Id. In its June 15, 2007 comment letter, SIFMA urged "the Commission to consider allowing a broker-dealer to remove funds from a reserve account to cover a large same-day request for payment of a free credit balance, as long as the free credit balance was included in the latest Rule 15c3-3 reserve computation and the broker-dealer begins a new reserve computation as of that date." See SIFMA 2 Letter.

181 17 CFR 240.15c3-3(g).

at this time to expand a firm's ability to make additional withdrawals from its reserve account.

b. Treatment of Free Credit Balances in a Sweep Program

The second and third set of conditions in the proposed rules addressed using or transferring free credit balances in the context of a sweep program.[182] In particular, the Commission proposed four conditions with respect to using or transferring free credit balances in a sweep program. A broker-dealer would have been required to meet: (1) all four conditions with respect to free credit balances in new accounts;[183] and (2) the second, third, and fourth conditions with respect to free credit balances in existing accounts.[184] The four conditions were:

1. The customer has previously affirmatively consented to such treatment of the free credit balances after being notified of the different general types of money market mutual fund and bank account products in which the broker or dealer may transfer the free credit balances and the applicable terms and conditions that would apply if the broker or dealer changes the product or type of product in which free credit balances are transferred;

2. The broker or dealer provides the customer on an ongoing basis with all disclosures and notices regarding the investment and deposit of free credit balances as required by the self-regulatory organizations for which the broker or dealer is a member;

3. The broker or dealer provides notice to the customer as part of the customer's quarterly statement of account that the money market mutual funds or bank deposits to which the free credit balances have been transferred can be liquidated on the customer's demand and held as free credit balances; and

4. The broker or dealer provides the customer with at least 30 calendar days notice before the free credit balances would begin being transferred to a different product, different product type, or into the same product but under materially different terms and conditions. The notice must describe the new money market fund, bank deposit type, or terms and conditions, and how the customer can notify the broker or dealer if the customer chooses not to have the free credit balances

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182 See Amendments to Financial Responsibility Rules, 72 FR at 12866.

183 See paragraph (j)(2)(ii)(A)–(D) of Rule 15c3-3, as adopted.

184 See paragraph (j)(2)(iii)(A)–(C) of Rule 15c3-3, as adopted.

transferred to the new product or product type, or under the new terms and conditions.

Commenters generally agreed with the fundamental principle embodied in the proposal – that customer free credit balances should not be transferred from an obligation of the broker-dealer to an obligation of another entity without the customer's authorization.[185] Other commenters supported the proposed disclosures but suggested additional disclosures be made to customers, including clarification with respect to other protections available to the customer.[186] Two commenters stated that the practice of sweep programs should be banned entirely or that the Commission should adopt a "harder stance" and require more than just disclosure.[187] One commenter responded to the Commission's request for comment as to the cost burdens that would result if the first condition (set forth in proposed paragraph (j)(2)(ii)(A)) to obtain a new customer's prior agreement were to be applied to existing customers. The commenter stated that such costs would be substantial because broker-dealers would be required to amend their agreements with all existing customers.[188] One commenter stated that the amendments in the proposing release did not adequately address situations in which broker-dealers change customer account elections without first obtaining customer authorization.[189]

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185 See SIFMA 2 Letter; First Clearing Letter; Pace Letter.

186 See SIPC Letter.

187 See Ellis Letter; Dworkin Letter. One commenter stated that broker-dealers profit from "excessive" fees charged to clients who opt out of the sweep programs. See Ellis Letter. The second commenter suggested that the broker-dealer's "customer has been effectively denied the opportunity to opt out of bank account sweeps by [the broker-dealer] preventing him or her from utilizing any other vehicle to park his or her free credit balances . . . ." See Dworkin Letter. The commenter noted that by opting out of the sweep, the customer is "confined to a situation where the free credit balance cannot earn any kind of return at all[.]" Id.

188 See SIFMA 2 Letter.

189 See Waddell Letter.

In adopting the final rule, the Commission has made some modifications to the language in the proposed rule in response to commenters and to clarify its application. For clarification and in response to comments, the Commission has defined the term Sweep Program in paragraph (a)(17) of Rule 15c3-3 to identify the types of transactions and products to which the new provisions apply.

Commenters raised concerns about limitations on the types of products broker-dealers could use for sweep arrangements under the proposed amendments. Three commenters suggested that the Commission should not limit the types of products broker-dealers can use for sweep arrangements to money market funds and bank deposit products.[190]

Sweep programs provide a mechanism for excess cash in a customer's securities account to be held in a manner that allows the customer to earn interest on the funds but retain the flexibility to quickly access that cash to purchase securities or withdraw it.[191] In effect, transferring this excess cash to a bank account or money market fund is an alternative to retaining a credit balance in the customer's securities account. The final rule is designed to accommodate this alternative by providing broker-dealers with flexibility in the operation of sweep programs. The Commission believes it is appropriate to confine this flexibility to products that approximate the holding of a customer's excess cash in a securities account. The Commission does not view sweep accounts as a mechanism for investing customers' excess cash without their specific consent in longer term or more volatile assets. For these reasons, the Commission does not believe it would be appropriate to expand the products covered by the final rule beyond money

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190 See SIFMA 2 Letter; First Clearing Letter; Raymond James 2 Letter.

191 See Ellis Letter; Dworkin Letter.

market funds as described in Rule 2a-7 under the Investment Company Act of 1940 or an account at an insured bank as described in paragraph (a)(17) of Rule 15c3-3.

Consequently, paragraph (a)(17) of Rule 15c3-3, as adopted, states "[t]he term Sweep Program means a service provided by a broker or dealer where it offers to its customers the option to automatically transfer free credit balances in the securities account of the customer to either a money market mutual fund product as described in [Rule 2a-7] or an account at a bank whose deposits are insured by the Federal Deposit Insurance Corporation."[192] The Commission intended that the definition of Sweep Program provide that the bank to which free credits are swept be insured by the FDIC.[193] The revised text of the rule makes this explicit. Finally, under this definition, a one-time or other special transfer of a customer's free credit balances would not qualify as a Sweep Program.

Three commenters raised the issue of bulk transfers.[194] They argued that the rule should allow broker-dealers to process bulk transfers of customer assets between, for instance, one money market fund and another money market fund or a bank deposit product and a money market fund. These commenters identify a potential ambiguity in the rule as proposed; namely, how transfers from one Sweep Program product to another Sweep Program product are to be handled under the rule if they do not involve passing funds through the customer's securities account. To address this issue, paragraph (j)(2)(ii) of Rule 15c3-3 is being modified from the proposal to clarify that the conditions

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192 See paragraph (a)(17) of Rule 15c3-3, as adopted.

193 See Amendments to Financial Responsibility Rules, 72 FR at 12866 ("[T]he bank deposit would be guaranteed up to the FDIC's $100,000 limit."). FDIC insurance covers all deposit accounts, including checking and savings accounts, money market deposit accounts and certificates of deposit. The standard insurance amount is currently $250,000 per depositor, per insured bank, for each account ownership category. 12 CFR 330.1(o).

194 See SIFMA 2 Letter; First Clearing Letter; E*Trade 2 Letter.

for operating a Sweep Program (which are set forth in paragraphs (j)(2)(ii)(A) and (B)) will apply to: (1) the transfer of free credit balances from a customer's securities account to a product in a Sweep Program; and (2) the transfer of a customer's interest in one Sweep Program product to another Sweep Program product. This will address both bulk transfers[195] of customer positions from one product (e.g., a money market fund) to another (e.g., a bank deposit product) and transfers of individual customer positions from one product to another.

The Commission is modifying paragraph (j)(2)(ii) of Rule 15c3-3 from the proposal to delete the phrase "to either a money market mutual fund as described in § 270.2a-7 of this chapter or an interest bearing account at a bank without a specific order, authorization or draft for each such transfer, provided" and instead to use the term Sweep Program as defined in paragraph (a)(17) of the final rule. The Commission also replaced the phrase "the account of a customer" with the phrase "a customer's securities account" to clarify that paragraph (j)(2)(ii) and its required conditions apply to the transfer of free credit balances in connection with a customer's securities account, in addition to the bulk transfers described above.[196] As adopted, paragraph (j)(2)(ii) to Rule 15c3-3 reads, in pertinent part: "[a] broker or dealer is permitted to transfer free credit balances held in a customer's securities account to a product in its Sweep Program or to transfer a

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195 See also NASD Rule 2510 (Discretionary Accounts) (providing an exception from the NASD rule for "bulk exchanges at net asset value of money market mutual funds . . . utilizing negative response letters provided: (A) The bulk exchange is limited to situations involving mergers and acquisitions of funds, changes of clearing members and exchanges of funds used in sweep accounts; (B) The negative response letter contains a tabular comparison of the nature and amount of the fees charged by each fund; (C) The negative response letter contains a comparative description of the investment objectives of each fund and a prospectus of the fund to be purchased; and (D) The negative response feature will not be activated until at least 30 days after the date on which the letter was mailed.").

196 The final rule also deletes the phrase "opened on or after the effective date of this paragraph" from paragraph (j)(2)(ii) and moves it to paragraph (j)(2)(ii)(A), as described below.

customer's interest in one product in a Sweep Program to another product in a Sweep Program, provided" the conditions set forth in paragraphs (j)(2)(ii)(A) and (B) are met.[197]

As adopted, paragraphs (j)(2)(ii)(A) and (B) establish four conditions that must be met to lawfully transfer a customer's free credit balances to a product in a Sweep Program or to transfer a customer's interest directly from one product in a Sweep Program to another product in a Sweep Program. The first condition – set forth in paragraph (j)(2)(ii)(A) – applies only with respect to accounts opened on or after the effective date of the rule. This addresses the burden that would have been associated with having broker-dealers re-document existing accounts. The remaining three conditions – set forth in paragraph (j)(2)(ii)(B)(1) through (3) – apply to both existing and new accounts.

Paragraph (j)(2)(ii)(A), as adopted, provides that for an account opened on or after the effective date of the rule, the customer must give prior written affirmative consent to having free credit balances in the customer's securities account included in the Sweep Program after being notified: (1) of the general terms and conditions of the products available through the Sweep Program; and (2) that the broker or dealer may change the products available under the Sweep Program.[198]

As stated above, the Commission has modified paragraph (j)(2)(ii)(A) in the final rule to read "the customer gives prior written affirmative consent to having free credit balances in the customer's securities account included in the Sweep Program after being notified . . . ."[199] The Commission modified this paragraph to incorporate the term

197 See paragraph (j)(2)(ii) of Rule 15c3-3, as adopted.

198 See paragraph (j)(2)(ii)(A) of Rule 15c3-3, as adopted.

199 Id. The proposed rule stated the "customer has previously affirmatively consented to such treatment of the free credit balances after being notified of . . . ." In addition, as noted above, the phrase "accounts opened on or after the effective date of this paragraph"

Sweep Program as defined in paragraph (a)(17) of the rule and the reference to the "customer's securities account" to make this paragraph consistent with other modifications to paragraph (j)(2) of the final rule. Additionally, the Commission modified this paragraph to clarify that the customer's consent must be written, consistent with the discussion in the proposing release, which noted customer consent could be given in an account opening agreement.[200]

The Commission received one comment stating that the text of proposed paragraph (j)(2)(ii)(A) that would have required the disclosure of "applicable terms and conditions that will apply if the broker or dealer changes the product or type of product" could be read to require highly specific disclosure about product terms and conditions that may only be established or modified in the future and, therefore, are unknown at the time the customer opens an account with the broker-dealer.[201] In addition, the commenter stated that under proposed paragraph (j)(2)(ii)(D), a broker-dealer would already be required to describe any changes to the terms and conditions it makes contemporaneously with such changes. Given this type of notice, the commenter stated that there is no need for the type of generalized (and therefore less effective) disclosure that would have been required by paragraph (j)(2)(ii)(A). The Commission agrees with the commenter and, therefore, has deleted the phrase "transfer the free credit balances

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was deleted from proposed paragraph (j)(2)(ii) and moved to paragraph (j)(2)(ii)(A), with the reference to specific paragraph (j)(2)(ii) inserted after the word "paragraph." Moving this phrase to paragraph (j)(2)(ii)(A) simplifies the final rule by eliminating the necessity of codifying two largely overlapping sets of conditions, with three of the conditions being repeated in both paragraphs. The effect of this change is to make the first condition only applicable to new accounts and the remaining conditions (paragraph (j)(2)(ii)(B)(1) through (3)) applicable to both new and existing accounts. The word "accounts" also has been replaced with the phrase "an account."

200 See Amendments to Financial Responsibility Rules, 72 FR at 12866 ("[T]he customer would need to agree prior to the change (e.g., in the account opening agreement) that the broker-dealer could switch the sweep option between those two types of products.").

201 See SIFMA 2 Letter.

and the applicable terms and conditions that will apply if the broker or dealer changes the product or type of product in which the free credit balances are transferred . . . ." In its place, the Commission is adopting language in paragraph (j)(2)(ii)(A)(2) of Rule 15c3-3 under which the broker-dealer must notify the customer that the broker or dealer may change the products available under the Sweep Program.[202]

Paragraph (j)(2)(ii)(B), as adopted, prescribes the following three conditions to sweeping the customer's free credit balances in a new or existing account:

- The broker-dealer provides the customer with the disclosures and notices regarding the Sweep Program required by each SRO of which the broker-dealer is a member;[203]

- The broker-dealer provides notice to the customer, as part of the customer's quarterly statement of account, that the balance in the bank deposit account or shares of the money market mutual fund in which the customer has a beneficial interest can be liquidated on the customer's order and the proceeds returned to the securities account or remitted to the customer;[204] and

- The broker-dealer provides the customer with written notice at least 30 calendar days before: (1) making changes to the terms and conditions of the Sweep Program; (2) making changes to the terms and conditions of a product currently available through the Sweep Program; (3) changing, adding or deleting products available through the Sweep Program; or (4) changing the customer's investment through the Sweep Program from one product to another; and the notice describes the new terms and conditions of the Sweep Program or product or the new product, and the options available to the customer if the customer does not accept the new terms and conditions or product.[205]

As proposed, paragraph (j)(2)(ii)(B) of Rule 15c3-3 would have required that the broker-dealer provide these disclosures and notices "on an ongoing basis." Three commenters stated that there are no current SRO requirements that broker-dealers make disclosures concerning sweep arrangements on an "ongoing basis" and that the

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202 See paragraph (j)(2)(ii)(A)(2) of Rule 15c3-3, as adopted.

203 See paragraph (j)(2)(ii)(B) of Rule 15c3-3, as adopted.

204 Id.

205 Id.

Commission should clarify the source and meaning of this requirement.[206] The Commission has deleted the phrase "ongoing basis" from the final rule. As adopted, the Commission has also modified the text in paragraph (j)(2)(ii)(B), now paragraph (j)(2)(ii)(B)(1), to delete the phrase "investment and deposit of free credit balances as" and inserted the phrase "Sweep Program" to incorporate the definition in paragraph (a)(17). Finally, the Commission has modified the phrase "the self-regulatory organizations" to read "each self-regulatory organization of" to clarify that the broker-dealer must provide the notices and disclosures required by each SRO of which it is a member (including an SRO that is not its DEA).[207]

As adopted, paragraph (j)(2)(ii)(B)(2) states that the broker-dealer must provide information on a quarterly basis with respect to the customer's balance in an account or fund "in which the customer has a beneficial interest."[208] The rule text has been modified to account for the fact that customers can have a beneficial interest in accounts in their name and in omnibus accounts in the name of a custodian in which the assets of multiple customers are commingled.

The Commission also modified language in paragraph (j)(2)(ii)(B)(2) of Rule 15c3-3 to replace the phrase "on the customer's demand" with the phrase "on the customer's order" to address concerns by two commenters that the former phrase could lead customers to believe that they will receive immediate re-payment of those funds, or

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206 See SIFMA 2 Letter; First Clearing Letter; Raymond James 2 Letter.

207 See 17 CFR 240.17d-1.

208 See paragraph (j)(2)(ii)(B)(2) of Rule 15c3-3, as adopted. More specifically, the Commission modified the phrase "that the money market mutual funds or bank deposits to which the free credit balances have been transferred" to read "that the balance in the bank deposit account or shares of the money market mutual fund in which the customer has a beneficial interest . . . ."

they could revert to holding those funds as free credit balances at the broker-dealer.[209] These commenters pointed out that the disclosed terms of most sweep programs allow the money market fund or bank up to seven days to meet requests for withdrawals. Further, there are some broker-dealers that do not allow customers to maintain free credit balances in securities accounts. In response to these comments, the Commission has deleted the phrase "demand and held as free credit balances" and replaced it with the phrase "and the proceeds returned to the securities account or remitted to the customer." This language is designed to account for broker-dealers that do not offer customers the option of having their funds held as free credit balances. In such cases, the broker-dealer would remit the funds withdrawn from the bank or derived from redeeming money market shares directly to the customer (e.g., by transferring them to the customer's bank account).

Proposed paragraphs (j)(2)(ii)(D) and (iii)(C) – now paragraph (j)(2)(ii)(B)(3) – would have required the broker-dealer to provide the customer with notice at least thirty days before the broker-dealer begins transferring the customer's free credit balances to a different product or product type, or into the same product but under materially different terms and conditions.[210] As adopted, paragraph (j)(2)(ii)(B)(3) will require broker-dealers to provide customers written notice at least 30 calendar days before the broker-dealer: (1) makes changes to the terms and conditions of the Sweep Program; (2) makes changes to the terms and conditions of a product currently available through the Sweep Program; (3) changes, adds, or deletes products available through the Sweep Program; or (4) changes the customer's investment through the Sweep Program from one product to

209 See SIFMA 2 Letter.

210 See Amendments to Financial Responsibility Rules, 72 FR at 12896.

another.[211] This modification to the final rule is in response to commenters' requests that the Commission provide clarity with respect to when the thirty day notice requirement would be triggered.[212] In response to comments, the final rule is designed to make clear that the triggering event for the thirty day notice is not exclusively related to the transfer of the customer's free credit balances, but rather changes relating to the terms and conditions of the Sweep Program, as well as, the products available through the Sweep Program. This greater specificity should enhance the protections under the final rule by providing greater certainty that the customer will have time to evaluate available options before a change to the Sweep Program is put into effect.

In addition, paragraphs (j)(2)(ii)(B)(3)(i)(A)–(D) of Rule 15c3-3 require the broker-dealer to provide the customer with written notice at least 30 calendar days before: (1) making changes to the terms and conditions of the Sweep Program; (2) making changes to the terms and conditions of a product currently available through the Sweep Program; (3) changing, adding or deleting products available through the Sweep Program; or (4) changing the customer's investment through the Sweep Program from one product to another.[213] Collectively, these provisions provide more specificity about the types of disclosures and notices required under the final rule than under the proposal. Further, the final rule includes the word "written" before the word "notice" to make explicit that a written notice is required.

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211 A broker-dealer could request exemptive relief from the rule in unusual or emergency cases where it may be impractical or contrary to investor protection for a broker-dealer to first provide customers 30 days' written notice under the rule before taking one of these actions. See, e.g., paragraph (k)(3) to Rule 15c3-3.

212 See SIFMA 2 Letter; First Clearing Letter; Cornell Letter; E*Trade Letter.

213 See paragraph (j)(2)(ii)(B)(3)(i) of Rule 15c3-3, as adopted. The requirements set forth in final paragraph (j)(2)(ii)(B)(3)(i) were proposed as paragraphs (j)(2)(ii)(D) and (iii)(C).

As adopted, paragraph (j)(2)(ii)(B)(3)(ii) requires that "[t]he notice must describe the new terms and conditions of the Sweep Program or product or the new product, and the options available to the customer if the customer does not accept the new terms and conditions or product."[214] The Commission modified the final rule in response to a comment regarding the text of proposed paragraphs (j)(2)(ii)(D) and (iii)(C).[215] The commenter stated that, as drafted, proposed paragraphs (j)(2)(ii)(D) and (iii)(C) would have required a broker-dealer to disclose "how the customer can notify the [broker-dealer] if the customer chooses not to have the free credit balances transferred to the new product or product type, or under new terms and conditions."[216] The commenter stated that these paragraphs appear to assume that the customer will have the option of continuing to have free credit balances treated as they were prior to the change to the sweep arrangement.[217] The commenter pointed out that, in fact, the broker-dealer may elect not to continue offering the prior sweep options and not to offer another sweep product.[218] To account for this possibility, the Commission has revised the text in paragraph (j)(2)(ii)(B)(3)(ii)[219] to require the broker-dealer to provide the customer with a notice that contains a description of the options available to the customer if the customer

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214 See paragraph (j)(2)(ii)(B)(ii) of Rule 15c3-3, as adopted. The final rule codifies this text in a separate paragraph in order to emphasize the specific items the notice must contain.

215 See SIFMA 2 Letter.

216 Id.

217 Id.

218 Id.

219 More specifically, paragraph (j)(2)(ii)(B)(3)(ii) provides that "the notice must describe the new terms and conditions of the Sweep Program or product or the new product, and the options available to the customer if the customer does not accept the new terms and conditions or product." A customer that does not accept the new terms and conditions or product would need to change how free credit balances are treated by, for example, selecting investments outside the Sweep Program or having the balances transferred to an account at another financial institution.

does not wish to accept the new terms and conditions or product.[220] This is intended to give customers sufficient opportunity to make an informed decision in connection with a Sweep Program.

6. "Proprietary Accounts" under the Commodity Exchange Act

Some broker-dealers also are registered as futures commission merchants under the Commodity Exchange Act ("CEA"). These firms carry both securities and commodities accounts for customers. The definition of free credit balances in paragraph (a)(8) of Rule 15c3-3 does not include funds carried in commodities accounts that are segregated in accordance with the requirements of the CEA.[221] However, regulations promulgated under the CEA exclude certain types of accounts ("proprietary accounts") from the CEA's segregation requirements.[222] This exclusion from the segregation requirements under the CEA has raised a question as to whether a broker-dealer must treat payables to customers in proprietary commodities accounts as "free credit balances" when performing a customer reserve computation.[223]

In response to this question, the Commission notes that the objective of the customer reserve requirement in Rule 15c3-3 is to require broker-dealers to hold sufficient funds or qualified securities to facilitate the prompt return of customer property

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220 See Dworkin Letter.

221 17 CFR 240.15c3-3(a)(8).

222 Rule 1.20 requires a futures commission merchant to segregate customer funds. See 17 CFR 1.20. Rule 1.3(k) defines the term customer for this purpose. See 17 CFR 1.3(k). The definition of customer excludes persons who own or hold a proprietary account as that term is defined in Rule 1.3(y). See 17 CFR 1.3(y). Generally, the definition of proprietary account refers to persons who have an ownership interest in the futures commission merchant. Id.

223 See Part 241-Interpretive Releases Relating to the Securities Exchange Act of 1934 and General Rules and Regulations Thereunder, Exchange Act Release No. 9922 (Jan. 2, 1973), 38 FR 1737 (Jan. 18, 1973) (interpreting the credit balance used in Item 1 of the Rule 15c3-3a formula "to include the net balance due to customers in non-regulated commodities accounts reduced by any deposits of cash or securities with any clearing organization or clearing broker in connection with the open contracts in such accounts").

to customers either before or during a liquidation proceeding if the firm fails.[224] Under SIPA, customer property generally does not include funds held in a commodities account.[225] Therefore, funds held in a proprietary commodities account generally would not constitute customer property and persons having claims to those funds would not be customers under SIPA.[226] Moreover, the regulations under the CEA similarly provide the persons having claims to funds in proprietary commodities accounts are not customers for purposes of those regulations.[227] For these reasons, the Commission proposed a specific amendment to the definition of the term free credit balances in paragraph (a)(8) of Rule 15c3-3 that would have clarified that funds held in a commodities account meeting the definition of a proprietary account under CEA regulations are not to be included as free

224 See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071 (Oct. 18, 2012), 77 FR 70214, 70274 (Nov. 23, 2012) (describing rationale and requirements of Rule 15c3-3 segregation requirements). See also Broker-Dealers; Maintenance of Certain Basic Reserves, Exchange Act Release No. 9856 (Nov. 10, 1972), 37 FR 25224, 25225 (Nov. 29, 1972) (stating that the intent of Rule 15c3-3 is, among other things, to "facilitate the liquidations of insolvent broker-dealers and to protect customer assets in the event of a SIPC liquidation through a clear delineation in Exchange Act Rule 15c3-3 of specifically identifiable property of customers."); Amendments to Financial Responsibility Rules, 72 FR at 12862, 12868.

225 As noted above, customer property under SIPA includes "cash and securities (except customer name securities delivered to the customer) at any time received, acquired, or held by or for the account of the debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted." 15 U.S.C. 78lll(4). To receive protection under SIPA, a claimant must first qualify as a customer as that term is defined in the statute. Generally, a customer is any person who has: (1) "a claim on account of securities received, acquired, or held by the [broker-dealer];" (2) "deposited cash with the debtor for the purposes of purchasing securities;" (3) "a claim against the debtor for…[positions]…received, acquired, or held in a portfolio margin account carried as a securities account pursuant to a portfolio margining program approved by the Commission;" or (4) "a claim against the [broker-dealer] arising out of sales or conversions of such securities." See 15 U.S.C. 78lll(2)(A)–(B). The definition of security in SIPA specifically excludes commodities and non-securities futures contracts and, thus, a person with a claim for such assets (not held in a portfolio margin account carried as a securities account) would not meet the definition of customer. See 15 U.S.C. 78lll(14).

226 Id.

227 See 17 CFR 1.3(k).

credit balances in the customer reserve formula.[228] As discussed below, the Commission is adopting the amendment substantially as proposed.

The Commission received three comments in support of the proposed rule change.[229] One commenter requested that the Commission clarify that the relevant definition of proprietary account for these purposes is the definition contained in Rule 1.3(y) under the CEA. While Rule 1.3(y) under the CEA currently contains the relevant definition of proprietary account for the purpose of the amendment, the definition could be codified in a different rule in the future. Consequently, the Commission is adopting the final rule amendment to paragraph (a)(8) of Rule 15c3-3, as proposed. Thus, the final rule does not include specific references to a specific rule. Rather, the amendment to paragraph (a)(8) to Rule 15c3-3, as adopted, more generally refers to a "proprietary account as that term is defined in regulations under the Commodity Exchange Act."

As stated above, this amendment to paragraph (a)(8) of Rule 15c3-3 is designed to clarify that funds held in a commodities account meeting the definition of a proprietary account under CEA regulations are not to be included as "free credit balances" in the customer reserve formula. Under Item 1 of Rule 15c3-3a, however, cash balances that do not meet the definition of free credit balances (e.g., because they are not subject to immediate payment) are included in the customer reserve formula if they meet the definition of other credit balances under paragraph (a)(9) of Rule 15c3-3.[230] Therefore,

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228 See Amendments to Financial Responsibility Rules, 72 FR at 12868. The Commission proposed additional amendments to paragraph (a)(8) of Rule 15c3-3 related to portfolio margining. See also discussion below in section II.B. of this release.

229 See SIPC Letter; SIFMA 2 Letter; SIFMA 4 Letter.

230 Item 1 of Rule 15c3-3a requires a broker-dealer to include in the customer reserve formula "free credit balances and other credit balances in customers' security accounts." Paragraph (a)(9) of Rule 15c3-3 defines other credit balances as "cash liabilities of a broker or dealer to customers other than free credit balances and funds in commodities accounts segregated as aforesaid." 17 CFR 240.15c3-3(a)(9).

in order to remove any ambiguity as to the proper exclusion of proprietary accounts under the CEA from Rule 15c3-3, the Commission also is amending the definition of the term other credit balances in the final rule to delete the words "as aforesaid" and insert the phrase "in accordance with the Commodity Exchange Act or in a similar manner, or funds carried in a proprietary account as that term is defined in regulations under the Commodity Exchange Act."[231] Consequently, the amendments clarify that both free credit balances and other credit balances as defined in Rule 15c3-3 do not include funds carried in proprietary accounts under the CEA.

One commenter also suggested that due to the changes to the swap markets mandated by Title VII of the Dodd-Frank Act, swap accounts (in addition to commodities accounts) are now subject to customer protection rules under the CEA.[232] This commenter suggested that the Commission make it clear that funds in swap accounts also do not constitute free credit balances, whether those funds are required to be segregated by rules under the CEA (e.g., cleared swap accounts or uncleared swap accounts that have opted for segregation) or excepted from segregation under the CEA (e.g., cleared swaps proprietary accounts or uncleared swap accounts that have not opted for segregation). The commenter noted this treatment "would be consistent with the treatment of funds in commodities accounts and with the regulation of swap accounts under the CEA."[233] The Commission agrees there may be additional accounts under the CEA, as amended by the Dodd-Frank Act, that should explicitly be excluded from the definition of free credit balances under Rule 15c3-3. However, the amendments today are designed to clarify the specific question raised with respect to the treatment of funds

231 See paragraph (a)(9) to Rule 15c3-3. See also comments and additional amendments to paragraph (a)(9) of Rule 15c3-3 discussed in section II.B. of this release.

232 See SIFMA 4 Letter.

233 Id.

in proprietary commodities accounts under the CEA and, consequently, the suggestions by the commenter are beyond the scope of this rulemaking.

7. Expansion of the Definition of "Qualified Securities" to Include Certain Money Market Funds

A broker-dealer is limited to depositing cash or qualified securities into the bank account it maintains to meet its customer (and now PAB account) reserve deposit requirements under Rule 15c3-3. Paragraph (a)(6) of Rule 15c3-3 defines qualified securities to mean securities issued by the United States or guaranteed by the United States with respect to principal and interest.[234] This strictly limits the types of assets that can be used to fund a broker-dealer's customer or PAB reserve account. The strict limitation is designed to further the purpose of Rule 15c3-3; namely, that customer assets be segregated and held in a manner that makes them readily available to be returned to the customer. As the Commission noted when first proposing Rule 15c3-3:

> The operative procedures of the Special [Reserve] Account are designed to protect the integrity of customer-generated funds by insulating them against inroads from the broker-dealer's firm activities, whether they be underwriting, market making, other trading, investing, or mere speculation in securities, meeting overhead or any other nature whatever. The Special [Reserve] Account should achieve a virtual 100% protection to customers with respect to the carrying and use of customers' deposits or credit balances which is mandated by Section 7(d) of the SIPC Act.[235]

In response to a petition for rulemaking,[236] the Commission proposed a limited expansion of the definition of qualified security to include shares of an unaffiliated

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234 17 CFR 240.15c3-3(a)(6).

235 Reserves and Related Measures Respecting the Financial Responsibility of Brokers and Dealers, Exchange Act Release No. 9388 (Nov. 8, 1971), 36 FR 22312 (Nov. 24, 1971).

236 As discussed in the proposing release, Federated submitted a petition for rulemaking on April 3, 2003, which it later amended on April 4, 2005. See Amendments to Financial Responsibility Rules, 72 FR at 12865, 12874. More specifically, Federated's petition

money market fund that: (1) is described in Rule 2a-7 under the Investment Company Act of 1940; (2) invests solely in securities issued by the United States or guaranteed by the United States as to interest and principal; (3) agrees to redeem fund shares in cash no later than the business day following a redemption request by a shareholder; and (4) has net assets equal to at least 10 times the value of the shares deposited by the broker-dealer in its customer reserve account.[237] Twenty commenters addressed the proposed amendment.[238] A majority of commenters supported the proposal and generally argued that the definition of qualified security should be expanded further to include more types of instruments. One commenter noted that permitting the use of certain money market funds to make up the required reserve account deposit would introduce "an intermediary

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requested that the Commission amend: (i) Rule 15c3-1 to lower the haircut for certain money market funds to 0%; and (ii) Rule 15c3-3 to: (a) permit a broker-dealer to pledge such money market funds when borrowing fully paid or excess margin securities from a customer under paragraph (b)(3); and (b) treat such money market funds as "qualified securities" that may be deposited into a broker-dealer's customer reserve account. On February 9, 2009, Federated submitted another request for rulemaking (Petition 4-577), reiterating its first petition with respect to amending Rule 15c3-3 to allow a broker-dealer to treat certain money market funds as "qualified securities" that may be deposited into a reserve account. However, this new petition changed the definition of the types of funds that could be treated as qualified securities. More specifically, the new petition proposed amending Rule 15c3-3(a)(6) to define the term qualified securities to include, "a redeemable security of an investment company registered under the Investment Company Act of 1940 and described in 17 CFR 270.2a-7, unaffiliated with the broker-dealer and which limits its investments to securities issued or guaranteed by the United States Government or its agencies or instrumentalities (including repurchase transactions)." See Amendments to Financial Responsibility Rules, 72 FR at 12874 and n.112; see also Public Petitions for Rulemaking No. 4-478 (Apr. 3, 2003) (available at http://www.sec.gov/rules/petitions/petn4-478.htm), as amended (Apr. 4, 2005) (amendment available at http://www.sec.gov/rules/petitions/petn4-478a.pdf), and No. 4-577 (Feb. 3, 2009) (available at http://www.sec.gov/rules/petitions/2009/petn4-577.pdf).

237 See Amendments to Financial Responsibility Rules, 72 FR at 12865.

238 See Federated Letter; Federated 2 Letter; Federated 3 Letter; Federated 4 Letter; Federated 5 Letter; Federated 6 Letter; Federated 7 Letter; Federated 8 Letter; Meeks Letter; Meeks 2 Letter; Crane Data Letter; SIPC Letter; Curian Letter; FAF Letter; Reserve Letter; Brown Brothers Letter; SIFMA Letter; First Clearing Letter; ICI Letter; Barclays Letter; American Beacon Letter; Chamber of

(namely, the holding company or money market fund) at which problems might arise."[239] The commenter also noted that a number of SIPA liquidations have involved the mishandling of money market or mutual fund shares or the confirmations of purchases of nonexistent "money market funds."[240]

The Commission recently has proposed substantial amendments to its rules on money market funds.[241] In light of these proposed amendments,[242] the Commission is deferring consideration of any further expansion of the definition of qualified security in Rule 15c3-3 at this time. This will allow the Commission to assess the potential impact of any money market fund reforms it may adopt and whether any such impact would have consequences for the customer protection objective of the reserve account requirement in Rule 15c3-3.

Commerce Letter; ABASA Letter; UBS Letter; Fidelity/NFS Letter; Barnard Letter; Federated 9 Letter; BOK Letter; Cornell Letter.

239 See SIPC Letter.

240 Id.

241 Money Market Fund Reform; Amendments to Form PF, Release No. IC-30551 (June 5, 2013), 78 FR 36834 (June 19, 2013) (The rule proposal includes two principal alternative reforms that could be adopted alone or in combination. One alternative would require a floating net asset value or "NAV" for prime institutional money market funds. The other alternative would allow the use of liquidity fees and redemption gates in times of stress. The proposal also includes additional diversification and disclosure measures that would apply under either alternative.). See also Division of Risk, Strategy, and Financial Innovation, Commission, Responses to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher (Nov. 30, 2012) (responding to questions posed by Commissioners Aguilar, Paredes, and Gallagher regarding effectiveness of the 2010 money market fund reforms, as well as how future reforms might affect demand for investments in money market fund substitutes and the implications for investors, financial institutions, corporate borrowers, municipalities, and states that sell their debt to money market funds), available at http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf.

242 Money Market Fund Reform; Amendments to Form PF, Release No. IC-30551 (June 5, 2013), 78 FR 36834 (June 19, 2013).

B. Holding Futures Positions in a Securities Portfolio Margin Account

Under SRO portfolio margin rules ("portfolio margin rules"),[243] a broker-dealer can combine securities and futures positions in a portfolio margin securities account to compute margin requirements based on the net market risk of all positions in the account.[244] Until the passage of the Dodd-Frank Act, however, SIPA only protected customer claims for securities and cash, and specifically excluded from protection futures contracts that are not also securities. This fact created a potential ambiguity as to how futures positions in a portfolio margin securities account would be treated in a SIPA liquidation. Consequently, the Commission proposed amendments to Rule 15c3-3 to accommodate the holding of futures positions in a securities account that is margined on a portfolio basis.[245]

Subsequent to the Commission's proposals, the Dodd-Frank Act amended the definitions of customer, customer property, and net equity in section 16 of SIPA to take into account futures and options on futures held in a portfolio margin account carried as a securities account pursuant to a Commission-approved portfolio margining program.[246]

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243 See Exchange Act Release No. 55471 (Mar. 14, 2007), 72 FR 13149 (Mar. 20, 2007) (SR-NASD-2007-013); Exchange Act Release No. 54918 (Dec. 12, 2006), 72 FR 1044 (Jan. 9, 2007) (SR-NYSE-2006-13); Exchange Act Release No. 54919 (Dec. 12, 2006), (SR-CBOE 2006-14); Exchange Act Release No. 54125 (July 11, 2006), 71 FR 40766 (July 18, 2006)(SR-NYSE-2005-93); Exchange Act Release No. 52031 (July 14, 2005), 70 FR 42130 (July 21, 2005) (SR-NYSE-2002-19); Exchange Act Release No. 52032 (July 14, 2005), 70 FR 42118 (July 21, 2005) (SR-CBOE-2002-03); see also Exchange Act Release No. 58251 (July 30, 2008), 73 FR 46111 (Aug. 7, 2008) (SR-FINRA-2008-041); Exchange Act Release No. 58243 (July 28, 2008), 73 FR 45505 (Aug. 5, 2008) (SR-CBOE-2008-73); and Exchange Act Release No. 58261 (July 30, 2008), 73 FR 46116 (Aug. 7, 2008) (SR-NYSE-2008-66) (making portfolio margin rules permanent).

244 See, e.g., FINRA Rule 4210(g) and CBOE Rule 12.4.

245 See Amendments to Financial Responsibility Rules, 72 FR at 12868–12870.

246 See Pub. L. No. 111–203 § 983.

As a result, persons who hold futures positions in a portfolio margining account carried as a securities account are now entitled to SIPA protection.

While the Dodd-Frank Act addressed the protection under SIPA of futures and futures options held in a securities portfolio margin account, the Commission's proposed amendments to Rule 15c3-3 and 15c3-3a will still serve an important purpose. In particular, they complement the Dodd-Frank SIPA amendments, and will provide additional protections to customers by requiring broker-dealers to treat these futures positions in accordance with the segregation requirements in Rules 15c3-3 and 15c3-3a. Consequently, the Commission is adopting the amendments with modifications to address, in part, comments.

To accommodate securities and futures portfolio margining, the Commission's proposals included several amendments. First, the Commission proposed amending the definition of free credit balance in paragraph (a)(8) of Rule 15c3-3 to provide that the term shall also include such liabilities carried in a securities account pursuant to an SRO portfolio margining rule approved by the Commission under section 19(b) of the Act ("SRO portfolio margining rule"), including daily marks to market, and proceeds resulting from closing out futures contracts and options thereon, and, in the event the broker-dealer is the subject of a proceeding under SIPA, the market value as of the filing date as that term is defined in SIPA (15 U.S.C. 78lll(7)) of any long options on futures contracts.

In addition, the Commission proposed amendments to treat the unrealized value of a futures option in a portfolio margin account on the SIPA filing date[247] as a free credit balance for purposes of Rule 15c3-3. This amendment was designed to clarify that the

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[247] The term filing date is defined in SIPA as, generally, being the date a SIPA proceeding is commenced. See 15 U.S.C. 78lll(7).

market value of such assets should be included in determining a customer's net equity claim in a SIPA proceeding. Unlike futures contracts, futures options do not generate cash balances on a daily basis in the account (i.e., they have unrealized market value at the end of a trading day). Since the broker-dealer is not holding cash for the customer, there is no need to treat the futures options as a free credit balance for purposes of the reserve formula. However, if the broker-dealer was liquidated under SIPA, the unrealized gains or losses of the futures options should be included in calculating the customer's net equity in the account (along with the securities positions and all futures-related and securities-related cash balances).[248] The proposed amendments were designed to provide for this outcome by defining the market value of the futures options as a free credit balance as of the filing date of a SIPA liquidation of the broker-dealer. As free credit balances, funds originating from futures transactions (e.g., margin deposits and daily marks to market) and the market value of futures options as of the SIPA filing date would constitute claims for cash in a SIPA proceeding and, therefore, become a part of a customer's net equity claim entitling the customer to up to $250,000 in advances to make up for shortfalls.

The Commission received six comments on the proposed amendments.[249] Three commenters generally supported the amendments.[250] One commenter stated that the amendments represent a positive step forward in resolving certain regulatory obstacles in

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248 See 15 U.S.C 78lll(11); see also Pub. L. No. 111–203 § 983 (revising definition of net equity).

249 See SIFMA 2 Letter; CME Letter; SIPC Letter; Citigroup Letter; American Bar Association Letter; SIFMA 4 Letter. The comment letters received as a result of the original solicitation of comment pre-date the Dodd-Frank Act. As such, these comment letters address the proposed amendments prior to the enactment of the Dodd-Frank SIPA amendments related to portfolio margining. The comment letters received subsequent to the passage of the Dodd-Frank Act address the SIPA amendments.

250 See SIFMA 2 Letter; Citigroup Letter; American Bar Association Letter.

connection with the inclusion of futures contracts in a portfolio margin account.[251] Another commenter stated that it supported the Commission's efforts to facilitate the cross-margining of futures and securities in the portfolio margin account by clarifying the treatment of futures and options positions under SIPA.[252] A commenter expressed support for the development of rules for portfolio margining, and supported the Commission's effort to provide greater legal certainty regarding the SIPA treatment of futures positions in a portfolio margin account.[253] In a subsequent comment letter, however, this commenter stated that this amendment is no longer necessary in light of the Dodd-Frank Act amendments, and recommended the Commission withdraw it.[254] Another commenter stated that the Commission's proposal is premature in that including futures in a portfolio margin account, which is a securities account, would conflict with the segregation provisions under the CEA[255] and that SIPC has not determined that protection should be extended to futures.[256]

The Commission agrees, in part, with the commenter who stated that the Dodd-Frank Act SIPA amendments make the Commission's proposed amendments to Rules 15c3-3 and 15c3-3a unnecessary.[257] As noted above, the definitions of customer, customer property, and net equity in section 16 of SIPA were amended by the Dodd-Frank Act to take into account futures and options on futures held in a portfolio margin account carried as a securities account pursuant to a Commission-approved portfolio

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251 See Citigroup Letter.

252 See American Bar Association Letter.

253 See SIFMA 2 Letter.

254 See SIFMA 4 Letter.

255 See, e.g., 17 CFR 1.20–1.29.

256 See CME Letter. See also SIPC Letter (expressing "grave concerns" about potential conflict between the proposed amendments and SIPA).

257 See SIFMA 4 Letter.

margining program.[258] Consequently, in a proceeding under SIPA, futures and options on futures positions held in a portfolio margin account carried as a securities account would be included in determining a customer's net equity claim.[259] Therefore, the proposed amendment relating to the unrealized value of a futures option is not necessary to achieve the objective of providing SIPA protection for such positions. As a result, the Commission is modifying the final rule to delete the proposed language in paragraph (a)(8) of Rule 15c3-3 that would have treated the unrealized value of a futures option in a portfolio margin account on the filing date of a SIPA proceeding as a free credit balance for purposes of Rule 15c3-3.[260]

As stated above, however, the remaining rule amendments to Rules 15c3-3 and 15c3-3a complement the amendments to SIPA and provide additional protections to customers. Consequently, the Commission is adopting them with some technical modifications in response to suggestions offered by commenters.

One commenter suggested a change to paragraph (a)(8) of Rule 15c3-3 that would expand the definition of free credit balances to include cash balances related to futures positions and the value of futures options positions on the SIPA filing date.[261] First, the

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258 See Pub. L. No. 111–203 § 983.

259 Under the Dodd-Frank Act SIPA amendments, a customer's net equity now includes all positions in futures contracts and options on futures contracts held in a portfolio margining account carried as a securities account pursuant to a portfolio margining program approved by the Commission, including all property collateralizing such positions, to the extent that such property is not otherwise included herein. See 15 U.S.C. 78lll(11)(A)(ii). Further, the amendment provided that a claim for a commodity futures contract received, acquired, or held in a portfolio margining account pursuant to a portfolio margining program approved by the Commission or a claim for a security futures contract, shall be deemed to be a claim with respect to such contract as of the filing date, and such claim shall be treated as a claim for cash. See 15 U.S.C. 78lll(11).

260 Specifically, the final rule does not include the proposed language: ", and, in the event the broker-dealer is the subject of a proceeding under SIPA, the market value as of the "filing date" as that term is defined in SIPA (15 U.S.C. 78lll(7)) of any long options on futures contracts."

261 See SIFMA 2 Letter.

commenter noted that paragraph (a)(8) of Rule 15c3-3 concerns free credit balances, which are funds subject to immediate payment (among other limitations).[262] The commenter expressed concern that the Commission's proposal could have been construed as excluding cash balances in a portfolio margin account that are not subject to immediate payment. The Commission agrees that the proposal could have been interpreted as requiring that futures-related cash balances be treated differently depending on whether or not they are subject to immediate payment.

The amendments to Rule 15c3-3 are designed to provide the same treatment to futures-related cash balances in a portfolio margin account as applies to securities-related cash balances. As discussed above, under Item 1 of Rule 15c3-3a, cash balances that do not meet the definition of free credit balances (e.g., because they are not subject to immediate payment) are included in the customer reserve formula if they meet the definition of other credit balances under paragraph (a)(9) of Rule 15c3-3.[263] Consequently, to remove any ambiguity as to the effect of the rule changes in response to the comments noted above, the Commission is amending paragraph (a)(9) of Rule 15c3-3 – which defines other credit balances – to include futures-related cash balances other than free credit balances. In addition, the Commission has deleted the phrase "shall include such liabilities," in the amendment to proposed paragraph (a)(8) and replaced it with "includes, if subject to immediate cash payment to customers on demand, funds..." to clarify that this paragraph relates to cash balances in a portfolio margin account that are

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262 Id.

263 Item 1 of Rule 15c3-3a requires a broker-dealer to include in the customer reserve formula free credit balances and other credit balances in customers' securities accounts. Paragraph (a)(9) of Rule 15c3-3 defines other credit balances as "cash liabilities of a broker or dealer to customers other than free credit balances and funds in commodities accounts segregated as aforesaid." 17 CFR 240.15c3-3(a)(9).

subject to immediate payment and, hence, that paragraph (a)(9) relates to other cash balances in a portfolio margin account.

One commenter suggested changes with respect to the marks to market language in the rule, stating that the phrase relating to daily marks to market be modified to read "variation margin or initial margin marks to market" and the phrase in the proposal that read "proceeds resulting from closing out futures contracts and options thereon" be modified to read "proceeds resulting from margin paid or released in connection with closing out, settling or exercising futures contracts and options thereon."[264] The Commission agrees with these technical suggestions because they clarify the rule by incorporating appropriate futures terminology.

Consequently, as adopted, the text in paragraphs (a)(8) and (a)(9) of Rule 15c3-3 expands the terms free credit balance and other credit balances to include "funds carried in a securities account pursuant to a self-regulatory organization portfolio margin rule approved by the Commission . . . including variation margin or initial margin, marks to market, and proceeds resulting from margin paid or released in connection with closing out, settling or exercising futures contracts and options thereon."[265] The amendments, as adopted, more precisely capture the Commission's intent in terms of identifying the types of futures-related cash balances that may be held in a portfolio margin account than the language in the proposed rule.

On the debit side of the customer reserve formula, the Commission is adopting, substantially as proposed, an amendment to Rule 15c3-3a Item 14 that permits a broker-dealer to include as a debit item the amount of customer margin required and on deposit at a derivatives clearing organization related to futures positions carried in a portfolio

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264 See SIFMA 2 Letter.

265 See also section II.A.6. of this release.

margin account.[266] Under SIPA, the term customer property includes, "resources provided through the use or realization of customers' debit cash balances and other customer-related debit items as defined by the Commission by rule," as well as, "in the case of a portfolio margining account of a customer that is carried as a securities account pursuant to a portfolio margining program approved by the Commission, a futures contract or an option on a futures contract received, acquired, or held by or for the account of a debtor from or for such portfolio margining account, and the proceeds thereof."[267] Under this provision of SIPA, this amendment to Rule 15c3-3 makes the margin required and on deposit at a derivatives clearing organization part of the "customer property" in the event the broker-dealer is placed in a SIPA liquidation. Thus, it would be available for distribution to the failed firm's customers.

Finally, one commenter suggested changes to Commission rules beyond those in the proposing release. This commenter urged the Commission to consider amending Rules 8c-1, 15c2-1, and 15c3-3 to provide that their provisions could be waived by customers that are entitled to engage in derivative transactions in a portfolio margin account, provided the customer agrees in writing to waive SIPA protection.[268] According

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266 The Commission also is amending Item 14 of Rule 15c3-3a to replace the phrase "Security futures products" with the phrase "security futures products." In addition, the Commission adopting some non-substantive amendments to Note G to Item 14, including: (1) in paragraph (a) replacing the word "shall" with the word "must"; (2) in paragraph (b) replacing the word "shall" with the word "will"; in the second line in paragraph (b)(2) inserting the phrase "futures in a" before the phrase "portfolio margin account" and deleting the word "margin"; (3) in paragraph (b)(2) replacing the word "shall" with the word "will" in three places; (4) in the sixth and seventh lines of paragraph (b)(2), inserting the phrase "futures in a" before the phrase "portfolio margin account" and deleting the phrase "futures margin"; in paragraph (b)(3)(iv) replacing the word "securities" with the word "security", inserting the phrase "futures in a" before the phrase "portfolio margin account" and deleting the word "futures"; and (4) in paragraph (c), replacing the word "shall" with the word "will", inserting the phrase "futures in a" before the phrase "portfolio margin account" and deleting the word "futures."

267 15 U.S.C. 78lll(4)(B) and (D); see also Dodd-Frank Act Section 983.

268 See American Bar Association Letter.

to the commenter, a customer executing such a waiver would not be entitled to the protections under SIPA for customers and would be deemed a general creditor of the broker-dealer with respect to claims arising from their portfolio margin accounts. At this time, the Commission does not believe it would be appropriate to amend the rules as recommended by the commenter because such changes are beyond the scope of this rulemaking.

C. Amendments With Respect to Securities Lending and Borrowing and Repurchase/Reverse Repurchase Transactions

In the proposing release, the Commission noted two concerns about stock lending that arose from the failure of the registered broker-dealer MJK Clearing, Inc. ("MJK");[269] namely: (1) that broker-dealers with principal liability in a stock loan transaction may purport to be acting in an agency capacity and, consequently, not taking appropriate capital charges; and (2) that broker-dealers that historically have not been active in stock loan activities may rapidly expand their balance sheets with such transactions and, thereby, increase leverage to a level that poses significant financial risk to the firm and its counterparties. In response, the Commission proposed, and is now adopting, amendments to Rules 15c3-1 and 17a-11.

With respect to the Rule 15c3-1 proposal, the Commission is adopting the amendment, as proposed. This amendment to subparagraph (c)(2)(iv)(B) of Rule 15c3-1 clarifies that broker-dealers providing securities lending and borrowing settlement services are deemed, for purposes of the rule, to be acting as principal and are subject to

[269] See Amendments to Financial Responsibility Rules, 72 FR at 12869. The failure of MJK raised several concerns regarding securities lending transactions. As explained in more detail in the proposing release, at the time of its failure, MJK owed cash collateral to several borrowing broker-dealers. Id. at 12862, 12869–12870. These broker-dealers suffered losses caused by MJK's failures and, in later proceedings related to these losses, questions arose as to whether these broker-dealers were acting as principal or agent.

applicable capital deductions.[270] Under the amendment, these deductions can be avoided if a broker-dealer takes certain steps to disclaim principal liability. In particular, the final rule provides that "a broker or dealer that participates in a loan of securities by one party to another party will be deemed a principal for the purpose of the deductions required under this section, [i.e., deductions from net worth] unless the broker or dealer has fully disclosed the identity of each party to the other and each party has expressly agreed in writing that the obligations of the broker or dealer do not include a guarantee of performance by the other party and that such party's remedies in the event of a default by the other party do not include a right of setoff against obligations, if any, of the broker or dealer."[271]

The Commission received five comments on the proposed amendment.[272] Two commenters objected to this amendment, stating that they believed the standard legal documents used in securities lending transactions provide sufficient legal certainty on the status of the parties.[273] The Commission, in recognition of standard stock loan agreement

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270 A broker-dealer is required to deduct from net worth most unsecured receivables, including the amount that the market value of a securities loan exceeds the value of collateral obtained for the loan. See 17 CFR 240.15c3-1(c)(2)(iv)(B). Similarly, with respect to repo transactions, a broker-dealer obligated to resell securities must, in computing net capital, deduct the amount that the market value of the securities is less than the resale price. See 17 CFR 240.15c3-1(c)(2)(iv)(F). A broker-dealer obligated to repurchase securities must, in computing net capital, deduct the amount that the market value of the securities is greater than the repurchase price to the extent the excess is greater than certain percentages. See 17 CFR 240.15c3-1(c)(2)(iv)(F).

271 See paragraph (c)(2)(iv)(B) of Rule 15c3-1, as adopted. Standard master securities loan agreements (including the annexes thereto) commonly used by the parties to a securities lending transaction contain provisions for establishing agent (as opposed to principal) status in a securities lending and borrowing transaction that are consistent with the requirements in paragraph (c)(2)(iv)(B) of Rule 15c3-1, as amended. See, e.g., 2000 Master Securities Loan Agreement, Annex I, published by SIFMA, available at www.sifma.org.

272 See Abbey National Letter; Dresdner Kleinwort Letter; SIFMA 2 Letter; Citigroup Letter; Cornell Letter.

273 See SIFMA 2 Letter; Citigroup Letter.

templates, designed the amendment to accommodate the continued use of these industry model agreements by incorporating their use into the rule's requirements. For the purposes of establishing a broker-dealer's status as agent or lender, these agreements may be sufficiently detailed to satisfy the new requirements. However, it would be the broker-dealer's responsibility to ensure that any "standard" agreement contains the necessary provisions to comply with this amendment, and that such provisions are not weakened by any other language in the agreement or any subsequent amendment. The goal is to avoid ambiguity about a broker-dealer's status as agent or principal regarding the applicability of the stock loan charges in the net capital rule. As the failure of MJK illustrated, disputes can arise over whether a broker-dealer is acting as a principal or agent in a stock loan transaction.[274] Under the formulation of the rule, a broker-dealer is presumed to be acting in a principal capacity unless it can demonstrate through its agreements with the other participants in the transaction that it is acting as agent. In this regard, a broker-dealer will be responsible for determining that its agreements are fully consistent with the standards of the rule.

One commenter asked for clarification on the timing of when the agent lender must disclose the principal parties to one another in order to disclaim principal liability under the rule.[275] This commenter stated that the amendment should be modified so as not to require pre-trade disclosure of the identity of the principal, since under the agency annex to standardized master lending agreements such disclosure can be made on the next business day.[276] The amendment is intended to accommodate the continued use of these industry model agreements by incorporating their use into the rule's requirements.

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274 See, e.g., Nomura v. E*Trade, 280 F.Supp.2d 184 (S.D.N.Y. 2003).

275 See SIFMA 2 Letter.

276 See, e.g., www.sifma.org for sample Master Securities Loan Agreements (and annex).

Consequently, disclosure of principals in conformance with the requirements of the "standard" stock loan agreement templates would be consistent with the requirements of the rule (as long as the identity of the borrower and the lender is disclosed within one business day after the trade date), which is designed to ensure that firms are taking the required net capital charges related to the securities lending activity to the extent they have principal liability.

The Commission also is adding new paragraph (c)(5) to Rule 17a-11 to help identify broker-dealers with highly leveraged non-government securities lending and borrowing and repurchase operations.[277] This new provision requires a broker-dealer to notify the Commission whenever the total amount of money payable against all securities loaned or subject to a repurchase agreement, or the total contract value of all securities borrowed or subject to a reverse repurchase agreement, exceeds 2,500 percent of tentative net capital; provided that, for purposes of this leverage threshold, transactions involving government securities as defined in section 3(a)(42) of the Exchange Act, are excluded from the calculation.[278] The amendment is designed to alert regulators to a sudden increase in a broker-dealer's stock loan and repo positions, which could indicate that the broker-dealer is taking on new risk that it may have limited experience in managing.

One commenter supported the proposed amendment and believes the notification could serve as "an early warning" that a firm is approaching insolvency and generally supports the Commission's efforts to protect customers from broker-dealers who recklessly rely on excessively leveraged transactions.[279]

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277 See paragraph (c)(5) of Rule 17a-11, as adopted.

278 15 U.S.C. 78c(a)(42). "Government securities" generally present less market risk than other types of securities used in securities lending and repo transactions. Consequently, they are excluded from the scope of the rule.

279 See Cornell Letter.

In the proposing release, the Commission estimated that a leverage threshold of 25 times tentative net capital would be triggered by 21 broker-dealers on a regular basis.[280] The Commission stated that this establishes a threshold high enough to only capture on a regular basis those few firms highly active in securities lending and repo transactions. The Commission did not receive any comments regarding the 2,500% tentative net capital threshold in the proposing release. Based on FOCUS Report data, as of December 31, 2011, there were six broker-dealers whose securities loaned and securities borrowed transactions exceeded 25 times their tentative net capital. The Commission continues to believe that the 2,500% threshold is an appropriate notice trigger for a firm that historically has not been as active in these transactions but rapidly leverages up its securities lending and repo positions. Given the updated estimates of how many broker-dealers would trigger this threshold, the Commission believes the proposed threshold is high enough to capture on a regular basis only those few firms highly active in securities lending and repo transactions. Therefore, the Commission is retaining this 2,500% threshold in the final rule without revision.

As proposed, the amendment to Rule 17a-11 also would have provided that a broker-dealer that submitted a monthly report of its stock loan and repo activity to its DEA need not file the notices. This provision was designed to accommodate large broker-dealers that are active in this business and regularly maintain stock loan and repo balances that exceed the threshold. The Commission expects that these broker-dealers have experience in managing the risks specific to these types of transactions and have established controls to address those risks. Consequently, a notice under paragraph (c)(5) from these broker-dealers might not be as useful in providing risk assessment information

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280 See Amendments to Financial Responsibility Rules, 72 FR at 12870 (providing rationale for 2,500% threshold).

to regulators. Instead, the monthly reports will provide the Commission and other financial regulators with information with which to develop trend analysis, when deemed appropriate. They could use this analysis to identify leverage levels that are outside the normal trend range, and which may be indicative of a material change in the firm's business model that could indicate it was taking on higher levels of leverage, branching into new products, or experiencing operational or financial difficulties (e.g., the firm could be reducing leverage rapidly because creditors were not willing to enter into new transactions).

Three commenters addressed the proposed monthly notification requirement.[281] They stated that the monthly report in lieu of the notification should be provided as part of the monthly FOCUS report many broker-dealers file with their DEA.[282] The Commission agrees that the FOCUS report may be an appropriate mechanism for reporting stock loan and repo positions in lieu of the proposed monthly notification requirement.[283] Consequently, the Commission has modified the final rule to delete the phrase "submits a monthly report of" and replace it with "reports monthly."[284] In addition, as adopted, in order to provide that the monthly report be sent to a broker-dealer's DEA, the Commission added the phrase "to its designated examining authority in a form acceptable" before "to its designated examining authority."[285] This language, as adopted, will provide each DEA with the flexibility to prescribe how the monthly reports are to be made and will accommodate a DEA that opts to use the FOCUS report

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281 See Abbey National Letter; Citigroup Letter; SIFMA 2 Letter; SIFMA 4 Letter.

282 See Abbey National Letter; Citigroup Letter; SIFMA 2 Letter.

283 Carrying broker-dealers generally are required to submit FOCUS reports on a monthly basis.

284 See paragraph (c)(5) of Rule 17a-11, as adopted.

285 Id.

as the reporting mechanism.[286] In summary, as adopted, the notice exemption in paragraph (c)(5) will state "provided further, however, that a broker or dealer will not be required to send the notice required by this paragraph (c)(5) if it reports monthly its securities lending and borrowing and repurchase and reverse repurchase activity (including the total amount of money payable against securities loaned or subject to a repurchase agreement and the total contract value of securities borrowed or subject to a reverse repurchase agreement) to its designated examining authority in a form acceptable to its designated examining authority."[287]

A commenter asked the Commission to clarify that the new reporting provision of paragraph (c)(5) of Rule 17a-11 is triggered only by principal activity meeting or exceeding stated thresholds.[288] The notification provision applies when a broker-dealer is acting as principal and exceeds the stated thresholds, and a broker-dealer will not need to include transactions for which it does not have principal liability in determining whether the notification threshold has been triggered.

D. Documentation of Risk Management Procedures

It is important for broker-dealers to document the controls they establish for managing the material risk exposures that arise from their business activities. For example, a broker-dealer active in securities lending is exposed to a variety of risks, including market risk,[289] credit risk,[290] and liquidity risk.[291] Other broker-dealer activities

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286 See also SIFMA 4 Letter.

287 See paragraph (c)(5) of Rule 17a-11, as adopted. The Commission also inserted the text "(c)(5)" in the final rule before the phrase "if it reports monthly" to make the paragraph reference more explicit.

288 See Dresdner Kleinwort Letter.

289 Generally, market risk is the risk that prices, values, or rates will adversely change.

290 Generally, credit risk is the risk of loss resulting from a counterparty or other type of obligor failing to meet an obligation, including an obligation with respect to a loan,

give rise to these risks as well, including managing a repo book, dealing in OTC derivatives, trading proprietary positions, and lending on margin. A well-documented system of internal controls designed to manage material risk exposures reflects the determination of a firm's management as to how its business activities should be conducted in light of such exposures. It also enables management to better identify, analyze, and manage the risks inherent in the firm's business activities with a view to preventing material losses and to review whether the firm's activities are being conducted in a manner that is consistent with such procedures and controls as well as in accordance with the Federal securities laws. Risk management controls are particularly important for the largest broker-dealers, which generally engage in a wide range of highly complex activities across many different markets and geographical locations.

While most broker-dealers already have well-documented procedures and controls for managing risks as a matter of business practice, it is important to reinforce the practice and make it easier for regulators to understand a broker-dealer's procedures and controls so that they can review whether the broker-dealer is adhering to them. Consequently, the Commission proposed an amendment to Rule 17a-3 that would have required a broker-dealer to create a record documenting its "internal risk management controls."[292]

Commenters raised concerns that the proposed amendment would be "overly broad and ambiguous"[293] and "so broad as to create uncertainty."[294] Three commenters

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security, swap, option, or settlement.

291 Generally, funding liquidity risk is the risk that a firm will not be able to meet cash demands as they become due and asset liquidity risk is the risk that an asset will not be able to be sold quickly at its market value.

292 See Amendments to Financial Responsibility Rules, 72 FR at 12899.

293 See E*Trade Letter.

argued that the requirement, if adopted, should be limited to market, credit, and liquidity risk management.[295] Another commenter recommended that the Commission propose the minimum elements required to be documented, such as market risk, credit risk, liquidity risk, and operational risk.[296] While market, credit, and liquidity risk were among the specific examples of risk identified in the proposed rule,[297] the Commission agrees that the phrase "risk controls" could be interpreted very broadly. To address this concern, the Commission has modified the final rule to clarify its application. The final rule requires the documentation of controls established specifically to manage market, credit, and liquidity risk, "which have more commonly understood meanings within the industry."[298] This also focuses the rule on the key risks inherent in conducting a securities business.

Commenters also requested that the Commission clarify that, when a broker-dealer is part of a corporate family, risk management controls could be applicable to multiple entities within the corporate family, including the broker-dealer.[299] In response, the final rule does not specify the type of controls a broker-dealer must establish to manage these risks. It simply requires the documentation of the procedures the broker-dealer has established. Broker-dealers that are part of holding companies may be subject to procedures that are used globally throughout the organization. As long as the broker-dealer maintains documented procedures of controls pertaining to the designated entity, the requirements of the rule would be met.

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294 See Citigroup Letter.

295 See E*Trade Letter; SIFMA 2 Letter; Citigroup Letter.

296 See Barnard Letter.

297 See Amendments to Financial Responsibility Rules, 72 FR at 12870.

298 E*Trade Letter. The final rule also deletes the term "internal" because it would be redundant.

299 See E*Trade Letter; SIFMA 2 Letter; Citigroup Letter.

Other commenters requested that the Commission clarify that the risk management controls do not have to include any minimum elements[300] and that the rule does not impose any qualitative requirements.[301] Two commenters suggested that because there were no stated content requirements for the risk management controls, it would be difficult for a firm to prove that their risk management procedures were adequate, which could lead to a "subjective process"[302] or to examiners applying a "one size fits all" best practices standard.[303] One commenter suggested that to address this issue, the Commission should articulate the process that examiners will follow when examining risk management controls.[304] Finally, one commenter encouraged the Commission to consider strengthening this requirement in terms of both its scope and applicability.[305]

The Commission is not mandating any specific controls, procedures, or policies that must be established by a broker-dealer to manage market, credit, or liquidity risk, nor is it requiring any minimum elements or specifying any procedures that would be required to be included in a firm's market, credit, and liquidity risk management policies. Rather, the Commission is requiring that a control, procedure, or policy be documented if it is in place. Based on staff experience monitoring large broker-dealers, the Commission anticipates that most brokers-dealers that will be subject to this rule already have documented controls, procedures, and policies as part of their overall risk management

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300 See SIFMA 2 Letter.

301 See Citigroup Letter.

302 See Coastal Securities Letter.

303 See American Bar Association Letter.

304 Id.

305 See Cornell Letter.

processes. The purpose of this amendment is not to change the controls, procedures, and policies that are in place, but to require that they be adequately documented.

For the foregoing reasons, paragraph (a)(23) to Rule 17a-3, as adopted, requires certain broker-dealers to make and keep current a record documenting the credit, market, and liquidity risk management controls established and maintained by the broker-dealer to assist it in analyzing and managing the risks associated with its business activities.[306] This documentation requirement applies only to broker-dealers that have more than (1) $1,000,000 in aggregate credit items as computed under the customer reserve formula of Rule 15c3-3, or (2) $20,000,000 in capital, including debt subordinated in accordance with Appendix D to Rule 15c3-1.[307]

The Commission also proposed adding paragraph (e)(9) to Rule 17a-4 to require a broker-dealer to retain the documented risk management controls or procedures until three years after the broker-dealer terminates the use of the system of controls or procedures documented therein. One commenter stated that given the minimal cost of electronic storage, the commenter believes that the retention period could be extended beyond three years.[308] Conversely, two commenters suggested that Rule 17a-4 be revised so that a broker-dealer would not be required to maintain outdated versions of its risk management controls.[309]

The Commission is adding paragraph (e)(9) to Rule 17a-4, with a minor modification from the proposed amendment. Specifically, the final rule is modified to

306 See paragraph (a)(23) of Rule 17a-3, as adopted.

307 The Commission also has modified paragraph (a)(23) of Rule 17a-3 from the proposed rule to delete the reference to the term "member" in two places in the final rule because the reference to "member" is unnecessary. Id.

308 Id.

309 See E*Trade Letter; SIFMA 2 Letter.

require retention of the records until three years after termination of the use of the risk management controls documented therein by replacing the phrase "systems of controls or procedures" with the phrase "risk management controls."[310] This modification maintains consistency with the terminology in paragraph (a)(23) of Rule 17a-3, as adopted, which requires broker-dealers to make and keep current a "record documenting the credit, market, and liquidity risk management controls established and maintained by the broker or dealer."[311] Finally, the three year retention period is designed to establish an audit trail between the risk management controls that have most recently been made inoperative and the risk management controls currently in effect to provide sufficient opportunity to review the former during the broker-dealer's exam cycle. Three years also is consistent with the retention period for many of the records required to be preserved under Rule 17a-4.[312]

Finally, one commenter noted that the proposed amendment does not impose any requirements beyond those applicable under Rule 15c3-4.[313] Accordingly, the commenter urged the Commission to create an exception from the proposed amendment to Rule 17a-3 for a broker-dealer that is effectively subject to Rule 15c3-4. With the modifications to the final rule to include only market, credit, and liquidity risk, a broker-dealer subject to the conditions of Rule 15c3-4 would already comply with this amendment given that these risks are included in the risks a broker-dealer would be

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310 See paragraph (e)(9) of Rule 17a-4, as adopted. The Commission also modified the final rule to delete the phrase "paragraph (a)(23) of" and insert "(a)(23)" immediately following "17a-3" to make the referenced citation consistent with other parts of the rule.

311 See paragraph (a)(23) of Rule 17a-3, as adopted.

312 See 17 CFR 240.17a-4(b).

313 See SIFMA 2 Letter. See also 17 CFR 240.15c3-4.

required to address under Rule 15c3-4. Therefore, an exception from the rule is unnecessary.

E. Amendments to the Net Capital Rule

Under Rule 15c3-1, broker-dealers are required to maintain, at all times, a minimum amount of net capital.[314] The capital standard in Rule 15c3-1 is a net liquid assets test. This standard is designed to allow a broker-dealer the flexibility to engage in activities that are part of conducting a securities business (e.g., taking securities into inventory) but in a manner that places the firm in the position of holding at all times more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities (e.g., money owed to customers, counterparties, and creditors).[315] For example, Rule 15c3-1 allows securities positions to count as allowable net capital, subject to standardized or

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314 See 17 CFR 240.15c3-1.

315 See, e.g., Interpretation Guide to Net Capital Computation for Brokers and Dealers, Exchange Act Release No. 8024 (Jan. 18, 1967), 32 FR 856 (Jan. 25, 1967) ("Rule 15c3-1 (17 CFR 240.15c3-1) was adopted to provide safeguards for public investors by setting standards of financial responsibility to be met by brokers and dealers. The basic concept of the rule is liquidity; its object being to require a broker-dealer to have at all times sufficient liquid assets to cover his current indebtedness.") (Footnotes omitted); Net Capital Treatment of Securities Positions, Obligations and Transactions in Suspended Securities, Exchange Act Release No. 10209 (June 8, 1973), 38 FR 16774 (June 26, 1973) (Commission release of a letter from the Division of Market Regulation) ("The purpose of the net capital rule is to require a broker or dealer to have at all times sufficient liquid assets to cover its current indebtedness. The need for liquidity has long been recognized as vital to the public interest and for the protection of investors and is predicated on the belief that accounts are not opened and maintained with broker-dealers in anticipation of relying upon suit, judgment and execution to collect claims but rather on a reasonable demand one can liquidate his cash or securities positions."); Net Capital Requirements for Brokers and Dealers, Exchange Act Release No. 15426 (Dec. 21, 1978), 44 FR 1754 (Jan. 8, 1979) ("The rule requires brokers or dealers to have sufficient cash or liquid assets to protect the cash or securities positions carried in their customers' accounts. The thrust of the rule is to insure that a broker or dealer has sufficient liquid assets to cover current indebtedness."); Net Capital Requirements for Brokers and Dealers, Exchange Act Release No. 26402 (Dec. 28, 1989), 54 FR 315 (Jan. 5, 1989) ("The rule's design is that broker-dealers maintain liquid assets in sufficient amounts to enable them to satisfy promptly their liabilities. The rule accomplishes this by requiring broker-dealers to maintain liquid assets in excess of their liabilities to protect against potential market and credit risks.") (Footnote omitted).

model-based deductions ("haircuts").[316] The rule, however, does not permit most unsecured receivables to count as allowable net capital.[317] This aspect of the rule severely limits the ability of broker-dealers to engage in activities that generate unsecured receivables (e.g., lending money without obtaining collateral). The rule also does not permit fixed assets or other illiquid assets to count as allowable net capital, which creates disincentives for broker-dealers to own real estate and other fixed assets that cannot be readily converted into cash.[318] For these reasons, Rule 15c3-1 incentivizes broker-dealers to confine their business activities and devote capital to activities such as underwriting, market making, and advising on and facilitating customer securities transactions.[319]

Rule 15c3-1 requires broker-dealers to maintain a minimum level of net capital (meaning highly liquid capital) at all times.[320] The rule requires that a broker-dealer perform two calculations: (1) a computation of the minimum amount of net capital the broker-dealer must maintain;[321] and (2) a computation of the amount of net capital the broker-dealer is maintaining.[322] The minimum net capital requirement is the greater of a fixed-dollar amount specified in the rule and an amount determined by applying one of two financial ratios: the 15-to-1 aggregate indebtedness to net capital ratio or the 2% of aggregate debit items ratio.[323]

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316 See 17 CFR 240.15c3-1(c)(2)(vi); 17 CFR 240.15c3-1e; 17 CFR 240.15c3-1f.

317 See 17 CFR 240.15c3-1(c)(2)(iv).

318 See, e.g., 17 CFR 240.15c3-1(c)(2)(iv)(A).

319 See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071 (Oct. 18, 2012), 77 FR 70214, 70219 (Nov. 23, 2012).

320 See 17 CFR 240.15c3-1.

321 See 17 CFR 240.15c3-1(a).

322 See 17 CFR 240.15c3-1(c)(2). The computation of net capital is based on the definition of net capital in paragraph (c)(2) of Rule 15c3-1. Id.

323 See 17 CFR 240.15c3-1(a).

In computing net capital, the broker-dealer must, among other things, make certain adjustments to net worth such as deducting illiquid assets, taking other capital charges, and adding qualifying subordinated loans.[324] The amount remaining after these adjustments is defined as tentative net capital.[325] The final step in computing net capital is to take prescribed percentage deductions ("standardized haircuts") from the mark-to-market value of the proprietary positions (e.g., securities, money market instruments, and commodities) that are included in its tentative net capital.[326] The standardized haircuts are designed to account for the market risk inherent in these positions and to create a buffer of liquidity to protect against other risks associated with the securities business.[327] Alternative Net Capital or "ANC" broker-dealers and a type of limited purpose broker-dealer that deals solely in OTC derivatives ("OTC derivative dealers") are permitted, with Commission approval, to, among other things, use internal models as the basis for taking market risk charges as an alternative approach in lieu of the standardized haircuts for classes of positions for which they have been approved to use models.[328] Rule 15c3-1 imposes substantially higher minimum capital requirements for ANC broker-dealers and OTC derivatives dealers, as compared to other types of broker-dealers, because, among

[324] See 17 CFR 240.15c3-1(c)(2)(i)–(xiii).

[325] See 17 CFR 240.15c3-1(c)(15).

[326] See 17 CFR 240.15c3-1(c)(2)(vi).

[327] See, e.g., Uniform Net Capital Rule, Exchange Act Release No. 13635 (June 16, 1977), 42 FR 31778 (June 23, 1977) ("[Haircuts] are intended to enable net capital computations to reflect the market risk inherent in the positioning of the particular types of securities enumerated in [the rule]"); Net Capital Rule, Exchange Act Release No. 22532 (Oct. 15, 1985), 50 FR 42961 (Oct. 23, 1985) ("These percentage deductions, or 'haircuts', take into account elements of market and credit risk that the broker-dealer is exposed to when holding a particular position."); Net Capital Rule, Exchange Act Release No. 39455 (Dec. 17, 1997), 62 FR 67996 (Dec. 30, 1997) ("Reducing the value of securities owned by broker-dealers for net capital purposes provides a capital cushion against adverse market movements and other risks faced by the firms, including liquidity and operational risks.") (Footnote omitted).

[328] See 17 CFR 240.15c3-1(a)(5) and (a)(7); 17 CFR 240.15c3-1e; 17 CFR 240.15c3-1f.

other reasons, the use of internal models to compute net capital can substantially reduce the deductions for securities and money market positions as compared with the standardized haircuts.[329]

1. Requirement to Deduct From Net Worth Certain Liabilities or Expenses Assumed By Third Parties

In the proposing release, the Commission expressed concern that some broker-dealers may be excluding from their calculations of net worth certain liabilities that relate directly to expenses or debts incurred by the broker-dealer.[330] The accounting justification for the exclusion is that a third party (usually a parent or affiliate) has assumed responsibility for these expenses and debts through an expense sharing agreement.[331] In some cases, however, the third party does not have the resources – independent of the broker-dealer's revenues and assets – to assume these liabilities. Thus, the third party is dependent on the resources of the broker-dealer to pay the expenses and debts. Excluding liabilities from the broker-dealer's net worth calculation in these situations may misrepresent the firm's actual financial condition, deceive the

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329 See 17 CFR 240.15c3-1(a)(5) and (a)(7). See also Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071, 77 FR at 70219 ("[T]he use of internal models to compute net capital can substantially reduce the deductions for securities and money market positions as compared with the standardized haircuts."); Alternative Net Capital Requirements for Broker-Dealers that are Part of Consolidated Supervised Entities, Exchange Act Release No. 49830 (June 8, 2004), 69 FR 34428, 34431 (June 21, 2004) ("We expect that use of the alternative net capital computation will reduce deductions for market and credit risk substantially for broker-dealers that use that method.").

330 See Amendments to Financial Responsibility Rules, 72 FR at 12871.

331 See, e.g., Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Elaine Michitsch, Member Firm Operations, NYSE, and Susan DeMando, Director, Financial Operations, NASD Regulation, Inc. (July 11, 2003) ("Third Party Expense Letter"); see also FINRA Notice to Members 03-63, Expense-Sharing Agreements (Oct. 2003) (discussing the issuance of the Third Party Expense Letter).

firm's customers, and hamper the ability of regulators to monitor the firm's financial condition.[332]

To address this issue, the Commission proposed – and is now adopting substantially as proposed – an amendment to Rule 15c3-1 to add a new paragraph (c)(2)(i)(F) that will require a broker-dealer, in calculating net capital, to take into account any liabilities that are assumed by a third party if the broker-dealer cannot demonstrate that the third party has the resources – independent of the broker-dealer's income and assets – to pay the liabilities.[333]

The Commission received five comments regarding this proposal.[334] Two commenters stated that the amendment was overly burdensome and that it would not result in a more accurate picture of a broker-dealer's financial condition than obtained through current requirements.[335] One of these commenters added that any implementation and enforcement of the amendments "should not be made retroactive."[336] This commenter stated that it is unclear how, and unlikely that, this amendment would achieve any of the desired results and argued that it could conversely impair a firm's ability to continue as a going concern.[337] Finally, this commenter also argued that this amendment would affect capital transactions that originate at the holding company level.[338] Two commenters agreed in principle with the amendments but urged the

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332 See Amendments to Financial Responsibility Rules, 72 FR at 12871.

333 As adopted, the final rule does not include the "-" in the phrase "third-party." In addition, the final rule uses the phrase "broker or dealer" in the place of the phrase "broker-dealer" (which appeared in two places) to maintain consistency throughout Rule 15c3-1, which uses the phrase "broker or dealer."

334 See Beer Letter; Levene Letter; Lowenstein Letter; SIFMA 2 Letter; NIBA 2 Letter.

335 See Beer Letter; Levene Letter.

336 See Levene Letter.

337 Id.

338 Id.

Commission to carefully consider the potential consequences of implementation and to provide clarification on the standard for demonstrating that the third party has adequate financial resources, including factors beyond those referred to in the proposing release that they believed would be potentially relevant.[339] One commenter supported the Commission's goal of clarifying disclosures relating to expense sharing or obligations.[340]

As with the proposal, the amendment, as adopted, is designed to prohibit a practice that could misrepresent a broker-dealer's actual financial condition, deceive the firm's customers, and hamper the ability of regulators to monitor the firm's financial condition. Moreover, the amendment, as adopted, should not impose undue burdens or present serious implementation difficulties because the requirement is consistent with prior staff guidance regarding the treatment of broker-dealer expenses assumed by a third party.[341] Finally, as compared to staff guidance, a federal regulation offers broker-dealers greater certainty as to how to treat expense sharing agreements under Rule 15c3-1.

In response to the comments discussed above, and as the Commission explained in the proposing release, a broker-dealer can demonstrate the adequacy of the third party's financial resources by maintaining records such as the third party's most recent (i.e., as of a date within the previous twelve months) audited financial statements, tax returns, or regulatory filings containing financial reports.[342] Given that the entity to which the broker-dealer is seeking to shift one or more liabilities typically is an affiliate, the staff's experience is that such records should be available to the broker-dealer.

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339 See Lowenstein Letter; SIFMA 2 Letter.

340 See NIBA 2 Letter.

341 See, e.g., Third Party Expense Letter.

342 See Amendments to Financial Responsibility Rules, 72 FR at 12872. The Commission specifically requested comment regarding the records by which a broker-dealer could demonstrate financial resources. It received no comments in response to this request.

Further, because the proposed rule change is consistent with prior staff guidance regarding the need to be able to demonstrate the third party's financial adequacy,[343] a broker-dealer seeking to shift a liability to a third party already would be expected to provide such evidence of the third party's financial resources. For these reasons, the change from staff guidance to Commission rule should not result in implementation and burden concerns of the magnitude raised by the two commenters.[344]

Finally, one commenter noted it would be helpful if the Commission would clarify whether this amendment supersedes the Commission staff guidance in the Third Party Expense Letter.[345] Unlike the PAIB Letter discussed above, the Commission is not directing the staff to withdraw the Third Party Expense Letter on the effective date of these amendments. The Third Party Expense Letter will still be relevant as staff guidance, notwithstanding that it contains a condition that has been codified into Rule 15c3-1 (i.e., that an expense of the broker-dealer assumed by a third party will be considered a liability for net capital purposes unless the broker-dealer can demonstrate that the third party has adequate resources independent of the broker-dealer to pay the liability or expense).[346] In particular, the letter contains additional staff guidance not incorporated into the rule that will be relevant as staff guidance with respect to complying with the amendment to Rule 15c3-1 being adopted today. For example, the letter contains staff guidance with respect to the records a broker-dealer would be expected to make, keep current, and preserve under Rules 17a-3 and 17a-4 with respect to broker-dealer liabilities and expenses assumed by a third party, as well as requirements regarding

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343 See, e.g., Third Party Expense Letter.

344 See Lowenstein Letter; SIFMA 2 Letter.

345 See SIFMA 2 Letter.

346 See Third Party Expense Letter, at 2–3.

written expense sharing agreements.[347] Broker-dealers can continue to rely on the guidance in the Third Party Expense Letter with respect to these matters in complying with today's amendment.

2. Requirement to Subtract From Net Worth Certain Non-Permanent Capital Contributions

In the proposing release, the Commission noted its concern that broker-dealers may be receiving capital contributions from investors that are subsequently withdrawn after a short period of time (often less than a year).[348] In some cases, the capital may be contributed under an agreement giving the investor the option to withdraw it at the investor's discretion. In the past, the Commission has emphasized that capital contributions to broker-dealers should not be temporary,[349] and the Commission staff has explained that a capital contribution should be treated as a liability if it is made with the understanding that the contribution can be withdrawn at the option of the investor.[350]

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347 Id.

348 See Amendments to Financial Responsibility Rules, 72 FR at 12873.

349 See Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991), 56 FR 9124 (Mar. 5, 1991). See also Study of Unsafe and Unsound Practices of Broker-Dealers, Report and Recommendations of the Securities and Exchange Commission, H.R. Doc. No. 92–231 (1971), at 17, 42 (recommending improvement of adequacy and permanency of capital) ("During the 1967-1970 period under review, many broker-dealers, some of them large retail houses, were found to have inadequate and impermanent capital in relation to their business.").

350 Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Raymond J. Hennessy, Vice President, NYSE, and Susan DeMando, Vice President, NASD Regulation, Inc. (Feb. 23, 2000) ("Temporary Capital Letter") ("It is the view of the Division that, for net capital purposes, if an individual investor contributes capital to a broker-dealer with an understanding that the contribution can be withdrawn at the option of the individual investor, the contribution may not be included in the firm's net capital computation and must be re-characterized as a liability. Any withdrawal of capital as to that investor within a period of one year, other than a withdrawal described in paragraph (e)(4)(iii) of Rule 15c3-1, shall be presumed to have been contemplated at the time of the contribution.") (footnote omitted); see also Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991), 56 FR 9124 (Mar. 5, 1991).

Consistent with these Commission and staff positions that capital is not temporary,[351] and given the importance of this issue and the Commission's concern that broker-dealers may not be properly treating short-term capital contributions as liabilities, the Commission proposed amending Rule 15c3-1 to add paragraph (c)(2)(i)(G) to further incorporate these positions into the rule.[352] The proposed change would require a broker-dealer to treat as a liability any capital that is contributed under an agreement giving the investor the option to withdraw it or that is contributed with the intent to withdraw the capital within one year. The Commission further proposed that capital withdrawn within one year would be presumptively subject to treatment as a liability (i.e., it would be presumed to have been contributed with the intent to withdraw within one year).[353]

The Commission is adopting the final rule amendment with certain modifications. As adopted, the rule requires that a broker-dealer treat as a liability any capital that is contributed under an agreement giving the investor the option to withdraw it. The rule, as adopted, also requires that a broker-dealer treat as a liability any capital contribution that is intended to be withdrawn within one year of its contribution. In addition, the final rule provides that capital withdrawn within one year of contribution is deemed to have been intended to be withdrawn within one year unless the broker-dealer receives permission in writing for the withdrawal from its DEA.[354] The ability of a broker-dealer

351 See Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991), 56 FR 9124 (Mar. 5, 1991).

352 See Amendments to Financial Responsibility Rules, 74 FR at 12871–12872.

353 Id.

354 These requirements will not apply to withdrawals covered by paragraph (e)(4)(iii) of Rule 15c3-1, namely, withdrawals used to make tax payments or to pay reasonable compensation to partners. See 17 CFR 240.15c3-1(e)(4)(iii). These types of payments are ordinary business expenditures and do not raise the types of concerns the proposed rule is designed to address. One commenter suggested that the rule be amended to explicitly exclude any withdrawals that would fall under paragraph (e)(4)(iii) of Rule 15c3-1.

to seek permission in writing from its DEA to withdraw capital contributed within one year will provide a means for firms to seek to withdraw capital in limited circumstances after review by its DEA without having to reclassify the withdrawn capital as a liability for net capital purposes.[355]

In the final rule, the Commission has modified the proposed language by moving the qualifier that the DEA can approve a withdrawal so that it modifies this presumption. Specifically, as proposed, the rule provided that a contribution of capital had to be subtracted from net worth if it "is intended to be withdrawn within a period of one year unless the withdrawal has been approved in writing by the Examining Authority for the broker or dealer." As adopted, the rule provides that "[a]ny withdrawal of capital made within one year of its contribution is deemed to have been intended to be withdrawn within a period of one year, unless the withdrawal has been approved in writing by the Examining Authority for the broker or dealer."[356] The change is intended to eliminate a potential ambiguity in the proposal as to whether a withdrawal of capital within one year could ever be approved by the firm's DEA and, therefore, afford the intended relief from the deduction.[357]

The Commission received five comments regarding the amendment to paragraph (c)(2)(i)(G)(2) of Rule 15c3-1.[358] In addition to the general request for comment included in the proposing release, the Commission also requested specific comment on

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355 See FINRA Rule 4110(c)(1) (providing, in part, that no equity capital of a member may be withdrawn for a period of one year from the date such equity capital is contributed, unless otherwise permitted by FINRA in writing).

356 See paragraph (c)(2)(i)(G)(2) of Rule 15c3-1, as adopted.

357 The phrase "to the broker or dealer" following "one year of its contribution" is not included in the final rule because it would be redundant, as the contributions covered in the amendment all involve contributions to the broker-dealer.

358 See Chicago Capital Management Letter; SIFMA 2 Letter; American Bar Association Letter; SIG Letter; NIBA 2 Letter.

whether the time period within which withdrawn and intended-to-be-withdrawn contributions must be treated as liabilities should be longer than one year.[359] While the commenters agreed in principle that contributions of capital to broker-dealers should not be subject to withdrawal at will, they expressed concerns regarding the negative effect that overly restrictive limitations on withdrawals of capital could have on obtaining capital contributions and, therefore, on the financial health of broker-dealers. One commenter, a registered broker-dealer, stated that it believed that the amendment would raise its cost of capital to the point where it would be impossible to obtain capital from unrelated third parties at all.[360] Two commenters also expressed concerns about the potential burden posed by the amendment to broker-dealers in need of capital.[361] One suggested the addition of exceptions to the rule for de minimis withdrawals and dividends or distributions.[362] Another commenter suggested that the proposal should be amended to exclude a redemption right – a form of option - provided to the investor in connection with the investor's capital contribution to the broker-dealer, where (i) the redemption right may only be exercised by the investor commencing more than one year following the date of the capital contribution to the broker-dealer and (ii) the redemption right would not be mandatorily redeemable.[363]

Another commenter opposed the rule, stating that it contravenes pertinent legal and accounting standards and is unnecessary in view of existing capital withdrawal limitations and notification requirements.[364] This commenter stated that neither GAAP

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359 See Amendments to Financial Responsibility Rules, 72 FR at 12871–12872.

360 See Chicago Capital Management Letter.

361 See American Bar Association Letter; SIFMA 2 Letter.

362 See SIFMA 2 Letter.

363 See American Bar Association Letter.

364 See SIG Letter.

nor Rule 15c3-1 contain a requirement that capital must be permanent, and the word "capital" has no intrinsic meaning that requires it to be permanent.[365] This commenter stated that if any further limitations on capital withdrawals are adopted beyond the current provisions of the net capital rule, they should be designed to allow for the ability of broker-dealer holding companies to withdraw excess net capital at their option for legitimate purposes.[366]

The fifth commenter agreed that there should be no circumstance in which a broker-dealer accepted a capital contribution for net capital purposes that could be withdrawn at the option of the investor.[367] This commenter, however, also stated that the standard for withdrawals should be shortened from one year to nine or six months to increase the availability of funds from investors and owners, allowing more broker-dealers to raise capital and strengthen their financial stability.[368] The commenter requested that the Commission consider the needs of small firms that it said likely will require additional net capital over the next decade.[369]

In response to the commenters' concerns about firms' ability to obtain capital and that the amendment contravenes pertinent legal and accounting standards, the amended rule merely clarifies what constitutes a broker-dealer's permanent capital under Rule 15c3-1 and further emphasizes the requirement that capital contributions cannot be

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365 Id.

366 Id.

367 See NIBA 2 Letter.

368 Id.

369 Id. The commenter also stated that rules that "restrict small broker-dealers from raising capital as a result of uncertainty of investors or owner-operators related to the return of their capital in a reasonable time frame will create a disproportionate and impossible hurdle for small broker-dealers to overcome." Id.

temporary.[370] Rule 15c3-1 imposes a capital standard that is distinct from the use of the term "capital" in other legal and accounting contexts, and the rule amendments under paragraph (c)(2)(i)(G) of Rule 15c3-1 are consistent with the Commission's and staff's views that capital under Rule 15c3-1 should not be temporary.[371]

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370 See Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991) ("The Commission wishes to emphasize that the net capital maintained in a broker-dealer should be permanent capital and not merely a temporary infusion of funds from an affiliate or other sources. For example, there are instances where a broker-dealer receives funds from an affiliate in an amount that would enable the broker-dealer to engage in a transaction that it would otherwise be prohibited from doing because of minimum net capital requirements. If the funds are transferred back to the affiliate within a relatively short period of time after the transaction, the Commission questions whether the funds transferred into the broker-dealer entity could properly be characterized as capital of the firm. Instead, the transaction could be viewed as a loan by the affiliate to the broker-dealer, with the result that the broker-dealer would have to treat the transaction as a liability."). See also Net Capital Requirements for Brokers and Dealers, Exchange Act Release No. 18417 (Jan. 13, 1982), 47 FR 3512 (Jan. 25, 1982) (describing subordination agreement requirements under Appendix D to Rule 15c3-1, including that, among other things, no prepayment may be made (except under the strictly defined limitations of paragraph (c)(5) of Appendix D) before the expiration of one year from the effective date of the subordination agreement, and noting this provision was designed to insure the adequacy as well as the permanence of capital in the industry.); Temporary Capital Letter; Study of Unsafe and Unsound Practices of Broker-Dealers, Report and Recommendations of the Securities and Exchange Commission, H.R. Doc. No. 92–231 (1971) (recommending improvement of adequacy and permanency of capital); and Letter from Nelson Kibler, Assistant Director, Division of Market Regulation to John Pinto, National Association of Securities Dealers, Inc. (Sept. 8, 1980).

371 See Study of Unsafe and Unsound Practices of Broker-Dealers, Report and Recommendations of the Securities and Exchange Commission, H.R. Doc. No. 92–231 (1971), at p. 15 ("The unfortunate use of the term "net capital" in the financial responsibility rules of the Commission and the various exchanges resulted in a semantic confusion which too frequently has led to the mistaken belief that a broker-dealer's net capital is the equivalent of or has some relationship to the concept of "capital", as that term is commonly understood. "Net Capital" applies only to a hard core residue of net liquid assets designed to enable a broker-dealer to meet all rightful current demands of customers for their funds and securities."). See also Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 FR at 70230 ("The net liquid assets test is imposed through the mechanics of how a broker-dealer is required to compute net capital pursuant to Rule 15c3-1. These requirements are set forth in paragraph (c)(2) of Rule 15c3-1, which defines the term net capital. The first step is to compute the broker-dealer's net worth under GAAP. Next, the broker-dealer must make certain adjustments to its net worth to calculate net capital. These adjustments are designed to leave the firm in a position where each dollar of unsubordinated liabilities is matched by more than a dollar of highly liquid assets. There are thirteen categories of net worth adjustments required by the rule.") (footnotes omitted).

The Commission also considered the commenter's suggestion that there be exceptions for de minimis withdrawals, dividends, or distributions. As previously stated, however, the Commission has emphasized that capital contributions should not be temporary.[372] Moreover, paragraph (e) of Rule 15c3-1 already contains mechanisms to permit a broker-dealer to make capital withdrawals for specified purposes.[373] Finally, if a broker-dealer believes it has a basis to appropriately withdraw capital within one year of contribution because, for example, the withdrawal would be de minimis, the final rule provides a mechanism for the broker-dealer to seek permission in writing from its DEA to make such a withdrawal.[374]

With respect to a commenter's view that the standard for withdrawal should be less than one year (e.g., six or nine months), the Commission continues to believe that one year is an appropriate amount of time that a broker-dealer must retain a contribution in order to classify it as capital and not a liability. This is the standard that the Commission staff and FINRA have applied for a number of years and there is no compelling reason to change it.[375] Because the final rule change is an incorporation of,

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372 See Study of Unsafe and Unsound Practices of Broker-Dealers, Report and Recommendations of the Securities and Exchange Commission, H.R. Doc. No. 92–231 (1971), at p. 15; Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 FR at 70230.

373 See 17 CFR 240.15c3-1(e)(1)(iii)(B) and (e)(4)(iii). See also Amendments to Financial Responsibility Rules, 72 FR at 12872, n.79 ("These requirements would not apply to withdrawals covered by paragraph (e)(4)(iii) of Rule 15c3-1, namely, withdrawals used to make tax payments or pay reasonable compensation to partners. These types of payments are ordinary business expenditures and do not raise the types of concerns the proposed rule is designed to address.").

374 See paragraph (c)(2)(i)(G)(2) of Rule 15c3-1, as adopted.

375 See Temporary Capital Letter; FINRA Rule 4110(c)(1) ("No equity capital of a member may be withdrawn for a period of one year from the date such equity capital is contributed, unless otherwise permitted by FINRA in writing."). See also Exchange Act Release No. 60933 (Nov. 4, 2009), 74 FR 58334 (Nov. 12, 2009) (SR-FINRA-2008-067); Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991) (emphasizing "that

among other things, existing Commission staff guidance into Rule 15c3-1, the requirement should not significantly alter current practice.

Moreover, with respect to commenters' concerns about the ability to obtain capital, the rule does not prohibit an investor from withdrawing capital at any time. It prohibits a broker-dealer from treating temporary cash infusions as capital for purposes of Rule 15c3-1. Finally, as stated above, the final rule provides a mechanism for a broker-dealer to apply to its DEA to make a withdrawal without triggering the deduction.[376] This provides a process for firms to affect withdrawals within one year where appropriate.

In summary, the Commission is adding paragraph (c)(2)(i)(G) to Rule 15c3-1 to require a broker-dealer to subtract from net worth any contribution of capital to the broker or dealer: "(1) [u]nder an agreement that provides the investor with the option to withdraw the capital; or (2) [t]hat is intended to be withdrawn within a period of one year of contribution."[377] The final rule further provides that "[a]ny withdrawal of capital made within one year of its contribution is deemed to have been intended to be withdrawn within a period of one year, unless the withdrawal has been approved in writing by the Examining Authority for the broker or dealer."[378]

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the net capital maintained in a broker-dealer should be permanent capital and not merely a temporary infusion of funds from an affiliate or other sources").

376 The final rule does not distinguish between complete and partial withdrawals of capital and, consequently, the deduction could be triggered in either event. Moreover, a partial withdrawal would require a deduction of the full amount of the original contribution as it would indicate that the contribution was merely temporary in nature.

377 See paragraph (c)(2)(i)(G) of Rule 15c3-1, as adopted.

378 Id.

3. Requirement to Deduct the Amount by which a Fidelity Bond Deductible Exceeds SRO Limits

Under SRO rules, certain broker-dealers that do business with the public or that are required to become members of SIPC must comply with mandatory fidelity bonding requirements.[379] SRO rules typically permit a broker-dealer to have a deductible provision included in the bond; however, such rules provide that the deductible may not exceed certain amounts. With regard to firms that maintain deductible amounts over the maximum amount specified, several SRO rules provide that the broker-dealer must deduct this excess amount from its net worth when calculating net capital under Rule 15c3-1.[380] Other SROs require that any deductible amount elected by a broker-dealer that is greater than 10% of the coverage purchased by the broker-dealer must be deducted from the broker-dealer's net worth when calculating net capital under Rule 15c3-1.[381]

Rule 15c3-1, however, does not specifically reference the SRO deductible requirements as a charge to net worth. Therefore, a broker-dealer would not be required to account for the deduction required by an SRO rule in computing net capital under Rule 15c3-1 or in the net capital computation reflected on the broker-dealer's FOCUS report. To address this inconsistency, the Commission proposed to amend Rule 15c3-1 to add paragraph (c)(2)(xiv) to require a broker-dealer to deduct, with regard to fidelity bonding requirements, the amount required by the rules of the broker-dealer's DEA, i.e., the

379 See, e.g., FINRA Rule 4360, CBOE Rule 9.22, and NASDAQ OMX PHLX Rule 705. SRO fidelity bonding requirements typically contain agreements covering areas such as: a "Fidelity" insuring clause to indemnify against loss of property through dishonest or fraudulent acts of employees; an "On Premises" agreement insuring against losses resulting from crimes such as burglary and theft and from misplacement of property of the insured; an "In Transit" clause indemnifying against losses occurring while property is in transit; a "Forgery and Alteration" agreement insuring against loss due to forgery or alteration of various kinds of negotiable instruments; and a "Securities Loss" clause protecting against losses incurred through forgery and alteration of securities. Id.

380 See, e.g., CBOE Rule 9.22.

381 See, e.g., FINRA Rule 4360.

amount in excess of the deductible prescribed in the applicable DEA's fidelity bond rule.[382] The Commission received one comment supporting the proposal and one opposing it.[383] The commenter opposing the amendment noted that amending Rule 15c3-1 to conform to FINRA Rule 4360 would create an increase in minimum net capital requirements for some broker-dealers.[384]

SRO rules prescribing fidelity bond deductibles, and capital charges for deductibles in excess of a certain amount, are designed to incentivize broker-dealers to carry fidelity bonds with a deductible low enough to help ensure customer protection. Moreover, in response to the comment that this amendment would increase minimum net capital requirements, the Commission notes that broker-dealers that are members of an SRO with such a fidelity bonding rule already must account for the deduction in complying with the net capital requirements of the SROs and nothing in the Commission's amendment to paragraph (c)(2)(xiv) of Rule 15c3-1 would alter this status quo. Rather, the proposed rule change would conform the capital calculation under paragraph (c)(2)(xiv) of Rule 15c3-1 to that required by the broker-dealer's SRO.

For these reasons, the Commission is adopting paragraph (c)(2)(xiv) to Rule 15c3-1 with technical revisions to the proposed rule text to make the text of the final rule, as adopted, a more generic cross reference to SRO fidelity bond requirements. The technical changes are designed to increase the flexibility of the final rule so that revisions to SRO fidelity bond requirements pursuant to section 19(b) of the Exchange Act[385] will

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382 See 17 CFR 240.15c3-1(c)(12) (defining examining authority for purposes of Exchange Act Rule 15c3-1).

383 See SIFMA 2 Letter; NIBA 2 Letter.

384 See NIBA 2 Letter.

385 15 U.S.C. 78s(b).

not require conforming amendments to paragraph (c)(2)(xiv) of Rule 15c3-1.[386] More specifically, the proposed rule text, as set forth in the proposing release, would have required the broker-dealer to deduct "with respect to fidelity bond coverage, the excess of any deductible amount over the maximum deductible amount permitted by the Examining Authority for the broker or dealer."[387] The final rule, as adopted, provides that the broker-dealer must deduct "the amount specified by rule of the Examining Authority for the broker or dealer with respect to a requirement to maintain fidelity bond coverage."[388] Thus, the final rule does not include the phrase "maximum permissible deductible amounts." This phrase was borrowed from SRO fidelity bond rules. Because the construction of the SRO rules may change over time, the Commission is making the cross-reference to the SRO rules more general.[389]

4. Broker-Dealer Solvency Requirement

The Commission is adopting an amendment to paragraph (a) of Rule 15c3-1 to require a broker-dealer to cease conducting a securities business if certain insolvency events were to occur. Specifically, as adopted, amended paragraph (a) of Rule 15c3-1 provides that a broker-dealer must not be insolvent as that term is defined in new paragraph (c)(16) of the rule.[390] By making solvency a requirement of Rule 15c3-1, this amendment will require an insolvent[391] broker-dealer to cease conducting a securities

386 See, e.g., FINRA Rule 4360.

387 See, e.g., Amendments to Financial Responsibility Rules, 72 FR at 12872.

388 See paragraph (c)(2)(xiv) of Rule 15c3-1, as adopted.

389 See, e.g., FINRA Rule 4360. See also Exchange Act Release No. 63961 (Feb. 24, 2011), 76 FR 11542 (Mar. 2, 2011).

390 The final rule also has been modified by replacing the word "shall" with the word "must."

391 The definition of insolvent is intended to be broad enough to encompass any type of insolvency proceeding or condition of insolvency; for example, the proposed definition

business pursuant to section 15(c)(3) of the Exchange Act, which generally prohibits a broker-dealer from effecting any transaction in, or inducing or attempting to induce the purchase or sale of, any security in contravention of the Commission's financial responsibility rules (which include Rule 15c3-1).[392]

As proposed, paragraph (c)(16) of Rule 15c3-1 would have defined the term insolvent as, among other things, a broker-dealer's placement in a voluntary or involuntary bankruptcy or similar proceeding; the appointment of a trustee, receiver, or similar official; a general assignment by the broker-dealer for the benefit of its creditors; an admission of insolvency; or the inability to make computations necessary to establish compliance with Rule 15c3-1.[393] As discussed more specifically below, the Commission modified paragraph (c)(16) of Rule 15c3-1 in the final rule in response to concerns raised by commenters.

In the proposing release, the Commission solicited comment on whether there are other insolvency events that should be captured in the proposed definition.[394] One commenter noted that involuntary insolvency proceedings do not necessarily indicate that the broker-dealer is insolvent, as such proceedings can be frivolous, malicious, or otherwise lacking in merit.[395] The commenter also noted that industry standard contract forms generally provide a grace period for a party to such a proceeding to obtain a stay or

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incorporates concepts of insolvency in the U.S. Bankruptcy Code and SIPA. See 11 U.S.C. 101; 15 U.S.C. 78eee(b)(1).

392 15 U.S.C. 78o.

393 See Amendments to Financial Responsibility Rules, 72 FR at 12872–12873. A broker-dealer's inability to make computations necessary to establish compliance with Rule 15c3-1 may also impact the broker-dealer's ability to make the computations necessary to establish compliance with Rule 15c3-3 and vice versa. See, e.g., Rule 15c3-1(a)(1)(ii) (incorporating computations under Rule 15c3-3 into the minimum net capital requirement).

394 See Amendments to Financial Responsibility Rules, 72 FR at 12873.

395 See SIFMA 2 Letter.

dismissal before an event of default is deemed to occur.[396] In response to this comment, the Commission notes that the number of broker-dealer bankruptcy filings (voluntary or involuntary) is small, and therefore, the institution of a frivolous involuntary proceeding involving a broker-dealer likely is a very rare event. Thus, the Commission must consider the potential need for an automatic grace period to address the potential for a frivolous involuntary bankruptcy as well as the harm that could result from allowing a broker-dealer to continue to effect securities transactions for a period of time even though it is properly the subject of a bankruptcy proceeding. The Commission believes the more appropriate approach is to address potentially frivolous proceedings on a case-by-case basis. In the event that a case arises where there would be a need to fashion relief for a broker-dealer that was the subject of a frivolous or meritless involuntary petition, the Commission's existing authority permits it sufficient flexibility to fashion exemptions under appropriate circumstances.[397]

In addition to the comment discussed above, the Commission received four other comment letters that addressed these amendments.[398] One commenter objected to the amendments as unnecessary, citing the Rule 15c3-1 prohibition on broker-dealers effecting securities transactions if their net capital is below certain minimums and noting that a broker-dealer that was insolvent would "by definition" be below those minimums.[399] In response to this comment, the Commission notes that the purpose of the amendment is to address cases where a broker-dealer is subject to an insolvency event but takes the position that it is in compliance with the net capital rule. While such instances

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396 Id.

397 See 15 U.S.C. 78mm(a). See also 17 CFR 240.15c3-1(b)(3).

398 See SIPC Letter; St. Bernard Financial Services Letter; American Bar Association Letter; Cornell Letter.

399 See St. Bernard Financial Services Letter.

may be rare, an insolvent broker-dealer could seek the protection of the bankruptcy laws but continue to effect transactions with the public, potentially jeopardizing customers and other creditors of the broker-dealer, including counterparties.

Another commenter requested that the Commission modify the definition of insolvent to carve out market-wide disruptions that prevent the computation of net capital but are unrelated to the solvency of the broker-dealer.[400] In response to this suggestion, the Commission notes that if appropriate and necessary, such an event can be addressed through the Commission's exemptive authority, rather than by a specific exception in the rule.

One commenter, while supporting the amendment, objected to the incorporation of the definition of insolvent from section 101 of the Bankruptcy Code.[401] This commenter argued a bankruptcy-based standard for insolvency was appropriate for a notice requirement but that the proper standard for determining whether a broker-dealer should be prohibited from continuing to conduct a securities business is its amount of net capital. As noted above, allowing an insolvent broker-dealer to continue conducting a securities business during the period of its insolvency, notwithstanding its net capital position, could jeopardize customers and other market participants because a broker-dealer that has made an admission of insolvency, or is otherwise deemed insolvent or entitled to protection from creditors, does not possess the financial resources necessary to operate a securities business.[402] Continuing to operate in such circumstances poses a significant credit risk to counterparties and to the clearance and settlement system, and, in the event the firm subsequently is placed in a liquidation proceeding under SIPA, may

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400 See American Bar Association Letter.

401 See SIFMA 2 Letter.

402 See Amendments to Financial Responsibility Rules, 72 FR at 12872.

impair the ability of the SIPA trustee to make customers of the broker-dealer whole and satisfy claims of other creditors out of the assets of the general estate.[403]

In addition, this commenter also was concerned that under the proposed amendment a firm would be prevented from effecting hedging or liquidating transactions intended to reduce the risk the firm poses to the financial markets and its customers. The commenter noted that such limitations also would be at odds with section 5(a)(2) of SIPA, which contemplates that a broker-dealer that is in, or approaching, financial difficulty may undertake to liquidate or reduce its business either voluntarily or pursuant to the direction of an SRO.[404] The final rule amendment is not intended to affect in any a broker-dealer's ability to act under section 5(a)(2) of SIPA.[405]

In addition, the Commission is amending the final rule to incorporate within the term insolvency the circumstance in which a broker-dealer is unable to make such computations as may be necessary to establish compliance with Rule 15c3-3.[406] In the proposing release, the Commission stated that the "proposed definition of 'insolvent' is intended to be broad enough to encompass any type of insolvency proceeding or condition of insolvency,"[407] and noted that the proposed definition incorporates concepts

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403 Id.

404 See SIFMA 2 Letter; SIPC Letter. See also 15 U.S.C. 78eee(a)(5).

405 See15 U.S.C. 78eee(a)(5). Further, the amendment is not intended to affect in any way a SIPA trustee's ability to liquidate a broker-dealer. Effectively, a SIPA trustee steps into the shoes of the debtor broker-dealer in order to liquidate the broker-dealer and protect its customers' interests.

406 The final rule adds the phrase "or with § 240.15c3-3" to follow the phrase "[i]s unable to make such computations as may be necessary to establish compliance with this section." See paragraph (c)(16)(iv) of Rule 15c3-1. See also generally, SIPC Letter (favoring an amendment requiring broker-dealers to cease doing business if insolvent as defined under proposed Rule 15c3-l(c)(16) and noting that the circumstances under which the broker would be required to cease doing business are consistent with the circumstances under which SIPC may seek to place a firm in liquidation).

407 See Amendments to Financial Responsibility Rules, 72 FR at 12872.

of insolvency from the U.S. Bankruptcy Code and SIPA.[408] Consequently, consistent with the discussion in the proposing release, the modification in the final rule will more closely align the definition of insolvent under paragraph (c)(16) of Rule 15c3-1 with the grounds for the commencement of a proceeding under SIPA,[409] which includes the circumstance that a broker-dealer is unable to make computations necessary to establish compliance with the financial responsibility or hypothecation rules.[410] Rule 3a40-1 defines the term financial responsibility rules to include, among others, any rule adopted by the Commission pursuant to section 15(c)(3) of the Exchange Act – Rules 15c3-1 and 15c3-3 were adopted under section 15(c)(3). As a financial responsibility rule, the inability of a broker-dealer to make a computation necessary to establish compliance with Rule 15c3-3 constitutes a basis for commencing a SIPA proceeding. Consequently, this modification to the proposed definition of insolvency under paragraph (c)(16) of Rule 15c3-1 will more closely align the definition with SIPA.[411]

The Commission also is adopting an amendment to the first sentence of paragraph (b)(1) of Rule 17a-11 to require that a broker-dealer meeting the definition of insolvent must provide immediate notice to the Commission, the firm's DEA and, if applicable, the CFTC. One commenter specifically favored this amendment.[412] This notice will assist

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408 Id. at n.85.

409 See 15 U.S.C. 78eee(b).

410 See 15 U.S.C. §78eee(b)(l)(D). See also 17 CFR 240.3a40-1 (defining the term financial responsibility rules for purposes of SIPA to include Rule 15c3-3).

411 The Commission also has made three technical modifications to the text of the insolvency definition. In response to a comment, the phrase "broker-dealer" was replaced with the phrase "broker or dealer" to be consistent with the use of the phrase in Rule 15c3-1. In addition, the phrase "for purposes of this section" was moved to the beginning of paragraph (c)(16) in order to clarify that the term insolvency is defined for purposes of Rule 15c3-1 in its entirety. Finally, the final rule does not include the phrase "whether commenced voluntarily or involuntarily" because the phrase would be redundant.

412 See SIPC Letter.

regulators in taking steps to protect the insolvent firm's customers, including, if appropriate, notifying SIPC of the need to commence a SIPA proceeding. The Commission is adopting the amendment to paragraph (b)(1) of Rule 17a-11, with one technical modification.[413]

5. Amendment to Rule Governing Orders Restricting Withdrawal of Capital from a Broker-Dealer

Paragraph (e) of Rule 15c3-1, which places certain conditions on a broker-dealer when withdrawing capital,[414] also allows the Commission to issue an order temporarily restricting a broker-dealer from withdrawing capital or making loans or advances to stockholders, insiders, and affiliates under certain circumstances.[415] The rule, however, limits such orders to withdrawals, advances, or loans that, when aggregated with all other withdrawals, advances, or loans on a net basis during a 30 calendar day period, exceed 30 percent of the firm's excess net capital.[416] When the Commission adopted this paragraph of Rule 15c3-1 more than 20 years ago, the Commission stated that it intended this section to be applied only where the continued viability of a broker-dealer appeared to be at stake.[417] In the ensuing years, the Commission has utilized this provision only one time.[418] The Commission has determined that the requirement is difficult to enforce, as it generally would not be clear when the 30% threshold had been reached, due to the inherent unreliability of a troubled broker-dealer's books and records. Consequently, the

413 The Commission is deleting the phrase "paragraph (c)(16) of" and inserting "(c)(16)" immediately following the second "15c3-1".

414 See 17 CFR 240.15c3-1(e).

415 See 17 CFR 240.15c3-1(e)(3).

416 Id.

417 Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991), 56 FR 9124, 9128 (Mar. 5, 1991).

418 Order Regarding Withdrawals, Unsecured Loans or Advances from Refco Securities, LLC and Refco Clearing, LLC, Exchange Act Release No. 52606 (Oct. 13, 2005).

Commission proposed, and is adopting, a change to delete this provision and instead to allow the Commission to restrict all withdrawals, advances, and loans so long as the other conditions under the rule (all of which remain unchanged) are met.[419]

The Commission received three comment letters addressing this proposal.[420] One commenter supported the deletion of the 30% threshold, but believed its removal reflected the Commission's desire to regulate large firms with complex capitalization without considering the needs of smaller firms.[421] This commenter recommended the Commission set forth all conditions required for a firm to withdraw, repay, or redeem any amount that affects its overall capitalization.[422] Specifically, the commenter suggested the following non-exclusive list of conditions for consideration: (1) "[r]egulatory minimum capital requirement related to all lines of business"; (2) "[e]xcess mandated by that firms' accruals for that period"; (3) "[e]xcess mandated by the firms' upcoming one-time non-recurring costs within that quarter"; (4) "[e]xcess mandated by operating costs expected[,] but not related to accruals for that period"; (5) [c]osts related to increased personnel coverage or recruitment within that quarter"; and (6) "[d]etermination of the Board of the firm that there is no reasonable expectation at the time of its approval of the capital withdrawal, repayment or redemption, that the firm would be required to, or advisable to, increase its net capital excess."

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419 The Commission also proposed revising the second sentence in paragraph (e)(3)(ii) to remove the text "The hearing" and in its place adding the text "A hearing on an order temporarily prohibiting the withdrawal of capital."

420 See NIBA 2 Letter; SIFMA 2 Letter; Raymond James 2 Letter.

421 See NIBA 2 Letter. As noted above, the 30% threshold provision only applied in emergency situations and has only been used once before. As such, its deletion should only affect a limited number of broker-dealers.

422 Id.

The second commenter recommended several modifications to the amendment, including: (1) clarifying that in addition to ordering complete restrictions on withdrawals, advances, and loans, the Commission may also issue orders imposing partial or conditional restrictions; (2) explicitly permitting certain types of withdrawals, advances, or loans, such as those in paragraphs (e)(4)(ii) and (iii) of Rule 15c3-1 (e.g., required tax payments or payments to partners for reasonable compensation) even after the issuance of a temporary restrictive order; and (3) clarifying that the provision in paragraph (e)(3)(ii) of the rule allowing a broker-dealer to request and receive a hearing on an order temporarily restricting withdrawals also applies to orders temporarily restricting advances and loans (in addition to withdrawals).[423]

Finally, the third commenter noted that the proposed amendment would eliminate the 30% requirement limit and allow the Commission to restrict all withdrawals, advances, and loans under specific circumstances.[424] The commenter believes this action will impose an additional compliance burden on broker-dealers and will significantly limit the flexibility of broker-dealers in the event of a liquidity crisis.[425]

In response to these comments, the Commission notes that the 30% threshold pertains only to paragraph (e)(3)(i) of Rule 15c3-1, which relates to the Commission's authority to temporarily restrict withdrawals of net capital. The Commission cannot impose these restrictions without concluding under subparagraph (e)(3)(i) that "such withdrawal, advance or loan may be detrimental to the financial integrity of the broker or dealer, or may unduly jeopardize the broker or dealer's ability to repay its customer claims or other liabilities which may cause a significant impact on the markets or expose

423 See SIFMA 2 Letter.

424 See Raymond James 2 Letter.

425 Id.

the customers or creditors of the broker or dealer to loss without taking into account the application of the Securities Investor Protection Act of 1970."[426] While paragraph (e)(3)(i) of Rule 15c3-1 would apply to all broker-dealers, the conditions under which the Commission may exercise its authority under the rule apply only to circumstances where the continued viability of the broker-dealer appears to be at stake.[427] As noted above, the Commission has only utilized this provision once.[428]

The Commission, however, agrees with the importance of maintaining flexibility in the context of ordering restrictions on withdrawals, advances, and loans. Therefore, the Commission is modifying the amendment, as adopted, to add language to paragraph (e)(3)(i) to state (following the phrase "employee or affiliate") that such orders will be issued, "under such terms and conditions as the Commission deems necessary or appropriate in the public interest or consistent with the protection of investors . . . ."[429] With respect to the suggestion that the Commission explicitly permit certain types of withdrawals, advances, or loans even after the issuance of a temporary order, the Commission does not believe that it would be appropriate to permit – by codifying in the rule – a broker-dealer to take the actions described if the Commission has issued an order placing temporary restrictions on a broker-dealer's ability to withdraw net capital under paragraph (e)(3) of the rule. The order would be intended to protect the customers and creditors of the broker-dealer, and permitting the actions by rule could undermine those protections. Moreover, there is no need to explicitly permit certain types of withdrawals,

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426 See paragraph (e)(3)(i) of Rule 15c3-1, as adopted.

427 Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991), 56 FR 9124, 9128 (Mar. 5, 1991).

428 Order Regarding Withdrawals, Unsecured Loans or Advances from Refco Securities, LLC and Refco Clearing, LLC, Exchange Act Release No. 52606 (Oct. 13, 2005).

429 See paragraph (e)(3)(i) of Rule 15c3-1, as adopted. See also 17 CFR 15c3-1(e). See generally, 15 U.S.C. 78mm(a)(1).

advances or loans because if there were circumstances that merited the broker-dealer making such payments, the Commission order could be fashioned as appropriate to permit those payments.

With respect to the suggestion that the Commission clarify in paragraph (e)(3)(ii) of Rule 15c3-1 that a broker-dealer may request and receive a hearing on orders temporarily restricting advances and loans (in addition to withdrawals), under the existing rule, a broker-dealer may request a hearing if the Commission has issued an order temporarily restricting advances and loans by a broker-dealer, in addition to withdrawals, and the Commission is therefore adopting the amendment to paragraph (e)(3)(ii), as proposed.[430]

6. Adjusted Net Capital Requirements

i. Amendment to Appendix A of Rule 15c3-1

The Commission is adopting an amendment to Appendix A of Rule 15c3-1, which permits broker-dealers to employ theoretical option pricing models to calculate haircuts for listed options and related positions that hedge those options.[431] The amendment makes permanent a temporary amendment the Commission originally adopted in 1997.[432] The temporary amendment expired on September 1, 1997, unless it was otherwise extended by the Commission.[433] The Commission staff subsequently issued a no-action letter on January 13, 2000, which stated that the staff would not

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430 17 CFR 240.15c3-1(e)(3)(ii). The Commission also is adopting revisions to the second sentence of paragraph (e)(3)(ii), replacing the phrase "The hearing" with the phrase "A hearing on an order temporarily prohibiting the withdrawal of capital."

431 17 CFR 240.15c3-1a.

432 See Net Capital Rule, Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997).

433 See 17 CFR 15c3-1a(b)(1)(iv)(B).

recommend enforcement action if broker-dealers continued to rely on the temporary amendment.[434]

The temporary amendment decreased the range of pricing inputs to the approved option pricing models, which effectively reduced the haircuts applied by the carrying firm with respect to non-clearing option specialist and market maker accounts.[435] The temporary amendment, which applied only to these types of accounts, was limited to major market foreign currencies and diversified indexes. Even during periods of substantial volatility, there have been no significant increases in the number of deficits in non-clearing option specialist and market-maker accounts, nor did the lower capital charges under paragraph (b)(1)(iv) result in excessive leverage. Consequently, this amendment appropriately aligns the net capital requirements of affected firms with the risks Rule 15c3-1 seeks to mitigate. The Commission received one comment letter regarding this aspect of the proposing release. The commenter concurred with the Commission's conclusions as to the effect of the temporary amendment and supported the proposal to make it permanent.[436] Accordingly, the Commission is amending

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434 Letter from Michael Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Richard Lewandowski, Vice President, Regulatory Division, The Chicago Board Options Exchange, Inc. (Jan. 13, 2000) (stating that the Division of Market Regulation "will not recommend . . . enforcement action if non-clearing option specialists and market-makers continue to rely on subparagraph (b)(1)(iv) of Appendix A to Rule 15c3-1 under the Exchange Act until such time as the Commission has determined whether it should be extended"). The letter did not grant any other relief.

435 See Net Capital Rule, Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997). Under Appendix A to Rule 15c3-1, a broker-dealer calculating net capital charges for its options portfolios shocks the products in each portfolio (grouped by underlying instrument) at ten equidistant points along a potential market move range. The market move ranges for major market foreign currencies, high-capitalization diversified indexes, and non-high-capitalization diversified indexes are, respectively: +(-) 6%, +(-) 10% and +(-) 15%. The temporary rule lowered these market move ranges to respectively: +(-) 4½%, + 6% (-) 8% and +(-) 10% in terms of calculating haircuts for positions of non-clearing options specialists and market makers. Id.

436 See SIFMA 2 Letter.

paragraph (b)(1)(iv) of Appendix A to Rule 15c3-1, as proposed, to make the temporary amendment permanent.[437]

ii. Money Market Funds

a. Clarification

The Commission is adopting an amendment to paragraph (c)(2)(vi)(D)(1) of Rule 15c3-1 to clarify that a money market fund, for the purposes of paragraph (c)(2)(vi)(D)(1), is a fund described in Rule 2a-7 under the Investment Company Act of 1940 ("Rule 2a-7").[438] The Commission did not receive any comments on this proposal and is adopting it, as proposed.

b. Proposed Haircut Reduction from 2% to 1%

The Commission proposed an amendment to reduce the "haircut" that broker-dealers apply under Rule 15c3-1 for money market funds.[439] In 1982, the Commission adopted a 2% haircut requirement for redeemable securities of money market funds.[440] In 1991, the Commission adopted certain amendments to Rule 2a-7 that strengthened the risk-limiting investment restrictions for money market funds.[441] Based on the enhancements to Rule 2a-7, the Commission proposed to amend paragraph (c)(2)(vi)(D)(1) of Rule 15c3-1 to reduce the haircut on such funds from 2% to 1% in order to better align the net capital charge with the risk associated with holding shares of

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437 As a result, the Commission also is redesignating paragraphs (b)(1)(iv)(A), (b)(1)(iv)(A)(1), (b)(1)(iv)(A)(2), and (b)(1)(iv)(A)(3) as paragraphs (b)(1)(iv), (b)(1)(iv)(A), (b)(1)(iv)(B), and (b)(1)(iv)(C), respectively.

438 See 17 CFR 270.2a-7.

439 See Amendments to Financial Responsibility Rules, 72 FR at 12874.

440 Net Capital Requirements for Brokers and Dealers, Exchange Act Release No. 18737 (May 13, 1982), 47 FR 21759 (May 20, 1982). See 17 CFR 240.15c3-1(c)(2)(vi)(D)(1).

441 Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 18005 (Feb. 20, 1991), 56 FR 8113 (Feb. 27, 1991).

a money market fund.[442] In addition to the general request for comments in the proposing release, the Commission also specifically requested comments regarding whether the haircut for certain types of money market funds should be reduced to 0% as suggested in a petition for rulemaking submitted to the Commission.[443]

The Commission received a total of 14 responses from 12 different commenters regarding this proposed amendment. All of the commenters supported a reduction in the haircut for money market funds and urged that the haircut be reduced below the proposed 1%, with the majority proposing a haircut of 0% for "top-rated" money market funds (i.e., those with the highest ratings).[444] Commenters cited the safety record of money market funds, in particular AAA-rated money market funds, in support of imposing lower haircuts.[445] Several commenters argued that top-rated money market funds were more liquid and posed less credit and interest rate risk than other instruments and suggested haircuts of 1/8 of 1% or even 0%.[446] One commenter argued that since broker-dealers (like investors) view money market funds as cash equivalents, they would view a 1% haircut as a significant cost and would therefore avoid using money market funds.[447] Two commenters suggested that if the Commission determined it necessary to impose a haircut on some Rule 2a-7 money market funds, it should implement a bifurcated scheme

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442 See Amendments to Financial Responsibility Rules, 72 FR at 12874.

443 See Public Petitions for Rulemaking No. 4-478 (Apr. 3, 2003) (available at http://www.sec.gov/rules/petitions/petn4-478.htm), as amended (Apr. 4, 2005) (available at http://www.sec.gov/rules/petitions/petn4-478a.pdf), and No. 4-577 (Feb. 3, 2009) (available at http://www.sec.gov/rules/petitions/2009/petn4-577.pdf).

444 See Federated Letter; Federated 3 Letter; Curion Clearing Letter; FAF Advisors Letter; Brown Brothers Harriman Letter; SIFMA 2 Letter; ICI Letter; Barclays Letter; National Chamber Foundation Letter; Blackrock Letter; Deutsche Bank Securities Letter; UBS Letter; SIFMA 4 Letter; NIBA 2 Letter.

445 See, e.g., Barclays Letter.

446 See, e.g., FAF Advisors Letter.

447 See Federated Letter.

under which money market funds that qualify for deposit into a broker-dealer's reserve account under Rule 15c3-3 would be subject to a 0% haircut,[448] with one arguing that such qualifying money market funds should in any case receive a haircut no greater than 1/8 of 1%.[449] Another commenter suggested that the proposed amendments to reduce the haircut for money market funds should be deferred until the results of the Commission's money market reforms are known.[450] Another commenter suggested a haircut of 5/8 of 1%, based on a combination of the 1/8 of 1% haircut applied to highly rated shorter-term (at least 30 but less than 91 days to maturity) commercial paper and municipal securities and an additional charge of 1/2 of 1% to account for any minimal risk associated with the nature or operation of mutual funds.[451] Finally, one commenter supported a 0% haircut for applied to money market funds that: (1) do not hold investments in their affiliates or holding companies; and (2) are not affiliated with the bank in which the broker-dealer holds its cash reserves and operating funds.[452]

As discussed above in section II.E.6.ii. of this release, the Commission recently proposed substantial amendments to its money market fund rules.[453] In light of these proposed amendments,[454] the Commission is deferring consideration of a reduction of the haircut for money market funds in Rule 15c3-1 at this time. Therefore, the haircut that broker-dealers apply for money market funds will remain at 2% under paragraph (c)(2)(vi)(D)(1) of Rule 15c3-1. Deferring action will allow the Commission to assess

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448 See Blackrock Letter; ICI Letter.

449 See Blackrock Letter.

450 See SIFMA 4 Letter.

451 See SIFMA 2 Letter.

452 See NIBA 2 Letter.

453 See Money Market Fund Reform; Amendments to Form PF, Release No. IC-30551 (June 5, 2013), 78 FR 36834 (June 19, 2013)

454 Id.

the potential impact of any money market fund reforms it may adopt and whether any such impact would have consequences for the net liquid asset standard of Rule 15c3-1.

c. Aggregate Debit Items Charge

The Commission proposed amendments to Rule 15c3-1 that would have eliminated a reduction to aggregate debit items that certain broker-dealers must take when computing their reserve requirements under Rule 15c3-3.[455] Under paragraph (a)(1)(ii)(A) of Rule 15c3-1, a broker-dealer using the "alternative standard"[456] to compute its minimum net capital requirement must reduce aggregate debit items by 3% when computing its customer reserve requirement under Rule 15c3-3. Conversely, Note E(3) to the customer reserve formula (Rule 15c3-3a) requires a broker-dealer using the "basic method" of computing net capital under Rule 15c3-1 to reduce by 1% the total debits in Item 10 of the formula (i.e., debit balances in customer cash and margin accounts).[457] Both of these provisions serve to increase the amount of funds a broker-dealer must deposit into its customer reserve account; however, the deduction applicable to alternative standard firms can result in an even larger reserve deposit requirement.

The Commission received four comment letters regarding these amendments and all were supportive.[458] However, recent market turmoil has highlighted the importance of maintaining adequate amounts of funds and qualified securities in the customer reserve account under Rule 15c3-3 to protect customers. Consequently, it would be imprudent to

455 See Amendments to Financial Responsibility Rules, 72 FR at 12867.

456 Under the "alternative standard," a broker-dealer's minimum net capital requirement is equal to 2% of the firm's aggregate debit items. 17 CFR 240.15c3-1(a)(1)(ii).

457 Under the "basic method," a broker-dealer cannot permit its aggregate indebtedness (generally total money liabilities) to exceed 1500% of its net capital. 17 CFR 15c3-1(a)(1)(i).

458 See Curian Clearing Letter; SIFMA 2 Letter; Deutsche Bank Securities Letter; Citigroup Letter.

lower the debit reduction requirement for broker-dealers using the alternative standard at this time (especially given the fact that this standard is primarily used by firms with a substantial customer business). Therefore, the Commission has determined to defer consideration of action on this amendment at this time.

F. Technical Amendments

The Commission proposed a number of technical amendments to these rules, including changes to the definitions of fully paid securities, margin securities, and bank in Rule 15c3-3.[459] These proposed technical amendments were not designed to substantively change the meanings of these defined terms but, rather, to amend out-of-date citations and remove text that the Commission believed to be superfluous or redundant.

Two commenters[460] opposed the proposed technical amendments to the Rule 15c3-3 definition of fully paid securities. As proposed, the definition of fully paid securities would have included "all securities carried for the account of a customer unless such securities are purchased in a transaction for which the customer has not made full payment."[461] The commenters contend that the amendments to the definition of fully paid securities would significantly expand the universe of fully paid securities because these securities generally are carried in a cash account, and under the proposed definition any security, in any account, including a margin account, could be considered a fully paid security (and subject to possession and control requirements) if it has been paid for in full. As such, the commenter noted that the term fully paid securities, as proposed, would require broker-dealers to determine whether securities in a margin account are fully paid

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459 17 CFR 240.15c3-3(a)(3), (4), and (7), respectively.

460 See SIFMA 2 Letter; Angel Letter.

461 See Amendments to Financial Responsibility Rules, 72 FR at 12894.

(in which case they could not be hypothecated even if they are not excess margin securities). As a result, the commenter suggested that this definition should be limited to include only securities in a cash account that have been paid for in full. After careful consideration, and in response to the comment, the Commission has modified the text of paragraph (a)(3) to Rule 15c3-3 to more closely follow the original definition, while still adopting the updated references and terminology to reflect changes made to Regulation T since 1972. As adopted, the term fully paid securities includes "all securities carried for the account of a customer in a cash account as defined in Regulation T (12 CFR 220.1 et seq.), as well as securities carried for the account of a customer in a margin account or any special account under Regulation T that have no loan value for margin purposes, and all margin equity securities in such account if they are fully paid . . . ."[462] The definition also states that, "the term "fully paid securities" does not apply to any securities purchased in transactions for which the customer has not made full payment."

The Commission did not receive any comments on the proposed amendments to the definition of margin securities under paragraph (a)(4) of Rule 15c3-3. The Commission is adopting this definition as proposed. In addition, the Commission did not receive any comments to the proposed amendments to the definition of bank under paragraph (a)(7) of Rule 15c3-3. The Commission, however, has modified the language in this paragraph to make the paragraph gender neutral by replacing the phrase "who maintains his principal place of business" with the phrase "that maintains its principal place of business."

The Commission also has amended other provisions of Rule 15c3-3 to make the rule gender neutral. Finally, the Commission has replaced the word "shall" throughout

[462] See paragraph (a)(3) of Rule 15c3-3, as adopted.

the rule, as amended, with clearer words, such as "will" or "must." This change will not change either the nature or substance of the affected rule provisions.

III. RESPONSES TO SPECIFIC REQUESTS FOR COMMENT

In the proposing release, the Commission requested comment on certain specific matters, in addition to the proposed rule amendments.[463] These matters included: (1) a proposal to reduce the Rule 17a-11 notice requirement for broker-dealers that carry over $10 billion in debits; (2) whether to harmonize the net capital deductions required under paragraph (c)(2)(iv)(B) of Rule 15c3-1 for securities lending and borrowing transactions with the deductions required under paragraph (c)(2)(iv)(F) for securities repo transactions; and (3) solicitation of comment on how third-party liens against customer fully paid securities carried by a broker-dealer should be treated under the financial responsibility rules, including Rule 15c3-3, Rule 17a-3 and Rule 17a-4.

The Commission received seven comment letters that addressed the solicitation of comments for these matters.[464] With respect to the early warning level proposal, one commenter proposed modifying the Commission's early warning levels for very large "alternative standard" firms with more than $10 billion in debits.[465] The commenter recommended this approach because of the increase in debit items at large broker-dealers and the increased focus on effective risk management practices.[466] Another comment supported the amendment, suggesting that the notification could serve as an early warning if a firm is approaching insolvency.[467]

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463 Id. at 12874.

464 See SIFMA 2 Letter; SIFMA 4 Letter; First Clearing Letter; Citigroup Letter; American Bar Association Letter; Cornell Letter; Raymond James 2 Letter.

465 See SIFMA 2 Letter.

466 Id.

467 See Cornell Letter.

In addition, the Commission received three comments with respect to harmonizing the net capital deductions required under paragraph (c)(2)(iv)(B) of Rule 15c3-1 for securities lending and borrowing transactions with the deductions required under paragraph (c)(2)(iv)(F) for securities repo transactions.[468] These commenters stated that the Commission should consider the potential disruption to the marketplace that may arise in connection with any effort to harmonize capital charges.[469]

The Commission also received seven comments in response to the solicitation of comment on how third-party liens against customer fully paid securities carried by a broker-dealer should be treated under the financial responsibility rules, including Rule 15c3-3, Rule 17a-3 and Rule 17a-4.[470] Two commenters stated that the Commission should not require that a broker-dealer include third party liens as a credit in the reserve formula and stated that this is an area in which it would be productive to have a detailed discussion between Commission staff and the industry before any amendments are proposed.[471] Another commenter stated that each of the suggested approaches in the proposing release imposes burdens and requirements on broker-dealers that do not serve to address the concerns noted by the Commission.[472] Two commenters stated that the most effective way to avoid confusion regarding third party liens in a SIPC liquidation would be to segregate securities subject to a lien to a separate pledge account in the name of the pledgee.[473] Finally, one commenter argued that requiring broker-dealers to include the amount of liens as a credit item in the reserve formula was not necessary to achieve

468 See SIFMA 2 Letter; Citigroup Letter; Raymond James 2 Letter.

469 Id.

470 See SIFMA 2 Letter; SIFMA 4 Letter; First Clearing Letter; Citigroup Letter; American Bar Association Letter; NIBA 2 Letter; Raymond James 2 Letter.

471 See SIFMA 2 Letter; SIFMA 4 Letter; Citigroup Letter.

472 See First Clearing Letter.

473 See American Bar Association Letter; NIBA 2 Letter.

customer protection and would impose significant costs and burdens on the broker-dealers.[474]

The Commission will consider the comments received in developing any proposals should the Commission decide to take further action in any of these areas.

IV. PAPERWORK REDUCTION ACT

Certain provisions of the amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[475] The Commission published a notice requesting comment on the collection of information requirements in the proposing release[476] and submitted the amendments to the Office of Management and Budget ("OMB") for review in accordance with the PRA.[477] 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 amended rules – Rule 15c3-1, Rule 15c3-3, Rule 17a-3, Rule 17a-4 and Rule 17a-11 – contain currently approved collections of information under, respectively, OMB control numbers 3235-0200, 3235-0078, 3235-0033, 3235-0279 and 3235-0085.

In response to comments received regarding the proposed amendments in the proposing release, the Commission has modified the language in the final rules being adopted, as discussed above. These comments and their impact on PRA estimates are discussed below. In addition, the initial burden estimates in the proposing release have

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474 See Raymond James 2 Letter.

475 44 U.S.C. 3501, et seq.

476 See Amendments to Financial Responsibility Rules, 72 FR at 12875.

477 44 U.S.C. 3507(d); 5 CFR 1320.11.

been adjusted,[478] as discussed below, to reflect updated information used to make the current estimates, including updated FOCUS Report data.[479]

Finally, one commenter specifically stated that the estimates the Commission provided utilized only that number of broker-dealers in its estimates that the Commission "justifiably considers to be affected by the proposals."[480] The commenter, however, believes that most, if not all, broker-dealers will spend over 90 hours each analyzing the effects of the rules as implemented, will spend many more than 90 hours each in implementing procedures and modifying their written supervisory procedures to comply with the new rules, will spend in excess of 240 hours each in the monitoring of such rules, and will spend in excess of $15,000 each for outside counsel and auditor opinions or work product.[481] This commenter did not provide additional detail about the basis for its view that the Commission's estimates were too low. The Commission agrees with the commenter that broker-dealers directly affected by the rule amendments may be required to implement procedures or modify their written supervisory procedures in order to comply with the rule amendments. In cases where the rule amendments are requiring a broker-dealer to implement or document certain policies and procedures, these hour burdens are already included in the final hour estimates discussed below.[482] In addition, the Commission acknowledges that a broker-dealer may need to review its operations to

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478 See Amendments to Financial Responsibility Rules, 72 FR at 12875.

479 The PRA estimates derived from FOCUS Reports filed by broker-dealers pursuant to Section 17 of the Exchange Act and Rule 17a-5 have been updated in this final release to reflect more recently available information, including FOCUS Report data as of December 31, 2011. The PRA estimates in the proposing release derived from FOCUS reports were from 2004 year end data. See Amendments to Financial Responsibility Rules, 72 FR at 12875.

480 See NIBA 2 Letter.

481 Id.

482 See, e.g., paragraph (j)(1) of Rule 15c3-3 and paragraph (a)(23) of Rule 17a-3, as adopted.

determine whether or not it has any obligations under the rule amendments. Even if a broker-dealer is not directly affected by the rule amendments, such a review may result in an indirect effect on its operations. These indirect effects or costs, however, are more appropriately addressed in the Economic Analysis in section V. of this release because they relate to the overall impact of the amendments, rather than to the specific collections of information discussed below. Consequently, the Commission addresses the commenter's concerns that directly relate to the collections of information below, and the indirect burdens and costs in the Economic Analysis in section V. of this release.

A. Summary of the Collection of Information Requirements

The rule amendments contain recordkeeping and disclosure requirements that are subject to the PRA. In summary, the amendments may require a broker-dealer, under certain circumstances, to: (1) disclose the principals and obtain certain agreements from the principals in a securities lending transaction where it performs settlement services if it is to be considered an agent (as opposed to a principal) for the purposes of the net capital rule;[483] (2) obtain permission in writing from its DEA to withdraw capital within one year of contribution;[484] (3) enter into a subordination agreement with an account holder in order to exclude such account holder from the definition of PAB account;[485] (4) provide written notice to PAB account holders that their securities may be used in the ordinary course of its securities business;[486] (5) perform a PAB reserve computation;[487] (6) obtain written notification from each bank with which it maintains a PAB reserve account that the bank was informed that all cash and/or qualified securities being held by the bank are

483 See paragraph (c)(2)(iv)(B) of Rule 15c3-1, as adopted.

484 See paragraph (c)(2)(i)(G) to Rule 15c3-1, as adopted.

485 See paragraph (a)(16) to Rule 15c3-3, as adopted.

486 See paragraph (b)(5) to Rule 15c3-3, as adopted.

487 See paragraph (e)(1) and (e)(3) of Rule 15c3-3, as adopted.

to use their PAB securities; (3) the broker-dealer performed the PAB reserve computation; and (4) the bank holding the PAB reserve account agreed to do so free of lien by entering into a written contract with the broker-dealer.

The records with respect to customer's free credit balances will assist examiners in verifying that: (1) a carrying broker-dealer has obtained the written affirmative consent of a new customer before including a customer's free credit balances in a Sweep Program; (2) a carrying broker-dealer has provided the required disclosures and notices to all customers with regard to the broker-dealer's Sweep Program; and (3) the broker-dealer has maintained adequate procedures with regard to the use of a customer's free credit balances prior to using such customer's free credit balances in its operations. The amendments to Rule 15c3-3 will facilitate the process by which the Commission, its staff, and SROs monitor how broker-dealers are fulfilling the customer protection requirements of the rule. The written affirmative consent, disclosures and notices required to be provided to customers also will alert customers to the alternatives available to them with respect to their free credit balances.

The Commission, its staff, and SROs will use the information collected under the amendments to Rules 17a-3 and 17a-4 to determine whether the broker-dealer is adhering to its documented credit, market, and liquidity risk management controls, as well as to evaluate the effectiveness of these controls.

The Commission, its staff, and SROs will use the information collected under the amendments to Rule 17a-11 to identify a broker-dealer experiencing financial difficulty. This information will assist the Commission and other regulators in promptly taking appropriate steps to protect customers, creditors, and counterparties. In particular, a notice of insolvency will assist regulators in responding more quickly to protect customers of a failing institution. The notices and reports with respect to securities lending and repos will assist regulators in identifying broker-dealers that are active in these transactions or suddenly take on large positions and thereby assist in monitoring systemic risk.

C. Respondents

The final estimates of respondents below have been updated to reflect more recent information.[495] The amendment to Rule 15c3-1 requiring a broker-dealer to make disclosures to, and obtain certain agreements from, securities lending principals will apply only to those firms that participate in the settlement of securities lending transactions as agents. The Commission estimates that approximately 122 broker-dealers will be affected by this requirement.[496] This estimate has been updated from the estimate of 170 broker-dealers in the proposing release.[497] No comments were received on this estimate.

The amendment to Rule 15c3-1 with respect to a broker-dealer obtaining permission in writing from its DEA prior to withdrawing capital within one year of contribution under Rule 15c3-1 will apply to any broker-dealer who wishes to withdraw such capital. Because most broker-dealers already comply with existing interpretations regarding the treatment of temporary capital contributions and similar SRO requirements, or are familiar with such interpretations and requirements, this part of the amendment to Rule 15c3-1 regarding temporary capital contributions likely will impact only a small number of the approximately 4,709 broker-dealers registered with the Commission, as of

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495 The final estimates of respondents derived from FOCUS Reports filed by broker-dealers pursuant to Section 17 of the Exchange Act and Rule 17a-5 have been updated in this final release to reflect more recently available information, including FOCUS Report data as of December 31, 2011. The estimates of respondents in the proposing release derived from FOCUS reports were from 2004 year end data. See Amendments to Financial Responsibility Rules, 72 FR at 12876.

496 This estimate is derived from FOCUS Reports.

497 See Amendments to Financial Responsibility Rules, 72 FR at 12876.

December 31, 2011 (based on FOCUS Report data).[498] Therefore, the Commission estimates that approximately 90 broker-dealers will seek permission from their DEA in writing to withdraw capital within one year of its contribution under the amendment.[499]

The amendments to Rule 15c3-3 requiring a broker-dealer to perform a PAB reserve computation and to obtain certain agreements and notices related to its PAB accounts will affect only those firms that carry such accounts. Based on FOCUS Report data, as of December 31, 2011, the Commission estimates that approximately 61 broker-dealers will carry such accounts.[500] The amendment to Rule 15c3-3 requiring a broker-dealer to obtain the affirmative consent of a new customer before changing the terms under which the customer's free credit balances are maintained will apply only to firms that carry free credit balances for customers. Based on FOCUS Report data, as of December 31, 2011, the Commission estimates that approximately 189 broker-dealers carry free credit balances.[501]

The Commission estimates that the amendment to Rule 15c3-3 permitting a broker-dealer to exclude certain accounts from being treated as PAB accounts under Rule

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498 Temporary Capital Letter; see also Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991), 56 FR 9124 (Mar. 5, 1991); and FINRA Rule 4110(c).

499 The Commission received 900 broker-dealer capital withdrawal notices under paragraph (e) of Rule 15c3-1 in 2012. Because this amendment is consistent with prior Commission and staff positions that capital is not temporary, as well as current SRO requirements, it is likely that only a small number of these notices are capital withdrawals made within one year of contribution, and therefore, based on staff experience with the application of Rule 15c3-1, the Commission estimates that approximately 90 broker-dealers (10% of 900) will seek permission from their DEA in writing to withdraw capital under the amendment. See Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991); Temporary Capital Letter; and FINRA Rule 4110.

500 This estimate has been updated from our estimate of 75 broker-dealers in the proposing release. See Amendments to Financial Responsibility Rules, 72 FR at 12876. No comments were received on this estimate.

501 In the proposing release, the Commission estimated approximately 256 broker-dealers carried free credit balances. See Amendments to Financial Responsibility Rules, 72 FR at 12876. No comments were received on this estimate.

15c3-3 by entering into subordination agreements with certain account holders will apply to all 61 broker-dealers that will carry such accounts. The Commission estimates that these 61 broker-dealers each will enter into an average of 11 subordination agreements.[502]

The amendments to Rules 17a-3 and 17a-4 requiring a broker-dealer to make and maintain records documenting the credit, market and liquidity risk management control for analyzing and managing risks will apply only to firms that have more than $1,000,000 in aggregate credit items, or $20,000,000 in capital. Thus, its impact will be limited to larger broker-dealers. Accordingly, the number of respondents will equal the number of broker-dealers meeting the thresholds set forth in the amendment. The Commission estimates that approximately 490 broker-dealers will meet at least one of these thresholds.[503]

One amendment to Rule 17a-11 will require a broker-dealer to provide the Commission with notice if it becomes subject to certain insolvency events. The Commission estimates that approximately two broker-dealers will become subject to one of these events in a given year.[504] Another amendment to Rule 17a-11 will require a

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502 See Order Granting Conditional Exemption Under the Securities Exchange Act of 1934 in Connection with Portfolio Margining of Swaps and Security-Based Swaps, Exchange Act Release No. 68433 (Dec. 14, 2012), 77 FR 75211, 75222 n.69 (Dec. 19, 2012). ("FINRA CRD data indicate that the 17 largest broker-dealers (i.e., those with total assets of $50 billion or more) reported a total of 188 affiliates that are themselves registered with the SEC (i.e., they have their own CRD numbers), representing approximately 11 affiliates per broker-dealer."). Carrying firms likely will enter into subordination agreements with affiliates, including foreign banks or foreign broker-dealers affiliated with the carrying broker-dealer to exclude such accounts from the rule.. See SIFMA 2 Letter.

503 This estimate has been updated from the proposing release estimate of 517 broker-dealers. See Amendments to Financial Responsibility Rules, 72 FR at 12876. No comments were received on this estimate.

504 This estimate is based on the 2012 SIPC Annual Report, which indicates that over the last ten-year-period, the annual average of new customer protection proceedings was two. A copy of the 2012 Annual Report is available at http://www.sipc.org/. This estimate has been updated from our proposing release estimate of 6, which was based on the SIPC

broker-dealer to provide notice to the Commission if its securities borrowed or loaned, or its securities repurchase or reverse repurchase activity reaches a certain threshold or, alternatively, provide monthly reports to its DEA about such activities. This amendment will only affect a limited number of firms per year. The Commission estimates that approximately one broker-dealer[505] will provide notice and six broker-dealers[506] will opt to send the monthly reports in a given year.

D. Total Annual Reporting and Recordkeeping Burden

1. Securities Lending Agreements and Disclosures

The amendments to paragraph (c)(2)(iv)(B) of Rule 15c3-1 will require a broker-dealer to make disclosures to, and obtain certain agreements from, securities lending principals in situations where the firm participates in the settlement of a securities lending transaction but wants to be deemed an agent for purposes of Rule 15c3-1.[507] The Commission has adopted the final rule substantially as proposed, and consequently, there

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2005 Annual Report. See Amendments to Financial Responsibility Rules, 72 FR at 12876. No comments were received on this estimate.

505 This estimate is derived from information filed by broker-dealers in their FOCUS Reports. This estimate has been updated from the proposing release estimate of 11. See Amendments to Financial Responsibility Rules, 72 FR at 12876. No comments were received on this estimate. Based on FOCUS Report data, as of December 31, 2011, there were seven broker-dealers whose securities borrowed or securities loaned exceeded 80% of 25 times their tentative net capital, and there were six broker-dealers whose securities borrowed or securities loaned exceeded 25 times their tentative net capital. Therefore, the Commission assumes for purposes of the PRA that six broker-dealers would chose to file monthly reports in lieu of the notice requirements, and that one would file a notice.

506 This estimate is derived from information filed by broker-dealers in their FOCUS Reports. Based on FOCUS Report data, as of December 31, 2011, there were six broker-dealers whose securities borrowed or securities loaned exceeded 25 times their tentative net capital. These firms likely will opt to file the monthly report under the proposed amendments to Rule 17a-11. This estimate has been updated from our proposing release estimate of 21 broker-dealers. See Amendments to Financial Responsibility Rules, 72 FR at 12876. No comments were received on this estimate. The estimated number of firms filing notices and monthly reports has decreased largely due to an overall decrease in the number of broker-dealers. See also id. at 12870 (discussing rationale for 2,500% threshold).

507 17 CFR 240.15c3-1(c)(2)(iv)(B).

were no changes to the final rule amendments that would affect the Commission's PRA estimates. In addition, the Commission did not receive any comments on the estimates in the proposing release,[508] and is therefore is retaining the amendment's PRA hour burden estimates without revision. The Commission, however, is updating the number of respondents to reflect more recently-available data from broker-dealer FOCUS Reports.

As discussed above in section II.C. of this release, the Commission, in recognition of standard stock loan agreements, designed the amendment to accommodate the continued use of these industry model agreements by incorporating their use into the rule's requirements. For the purpose of establishing a broker-dealer's status as agent or lender, these agreements may be sufficiently detailed to satisfy the new requirements. Thus, the standard agreement used by the vast majority of broker-dealers may contain the representations and disclosures required by the amendment. Nevertheless, based on staff experience with securities lending agreements and disclosure and the application of Rule 15c3-1, the Commission continues to believe that a small percentage of broker-dealers may need to modify their standard agreements. In the proposing release, the Commission estimated that 5%[509] of broker-dealers may need to modify their standard agreements. No comments were received on this estimate and the Commission believes 5% continues to be an appropriate estimate for the final rule amendments. Thus, the Commission estimates that 5% of the approximately 122 firms engaged in this business, or approximately 6 firms, will not have used the standard agreements.[510] The Commission estimates each of these firms will spend approximately 20 hours of employee resources

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508 See Amendments to Financial Responsibility Rules, 72 FR at 12876.

509 Id.

510 This estimate is updated from the estimate of 9 firms (5% of 170 firms) in the proposing release. Id.

updating their standard agreement template.[511] Therefore, the Commission estimates that the total one-time burden to broker-dealers as a result of this requirement will be approximately 120 hours.[512]

2. DEA Permission to Withdraw Capital within One Year of Contribution

The amendment to paragraph (c)(2)(i)(G)(2) of Rule 15c3-1 will require that a broker-dealer treat as a liability any capital contribution that is intended to be withdrawn within one year of its contribution.[513] The rule amendment also includes the presumption that capital withdrawn within one year of contribution is presumed to have been intended to be withdrawn within one year, unless the broker-dealer receives permission in writing for the withdrawal from its DEA. This amendment likely will impose annual recordkeeping burdens on broker-dealers making the request.

The Commission estimates that 90 broker-dealers will seek to obtain permission from their DEA in writing to withdraw capital within one year of its contribution, and that it will take a broker-dealer approximately one hour to prepare and submit the request to its DEA to withdraw capital.[514] Therefore, the Commission estimates that the total annual hour burden with respect to the rule amendment will be approximately 90 hours.[515]

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511 Because these firms are already engaging in stock loan and repo activities, these functions likely will be performed by in-house employees, rather than outside counsel.

512 6 broker-dealers x 20 hours per firm = 120 hours. This is an update from the proposing release estimate of 9 broker-dealers x 20 hours = 180 hours. Id.

513 17 CFR 240.15c3-1(c)(2)(i)(G)(2).

514 See section IV.C. of this release.

515 90 broker-dealers x 1 hour = 90 hours.

3. Written Subordination Agreements under Rule 15c3-3

As discussed above in section II.A.2. of this release, in response to comments, the final rule amendment adopted by the Commission excludes from the definition of PAB account in paragraph (a)(16) of Rule 15c3-3, an account that "has been subordinated to the claims of creditors of the carrying broker or dealer."[516] This modification to the final rule will result in one-time burdens under the collection of information for Rule 15c3-3.[517]

In light of comments received[518] and based on staff experience, the Commission understands most PAB account holders that enter into a subordinated loan agreement with a carrying broker-dealer in order to not be treated as PAB accounts under paragraph (a)(16) likely will be affiliates of the broker-dealer.[519] The Commission estimates that the 61 broker-dealers that carry PAB accounts will enter into an average of 11 subordination agreements as a result of the rule amendment.[520] The Commission estimates that it will take a carrying broker-dealer approximately 20 hours to develop a subordination agreement, based on the Commission's prior experience with the

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516 17 CFR 240.15c3-3(a)(16).

517 The proposing release did not contain any proposals with regard to subordination agreements.

518 See SIFMA 2 Letter; SIFMA 4 Letter; Deutsche Bank Securities Letter.

519 See Deutsche Bank Letter; SIFMA 2 Letter.

520 See section IV.C. of this release.

development of subordination agreements.[521] Therefore, the Commission estimates that the total one-time hour burden resulting from this requirement will be 13,420 hours.[522]

4. PAB Reserve Bank Account Recordkeeping Requirements

The amendments to Rules 15c3-3 and 15c3-3a require carrying broker-dealers to: (1) perform a separate reserve computation for PAB accounts (in addition to the reserve computation currently required for Rule 15c3-3 customer accounts); (2) establish and fund a separate PAB reserve account; and (3) obtain and maintain physical possession or control of non-margin securities carried in PAB accounts unless the carrying broker-dealer has provided written notice to the PAB account holders that it will use those securities in the ordinary course of its securities business, and has provided opportunity for the PAB account holder to object to such use.

In the proposing release, the Commission proposed to require that the carrying broker-dealer obtain written permission from a PAB account holder before it could use the securities of the PAB account holder in the ordinary course of its securities business. The Commission estimated that, based on FOCUS Report data, there were approximately 2,533 existing PAB customers, and therefore, broker-dealers would have to amend approximately 2,533 existing PAB agreements.[523] The Commission further estimated that, on average, a firm would spend approximately 10 hours of employee resources amending each agreement and that 75 firms would spend 20 hours amending their

521 See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071, 77 FR at 70299. See also Order Granting Conditional Exemption Under the Securities Exchange Act of 1934 in Connection with Portfolio Margining of Swaps and Security-Based Swaps, Exchange Act Release No. 68433 (Dec. 14, 2012), 77 FR 75211 (Dec. 19, 2012).

522 61 broker-dealers x 11 accounts x 20 hours = 13,420 hours.

523 See Amendments to Financial Responsibility Rules, 72 FR at 12877.

standard PAB agreement template, for a total of 26,830 hours.[524] The Commission did not receive any comments regarding these estimates in the proposing release.

In response to comments, as discussed above, the Commission determined not to adopt the requirement, as proposed. Instead, paragraph (b)(5) of Rule 15c3-3 requires the carrying broker-dealer to provide PAB account holders with written notice that the account holder's non-margin securities may be used in the ordinary course of its business.[525] Therefore, the Commission is revising the final one-time hour burden in light of the change in the rule to a notice requirement, which is expected to be less burdensome than the proposed customer consent provision while still providing customers with necessary information. The Commission estimates, based on FOCUS Report data, that approximately 61 broker-dealers carry PAB accounts.[526] The Commission further estimates, based on similar collections of information and the fact that these firms already carry PAB accounts, and on average, a firm will spend approximately 10 hours of employee resources drafting a standard notice template, for a total one-time burden of 610 hours.[527] In addition, based on FOCUS Report data, the Commission estimates that there are approximately 1,551 existing PAB customers and,

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524 (2,533 PAB customers x 10 hours per customer) + (75 firms x 20 hours per firm) = 26,830. Id.

525 17 CFR 240.15c3-3(b)(5).

526 This estimate is based on the number of broker-dealers carrying PAB accounts as of December 31, 2011. This is an update from the proposing release estimate of approximately 75 broker-dealers that carry PAB accounts. See Amendments to Financial Responsibility Rules, 72 FR at 12877.

527 61 firms x 10 hours = 610 hours. See also Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071, 77 FR at 70298 (estimating that the notice required to be sent by a security based swap dealer to a counterparty pursuant to section 3E(f) of the Exchange Act would take an outside counsel 10 hours to draft).

therefore, broker-dealers will have to send approximately 1,551 written notices.[528] The Commission estimates, based on staff experience, that a firm will spend approximately 10 minutes per account sending out the required written notice, for a total one-time burden of 259 hours.[529]

The Commission estimates that a broker-dealer will incur postage costs sending out the required written notice to customers. These carrying broker-dealers likely will use the least cost method to comply with this requirement and may include this notification with other mailings sent to PAB account holders. The Commission, however, conservatively estimates that the postage cost of for each notification, using the current price of first class postage, will be approximately $.46 per document sent. Therefore, the staff estimates that the cost of sending the required written notification to PAB account holders will be approximately $713.[530]

Based on FOCUS Report data, the Commission also estimates that approximately 61 broker-dealers carry PAB accounts, and based upon differences between the PAIB Letter and the final rule, these 61 firms would have to amend their standard PAB agreement template. The Commission estimates a firm will spend, on average, approximately 20 hours of employee resources on this task, for a total of 1,220 hours.[531]

In light of the changes to the final rule amendments which require a broker-dealer to send a written notice, rather than obtain a customer's consent regarding the use of a

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[528] The number of customers also is updated from the proposing release estimate of 2,533 customers. See Amendments to Financial Responsibility Rules, 72 FR at 12877.

[529] 1,551 PAB account holders x 10 minutes = 15,510 minutes/60 minutes = 258.5 hours (rounded to 259 hours). See generally, Exchange Act Release No. 68071, 77 FR at 70298 (estimating that the notice required to be sent by a security based swap dealer to a counterparty pursuant to section 3E(f) of the Exchange Act would take 10 minutes to send).

[530] 1,551 notices x $0.46 = $713.46.

[531] 61 firms x 20 hours = 1,220.

PAB account holder's securities, the 61 broker-dealers carrying PAB accounts likely will engage outside counsel[532] to review the required notice,[533] as well as the standard PAB template agreement under the final rule amendments to Rule 15c3-3. As a result, the Commission estimates that these 61 broker-dealers will likely incur $2,000 in legal costs,[534] or $122,000[535] in aggregate initial burden to review and comment on these materials.

The requirements to perform a PAB reserve computation and obtain agreements and notices from banks holding PAB accounts will result in annual burdens based on the number of broker-dealers that hold PAB accounts and the number of times per year these broker-dealers open new PAB reserve accounts. Currently, to obtain the relief provided in the PAIB Letter, broker-dealers are required to obtain the agreements and notices from the banks.[536] The Commission understands that broker-dealers generally already obtain these agreements and notices. Therefore, the Commission estimates there will be no

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532 See NIBA 2 Letter.

533 17 CFR 240.15c3-1(b)(5).

534 5 hours x $400 per hour = $2,000. The Commission estimates the review of the notice and standard PAB template would require 5 hours of outside counsel time, which is the same estimate used for outside counsel review in another recent release. Based on staff experience with the PAIB Letter and the application of Rule 15c3-3, the Commission estimates the outside counsel review related to the PAB amendments will take a comparable amount of time. See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release 68071, 77 FR at 70297, n.904. The Commission estimates that the outside counsel would cost $400 per hour, which is the same estimate used by the Commission in other recent releases. See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release 68071, 77 FR at 70297; Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, Exchange Act Release No. 67453 (July 18, 2012), 77 FR 48208 (Aug. 13, 2012).

535 61 firms x $2,000 legal cost = $122,000.

536 See PAIB Letter.

additional burden imposed by this requirement.[537] The Commission did not receive any comments on this estimate from the proposing release.

The amendment requiring a PAB reserve computation will produce a one-time burden. Based on FOCUS Report data, as of December 31, 2011, the Commission estimates that approximately 61 broker-dealers will perform a PAB reserve computation.[538] These firms already perform a reserve computation for domestic broker-dealer customers under the PAIB Letter. Nonetheless, the Commission estimates these firms will spend, on average, approximately 30 hours of employee resources per firm updating their systems to implement changes that will be necessitated by the amendment. Therefore, consistent with the hour estimates in the proposing release, the Commission estimates that the total one-time burden to broker-dealers arising from updating their systems to comply with this requirement will be approximately 1,830 hours.[539]

The amendment requiring a PAB reserve computation also will produce an annual burden. Based on FOCUS Report data, the Commission estimates that of the 61 broker-dealers estimated to perform a PAB reserve computation, approximately 56 of the current PAB filers will perform the PAB reserve computation on a weekly basis, two broker-dealers will perform it on a monthly basis, and three broker-dealers will perform the PAB reserve computation on a daily basis.[540] The Commission further estimates that a broker-

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537 In addition, the hour burdens for broker-dealers to open new customer reserve bank account under Rule 15c3-3 are already included within the currently approved collection of information for Rule 15c3-3.

538 This estimate is based on the number of broker-dealers which currently perform a PAB computation as of December 31, 2011. This is an update from the estimate in the proposing release of 75 broker-dealers.

539 61 broker-dealers x 30 hours per firm = 1,830 hours. This is an update from the proposing release estimate of 75 firms x 30 hours per firm = 2,250 hours. See Amendments to Financial Responsibility Rules, 72 FR at 12877.

540 These estimates are based on the number of broker-dealers performing a PAB reserve computation monthly, weekly, and daily, as of December 31, 2011. This is an update

dealer will spend, on average, approximately 2.5 hours to complete the PAB reserve computation in order to make a record of such computation under Rule 15c3-3 as a result of the amendment.[541] Therefore, consistent with the hour burden estimates in the proposing release, the Commission estimates that the total annual burden to broker-dealers from this requirement will be approximately 9,215 hours.[542]

5. Adequate Procedures Required under Paragraph (j)(1) of Rule 15c3-3

The Commission proposed importing requirements in Rule 15c3-2 into Rule 15c3-3 and eliminating Rule 15c3-2 as a stand-alone rule in the Code of Federal Regulations, and adopting new paragraph (j)(1) to Rule 15c3-3, which includes a condition that a broker-dealer must establish adequate procedures that will impose a paperwork burden if a broker-dealer wishes to accept or use any free credit balance for the account of any customer of the broker-dealer. The Commission is adopting this amendment substantially as proposed, which provides, "[a] broker or dealer must not accept or use any free credit balance carried for the account of any customer of the broker or dealer unless such broker or dealer has established adequate procedures pursuant to which each customer for whom a free credit balance is carried will be given or sent,

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from the estimate in the proposing release, which provided that of the 75 broker-dealers estimated to perform a PAB computation, 71 broker-dealers would prefer PAB computations on a weekly basis and four broker-dealers would perform it on a monthly basis. See Amendments to Financial Responsibility Rules, 72 FR at 12877. No broker-dealers performed daily PAB computations as of the date of the proposing release. No comments were received on this estimate.

541 This estimate is based on staff experience with the current estimate of 2.5 hours under the current collection of information for Rule 15c3-3 to make a record of each reserve computation. See 17 CFR 240.15c3-3(e)(3).

542 (56 weekly filers x 52 weeks x 2.5 hours per computation) + (2 monthly filers x 12 months x 2.5 hours per computation) + (3 daily filers x 250 business days per year x 2.5 hours per computation) = 9,215 total hours. This is an update from the proposing release estimate of 9,350 hours. See Amendments to Financial Responsibility Rules, 72 FR at 12877, n.137.

together with or as part of the customer's statement of account, whenever sent but not less frequently than once every three months, a written statement informing the customer of the amount due to the customer by the broker or dealer on the date of the statement, and that the funds are payable on demand of the customer."[543]

The requirement that broker-dealers establish adequate procedures with regard to free credit balances will result in one-time and annual hours burdens for broker-dealers subject to the requirements of new paragraph (j)(1) to Rule 15c3-3. Based on FOCUS Report data, the Commission estimates that 189 broker-dealers carry free credit balances. Most firms may already have such procedures in place with regard to the requirements of the rule, because these provisions are being imported from current Rule 15c3-2, which is being eliminated as a result of these amendments. Therefore, the Commission estimates that a broker-dealer will spend approximately 25 additional hours reviewing and updating its procedures to ensure it is in compliance with new paragraph (j)(1) to Rule 15c3-3 and approximately 10 additional hours per year reviewing and updating its procedures, for a total one-time and annual hour burden of 4,725 hours[544] and 1,890 hours,[545] respectively.[546]

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543 17 CFR 240.15c3-3(j)(1).

544 189 broker-dealers x 25 hours = 4,725 hours. The 25 and 10 hour estimates are based on similar collections of information and the Commission's belief that many of these broker-dealers already have procedures in place and, therefore, most broker-dealers will only be revising and updating their current policies and procedures to ensure compliance with the rule. See Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934, Exchange Act Release No. 64532 (Apr. 27, 2011), 76 FR 26550, 26568 (May 6, 2011).

545 189 broker-dealers x 10 hours = 1,890 hours.

546 See NIBA 2 Letter.

6. Treatment of Free Credit Balances

New paragraph (j)(2) to Rule 15c3-3 will require a broker-dealer to obtain the written affirmative consent of a new customer before including a customer's free credit balances in a Sweep Program, as well as to provide certain disclosures and notices to all customers with regard to the broker-dealer's Sweep Program.

These requirements will result in one-time and annual burdens to broker-dealers subject to its provisions. However, these requirements will apply only to a firm that carries customer free credit balances and opts to have the ability to change how its customers' free credit balances are treated. The Commission did not receive comments regarding the hour burden estimates relating to the treatment of free credit balances in the proposing release.

In the proposing release, the Commission estimated that approximately 50 broker-dealers[547] would choose to provide new customers with the disclosures and notices required under the amendment in order to have the ability to change how their customers' free credit balances were treated. The Commission did not receive any comments on this estimate. The Commission, however, is revising this estimate for the final rule to include all 189 broker-dealers that carry free credit balances to reflect the fact that these firms may have to update their systems to comply with these new requirements. The Commission further estimates these firms will spend, on average, approximately 200 hours of employee resources per firm updating their current systems (including processes for generating customer account statements) to incorporate changes that will be necessitated by the amendment. Therefore, the Commission estimates that the total one-

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547 See Amendments to Financial Responsibility Rules, 72 FR at 12877.

time burden to broker-dealers arising from this requirement will be approximately 37,800 hours.[548]

The Commission also estimates that these firms will consult with outside counsel in making these systems changes, particularly with respect to the language in the disclosures and notices under new paragraph (j)(2) to Rule 15c3-3. The Commission estimates that an outside counsel will spend, on average, approximately 50 hours assisting a broker-dealer in updating its systems[549] for a one-time aggregate burden to broker-dealers of 9,450 hours.[550] The Commission estimates that the average hourly cost for an outside counsel will be approximately $400 per hour.[551] For these reasons, consistent with its estimate in the proposing release, the Commission estimates that the average one-time cost to a broker-dealer will be approximately $20,000[552] and the one-time cost to broker-dealers will be approximately $3,780,000.[553]

As for the annual hour burden, the Commission estimates, consistent with its estimate in the proposing release, these requirements will impact 5%[554] of the total

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548 189 broker-dealers x 200 hours per firm = 37,800.

549 Because broker-dealers affected by these amendments are likely to already have existing sweep programs in place, a broker-dealer likely will need to update its existing systems, rather than be required to purchase additional hardware to comply with these rule amendments.

550 189 broker-dealers x 50 hours per firm = 9,450 hours.

551 Based on staff experience, the Commission used the estimate of $400 per hour for legal services provided by outside counsel, which is the same estimate used by the Commission in other recent releases. See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release 68071, 77 FR at 70297; Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping; Final Rule, Exchange Act Release No. 67453 (July 18, 2012), 77 FR 48208 (Aug. 13, 2012).

552 $400 per hour x 50 hours = $20,000.

553 189 broker-dealers x $20,000 = $3,780,000.

554 See Amendments to Financial Responsibility Rules, 72 FR at 12877.

broker-dealer customer accounts per year. Based on FOCUS Report data, the Commission estimates there are approximately 110,493,215 customer accounts and, consequently, 5% of the accounts (5,524,661 accounts per year) will be impacted.[555] Based on staff experience with similar requirements under the existing PRA collection for Rule 17a-3, the Commission further estimates that a broker-dealer will spend, on average, four minutes[556] of employee resources to process a written affirmative consent for new customers, as well as disclosures required under paragraph (j) to Rule 15c3-3. Therefore, the Commission estimates that the annual burden to broker-dealers arising from the requirement will be approximately 368,311 hours.[557]

7. Documentation of Risk Management Procedures

The amendments to Rules 17a-3 and 17a-4 will require certain large broker-dealers to make and keep current a record documenting credit, market, and liquidity risk management controls established and maintained by the broker-dealer to assist it in analyzing and managing the risks associated with its business activities. The amendment only will apply to broker-dealers that have more than (1) $1,000,000 in aggregate credit items as computed under the customer reserve formula of Rule 15c3-3, or (2) $20,000,000 in capital, including debt subordinated in accordance with Appendix D to Rule 15c3-1.

As proposed, the amendment would have required a broker-dealer to create a record documenting its "internal risk management controls."[558] To address commenters'

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555 These estimates have been updated from the proposing release estimates of 109,300,000 customer accounts and 5% of the customer account or 5,465,000 accounts. Id.

556 Id.

557 [5,524,661 accounts x 4 minutes/account]/60 minutes = 368,311 hours. This is an update from our proposing release estimate of 5,465,000 accounts x 4 minutes/account = 364,333 hours. Id. at 12878.

558 Id. at 12899.

concerns that the proposed rule language was ambiguous and that the Commission should narrow the application of the rule, the Commission modified new paragraph (a)(23) to Rule 17a-3, as stated above, so that the final rule requires certain broker-dealers to document risk management controls established to manage market, credit, and liquidity risk, rather than all of its "internal risk management controls."

In the proposing release, the Commission estimated that based on FOCUS Report data, that there would be approximately 517 broker-dealers that would meet the applicability threshold of this amendment ($1,000,000 in credits or $20,000,000 in capital), and therefore would be subject to the proposed rule.[559] The Commission also estimated that this requirement would result in a one-time burden to broker-dealers of approximately 62,040 hours, based on the estimate that a broker-dealer would spend approximately 120 hours of employee resources augmenting its procedures to comply with the proposed rule.[560] The Commission did not receive any comments on this estimate in the proposing release.

In light of the change in the final rule text to require the documentation of controls established to manage market, credit, and liquidity risk, rather than all of its "internal risk management controls," the Commission is reducing the final PRA estimate for Rule 17a-3 because the final rule narrows the scope of internal risk management controls the broker-dealer is required to document. Consequently, the change to the final rule should result in a reduction in the one-time hour burden estimate. The rule does not specify the type of controls a broker-dealer must establish to manage these risks. It simply requires the documentation of the procedures the broker-dealer has established. Broker-dealers that are part of holding companies may be subject to procedures that are

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559 Id. at 12878.

560 517 broker-dealers x 120 hours = 62,040 hours.

used globally throughout the organization. As long as the broker-dealer maintains documented procedures of controls pertaining to the designated entity, the requirements of the rule would be met. The one-time hour burden to comply with the rule will vary depending on the size and complexity of a firm. In addition, some larger broker-dealers required to comply with Rule 15c3-4 (Internal Risk Management Control Systems for OTC Derivatives Dealers) already would be required to document their internal risk management control systems related to market, credit, and liquidity risk.[561]

Taking this into account, as well as based on staff experience monitoring compliance of risk management controls of broker-dealers, the Commission estimates that a broker-dealer will spend, on average, approximately 100 hours of employee resources to comply with this amendment to ensure its market, credit, and liquidity risk controls are documented. For the reasons discussed above, including narrowing the scope of the final rule, the estimate of 100 hours reflects a 20% reduction from the estimate in the proposing release of 120 hours. Based on FOCUS Report data, as of December 31, 2011, the Commission estimates there are approximately 490 broker-dealers that would be subject to the final rule amendment (because the firm has $1,000,000 in credits or $20,000,000 in capital). Therefore, the Commission estimates the total one-time burden to broker-dealers will be approximately 49,000 hours.[562]

In addition to the one-time hour burden discussed in the proposing release,[563] based on similar collections of information requiring the documentation of risk management controls,[564] large broker-dealers required to comply with the amendment as

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561 See 17 CFR 240.15c3-4(a).

562 490 broker-dealers x 100 hours = 49,000 hours.

563 See Amendments to Financial Responsibility Rules, 72 FR at 12878.

564 See Risk Management Controls for Brokers or Dealers with Market Access; Final Rule, Exchange Act Release No. 63241 (Nov. 3, 2010), 75 FR 69792, 69815 (Nov. 15, 2013).

adopted likely will incur annual hour burdens.[565] Consequently, the Commission is incorporating annual hour burdens for this collection of information in the final rule amendments.[566] Therefore, the Commission estimates that a broker-dealer would spend approximately 45 hours per year to ensure its compliance with the amendment to Rule 17a-3, for a total annual hour burden to the industry of 22,050 hours.[567]

Additionally, the proposing release did not specifically allocate the estimated hour burdens with respect to the amendments to Rule 17a-3 and 17a-4 between these two rules.[568] As discussed above, and based on staff experience with the application of Rule 17a-4, the Commission estimates that broker-dealers meeting the threshold requirements of paragraph (a)(23) of Rule 17a-3 will already have documented their established procedures and controls to manage the risks arising from their business. Consequently, the amendment to Rule 17a-4 to require a broker-dealer to preserve the records required pursuant to paragraph (a)(23) of Rule 17a-3 until three years after the termination of the use of the risk management controls documented therein should have a minimal impact on the current annual hour burden for Rule 17a-4 because the paperwork burden associated with this amendment derives from the substance of the amendments to paragraph (a)(23) of Rule 17a-3. Therefore, the Commission is retaining the current annual hour burden for Rule 17a-4 without change.

See also Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release 68071, 77 FR at 70295 and 70297.

565 See NIBA 2 Letter.

566 The proposing release did not contain annual hour burden estimates for this collection of information.

567 490 broker-dealers x 45 hours = 22,050 hours. The 45 per hour annual estimate is based on a similar collection of information. See Risk Management Controls for Brokers or Dealers with Market Access; Final Rule, Exchange Act Release No. 63241 (Nov. 3, 2010), 75 FR 69792, 69815 (Nov. 15, 2010).

568 See Amendments to Financial Responsibility Rules, 72 FR at 12878.

Because the final rule amendment requires a broker-dealer to document its liquidity, credit, and market risk management controls, if it has established such controls, these broker-dealers may incur one-time startup costs to hire outside counsel to review the documented controls to ensure the broker-dealer is meeting the requirements of the rule. Based on staff experience with similar reviews, the Commission estimates that these broker-dealers would incur $2,000 in legal costs,[569] or $980,000,[570] in the aggregate, initial one-time burden to review and comment on the documented risk management controls.[571]

8. Notice Requirements

The amendment to Rule 17a-11 requiring notice when a broker-dealer becomes subject to certain insolvency events will result in irregular filings from a small number of broker-dealers. As noted above, SIPC's 2012 annual report indicates that the average annual number of broker-dealers which have become subject to a liquidation proceeding under SIPA over the last ten years is two. Accordingly, the Commission estimates that approximately two insolvency notices will be sent per year and that a broker-dealer will spend, on average, approximately ten minutes of employee resources to prepare and send the notice.[572] The Commission did not receive any comments on its estimates from the

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569 The Commission staff estimates that the review of the documented controls would require 5 hours of outside counsel time at a cost of $400 per hour. See also Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release 68071, 77 FR at 70297, n.904.

570 490 broker-dealers x $2,000 = $980,000.

571 See NIBA 2 Letter.

572 This is an update from the proposing release estimate of an average of six broker-dealers per year have become subject to a liquidation proceeding under SIPA, based on SIPC's 2005 annual report. The proposing release also contained a 10 minute estimate per broker-dealer (6 notices x 10 minutes per notice = 1 hour). See Amendments to Financial Responsibility Rules, 72 FR at 12878.

proposing release. Therefore, the Commission estimates that the total annual burden to broker-dealers arising from this amendment will be approximately 20 minutes.[573]

The amendment to Rule 17a-11 requires broker-dealers engaged in securities lending or repurchase activities to either: (1) file a notice with the Commission and their DEA whenever the total money payable against all securities loaned, subject to a reverse repurchase agreement or the contract value of all securities borrowed or subject to a repurchase agreement, exceeds 2,500% of tentative net capital; or, alternatively, (2) report monthly their securities lending and repurchase activities to their DEA in a form acceptable to their DEA. The Commission did not receive any comments on these specific estimates in the proposing release and continues to believe they are appropriate. As such, the Commission is adopting this amendment with a minor modification that does not impact the collection of information.

In addition, based on FOCUS Report data, as of December 31, 2011, the Commission estimates that approximately one stock loan/borrow notice will be sent per year.[574] The Commission further estimates that a broker-dealer will spend, on average, approximately ten minutes of employee resources to prepare and send the notice. Therefore, the Commission estimates that the total annual burden to broker-dealers arising from this amendment will be approximately ten minutes.[575]

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573 2 notices x 10 minutes per notice = 20 minutes.

574 This estimate is an update of the proposing release estimate that twelve notices will be sent per year based on FOCUS data. See Amendments to Financial Responsibility Rules, 72 FR at 12878. As of December 31, 2011, there were seven broker-dealers whose securities borrowed or securities loaned exceeded 80% of 25 times their tentative net capital, and there were six broker-dealers whose securities borrowed or securities loaned exceeded 25 times their tentative net capital. The Commission assumes for purposes of the PRA that six broker-dealers would chose to file monthly reports in lieu of the notice requirements, and that one would file a notice.

575 1 notice x 10 minutes per notice = 10 minutes. This is an update of the proposing release estimate of 2 hours (12 notices x 10 minutes per notice). See Amendments to Financial Responsibility Rules, 72 FR at 12878. The Commission does not expect broker-dealers

Based on FOCUS Report data, as of December 31, 2011, and staff experience, the Commission estimates that, annually, six broker-dealers will submit the monthly stock loan/borrow report.[576] Based on staff experience, the Commission estimates each firm will spend, on average, approximately 100 hours of employee resources updating its systems to generate the information required in the monthly report. Therefore, the Commission estimates that the total one-time burden to broker-dealers arising from this requirement will be approximately 600 hours.[577] With respect to the annual hour burden, the Commission estimates each firm will spend, on average, approximately one hour per month (or twelve hours per year) of employee resources to prepare and send the report or to prepare the information for the FOCUS report (as required by the firm's DEA, if applicable). Therefore, the Commission estimates the total annual burden arising from this amendment will be approximately 72 hours.[578]

E. Collection of Information Is Mandatory

These recordkeeping and notice requirements are mandatory with the exception of: (1) the option for a broker-dealer to report monthly its securities lending activities to its DEA in lieu of filing the notice required under paragraph (c)(5) of Rule 17a-11; (2) the option for a broker-dealer to request written approval from its DEA in order to withdraw capital that has been contributed within one year under paragraph (c)(2)(i)(G)(2) of Rule

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to incur postage costs as a result of this amendment because most broker-dealers file these notices via facsimile or email. Therefore, any incremental postages costs will likely be minimal.

576 This is an update from the proposing release estimate that 21 broker-would submit a monthly report. See Amendments to Financial Responsibility Rules, 72 FR at 12878.

577 6 broker-dealers x 100 hours per firm = 600 hours. This is an update from our proposing release estimate of 2,100 hours (21 broker-dealers x 100 hours per firm). See Amendments to Financial Responsibility Rules, 72 FR at 12878.

578 6 broker-dealers x 12 hours per year = 72 hours. This is an update from the proposing release estimate of 252 hours (21 broker-dealers x 12 hours per year). See Amendments to Financial Responsibility Rules, 72 FR at 12878.

15c3-1; and (3) the option of a carrying broker-dealer to enter into a subordination agreement with an account holder in order to exclude such account holder's account from being treated as a PAB account under paragraph (a)(16) of Rule 15c3-3.

F. Confidentiality

Some of the information the Commission expects to receive may be confidential information. The information collected under the amendments to Rules 15c3-1, 15c3-3, 17a-3, and 17a-4 would be stored by the broker-dealers and made available to the Commission, Commission staff, and SROs, as required in connection with examinations, investigations, and enforcement proceedings. The information collected under the amendments to Rule 17a-11 would be generated from the internal records of the broker-dealers. It would be provided to the Commission, its staff, and SROs but not on a regular basis (except for the optional monthly reports).

To the extent that the Commission receives confidential information pursuant to these collections of information, the Commission is committed to protecting the confidentiality of such information to the extent permitted by law.[579]

Broker-dealers will send required written notices regarding use of a PAB account holder's securities to its customers, as required by Rule 15c3-3.[580] In addition, broker-dealers will send certain notices and disclosures to customers regarding the treatment of

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579 See, e.g., Exchange Act Section 24, 15 U.S.C. 78x (governing the public availability of information obtained by the Commission) and 5 U.S.C. 552 et seq. (Freedom of Information Act – "FOIA"). FOIA provides at least two pertinent exemptions under which the Commission has authority to withhold certain information. FOIA Exemption 4 provides an exemption for "trade secrets and commercial or financial information obtained from a person and privileged or confidential." 5 U.S.C. 552(b)(4). FOIA Exemption 8 provides an exemption for matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." 5 U.S.C. 552(b)(8).

580 See 17 CFR 15c3-3(b)(5).

their free credit balances under new paragraph (j)(2) to Rule 15c3-3. To the extent these standard notices and disclosures are made available to the Commission, they may not be kept confidential.

G. Record Retention Period

One amendment to Rule 15c3-1 will require broker-dealers to make disclosures to principals and obtain agreements from principals with respect to securities lending transactions where the broker-dealer acts as agent. In addition, the amendment to Rule 15c3-3 to define the term PAB account will require carrying broker-dealers to enter into subordination agreements with certain account holders if they wish their account to be excluded from the definition. These records will have to be maintained for not less than three years under paragraph (b)(7) of Rule 17a-4.[581]

The amendments to Rule 15c3-3 require broker-dealers to provide PAB account holders with written notice that the securities may be used in the ordinary course of its business, obtain the written affirmative consent of a new customer before including a customer's free credit balances in a Sweep Program, and provide certain disclosures and notices to all customers with regard to the broker-dealer's Sweep Program. These agreements relate to the terms and conditions of the maintenance of the customer's account and, accordingly, fall within the record retention requirements of paragraph (c) of Rule 17a-4.[582] Under this paragraph, the records must be retained until six years after the closing of the customer's account. The amendments to Rule 15c3-3 also require broker-dealers to obtain notices and contracts from the banks holding their PAB reserve accounts. In order to comply with Rule 15c3-3, broker-dealers must have these notices

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581 17 CFR 240.17a-4(b)(7).

582 17 CFR 240.17a-4(c).

and contracts in place and documented. These records will have to be maintained for not less than three years under the requirements of Rule 17a-4.[583]

The amendments to Rules 17a-3 and 17a-4 require broker-dealers to document credit, market, and liquidity risk management controls. The amendments to Rule 17a-4 include the establishment of a retention period for these records, which will be until three years after the termination of the use of the risk management controls documented therein under new paragraph (e)(9) of Rule 17a-4. The three-year retention period is designed to document former and current procedures and to provide sufficient opportunity to review the records during the broker-dealer's normal exam cycle.

The amendments to Rule 17a-11 will require broker-dealers to provide notice or report monthly to the Commission and other regulatory authorities under certain circumstances. These notices and reports will constitute communications relating to a broker-dealer's "business as such" and, therefore, will need to be retained for three years.[584]

V. ECONOMIC ANALYSIS

A. Introduction

The Commission is sensitive to the costs and benefits of its rules. When engaging in rulemaking that requires the Commission to consider or determine whether an action is necessary or appropriate in the public interest, section 3(f) of the Exchange Act requires that the Commission consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[585] In addition, section 23(a)(2) of the Exchange Act requires the Commission to consider the effects on

583 17 CFR 240.17a-4.

584 17 CFR 240.17a-4(b)(4).

585 15 U.S.C. 78c(f).

competition of any rules the Commission adopts under the Exchange Act, and prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[586]

In the proposing release,[587] the Commission solicited comment on the costs and benefits of the proposed amendments including whether these costs and benefits were accurate.[588] The Commission also requested that commenters identify and assess any costs and benefits not discussed in the proposing release. The Commission further encouraged commenters to provide specific data and analysis in support of their views.[589] The Commission also requested comment on whether the proposed amendments would place a burden on competition, and promote efficiency, competition, and capital formation.[590] In May 2012, the Commission re-opened the comment period to permit commenters additional opportunity to address these, and any other, issues raised by the

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586 15 U.S.C. 78w(a)(2).

587 See Amendments to Financial Responsibility Rules, 72 FR at 12879; see also Amendments to Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 66910 (May 3, 2012), 77 FR 27150 (May 9, 2012) (re-opening of comment period).

588 For the purposes of this final economic analysis, the Commission is using salary data from the SIFMA Management & Professional Earnings in the Securities Industry 2012, which provides base salary and bonus information for middle-management and professional positions within the securities industry. The salary costs derived from the report and referenced in this cost/benefit section, are modified to account for an 1800-hour work year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. Hereinafter, references to data derived from the report as modified in the manner described above will be cited as "SIFMA 2012 Report as Modified." The proposing release used salary information for New York based employees derived from the SIA Report on Management and Professional Earnings in the Securities Industry 2005. See Amendments to Financial Responsibility Rules, 72 FR at 12879, n.151.

589 Id. at 12879.

590 Id.

proposed rule amendments.[591] The general comments received, as well as comments received relating to specific rule amendments, are discussed below.

In adopting the rule amendments, the Commission has been mindful of the associated costs and benefits. The discussion focuses on the Commission's reasons for adopting these amendments, the affected parties, the costs and benefits of the amendments compared to a baseline, and alternative courses of action. The discussion of the costs of the rule amendments includes a discussion of certain implementation burdens and related costs,[592] which may include assessment costs, personnel costs, and other costs (e.g., technology costs).[593] The cost estimates and related data derived from FOCUS Reports discussed in the proposing release have also been updated in this final release to reflect more recently available data.[594]

Many of the benefits and costs discussed below are difficult to quantify, in particular when discussing enhancements in investor protection. For example, it is unknown how much the amendments to the financial responsibility rules will result in enhanced compliance with those rules. Therefore, much of the discussion is qualitative in nature but, where possible, the Commission has attempted to quantify the costs. However, the inability to quantify these costs and benefits does not mean that the costs and benefits of these rule amendments are any less significant.

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591 Amendments to Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 66910 (May 3, 2012), 77 FR 27150 (May 9, 2012).

592 In the proposing release, the Commission estimated that the one-time and annual costs to broker-dealers would be $32,814,454 and $39,651,716, respectively. See Amendments to Financial Responsibility Rules, 72 FR at 12887.

593 As discussed in section IV. of this release, the Commission has estimated certain indirect burdens and related costs of these implementation requirements.

594 See Amendments to Financial Responsibility Rules, 72 FR at 12887. The FOCUS Report data from the proposing release was derived from 2004 year end numbers.

As discussed throughout this release, in part in response to comments, the Commission has modified the proposed rules to reduce compliance burdens where consistent with investor protection. In addition, where commenters identified additional costs, the Commission has revised its economic analysis of the final rules to take these costs into account. Finally, the Commission has considered all comment letters received related to the impact of the proposed amendments on efficiency, competition, and capital formation, and responds to these comments in the sections below discussing individual rule amendments.

B. Economic Baseline

The regulatory changes adopted today amend requirements that apply to broker-dealers registered with the Commission. The discussion below includes the approximate numbers of broker-dealers that will be affected by today's amendments and a description of the economic baseline against which the costs and benefits, as well as the impact on efficiency, competition, and capital formation, of today's amendments are measured.

The broker-dealers registered with the Commission vary significantly in terms of their size, business activities, and the complexities of their operations. For example, carrying broker-dealers hold customer securities and funds.[595] Clearing broker-dealers clear transactions as members of security exchanges, the Depository Trust & Clearing

[595] Rule 15c3-1 specifies that a broker-dealer shall be deemed to carry customer accounts "if, in connection with its activities as a broker or dealer, it receives checks, drafts, or other evidences of indebtedness made payable to itself or persons other than the requisite registered broker or dealer carrying the account of a customer, escrow agent, issuer, underwriter, sponsor, or other distributor of securities" or "if it does not promptly forward or promptly deliver all of the securities of customers or of other brokers or dealers received by the firm in connection with its activities as a broker or dealer." 17 CFR 240.15c3-1(a)(2)(i). Rule 15c3-3 defines the term <u>securities carried for the account of a customer</u> to mean "securities received by or on behalf of a broker or dealer for the account of any customer and securities carried long by a broker or dealer for the account of any customer," as well as securities sold to, or bought for, a customer by a broker-dealer. 17 CFR 240.15c3-3(a)(2).

Corporation and the Options Clearing Corporation.[596] Many clearing broker-dealers are carrying broker-dealers, but some clearing broker-dealers clear only their own transactions and do not hold customer securities and cash.

In addition, a broker-dealer that does not hold customer securities and/or cash is generally referred to as a "non-carrying broker-dealer." Non-carrying broker-dealers include "introducing brokers."[597] These introducing broker-dealers accept customer orders and introduce their customers to carrying broker-dealers that hold the securities and cash of the customers of the introducing broker-dealers along with the securities and cash of their direct customers. A carrying broker-dealer generally receives and executes orders of the introducing broker-dealers' customers.[598] Carrying broker-dealers generally also prepare trade confirmations, settle trades, and organize book entries of the securities purchased and sold.[599] Introducing broker-dealers also may use carrying broker-dealers to clear the introducing firm's proprietary trades and carry the firm's securities. Another group of non-carrying broker-dealers effects transactions in securities like mutual funds on a subscription-way basis, where customers generally purchase the securities by

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596 See Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks, Exchange Act Release No. 56501 (Sept. 24, 2007), 72 FR 56514 (Oct. 3, 2007), at n.269.

597 Id. at ¶ 1.15; see also Net Capital Rule, Exchange Act Release No. 31511 (Nov. 24, 1992), 57 FR 56973 (Dec. 2, 1992) (describing role of introducing broker-dealers).

598 Net Capital Rule, Exchange Act Release No. 31511 (Nov. 24, 1992), 57 FR 56973 (Dec. 2, 1992).

599 See, e.g., FINRA Rule 4311 (Carrying Agreements). This FINRA rule governs the requirements applicable to FINRA members when entering into agreements for the carrying of any customer accounts in which securities transactions can be effected. Historically, the purpose of this rule has been to ensure that certain functions and responsibilities are clearly allocated to either the introducing or carrying firm, consistent with the requirements of the SRO's and Commission's financial responsibility and other rules and regulations, as applicable. See also Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change Adopting, as Modified by Amendment No. 1, Rules Governing Guarantees, Carrying Agreements, Security Counts and Supervision of General Ledger Accounts in the Consolidated FINRA Rulebook, Exchange Act Release No. 63999 (Mar. 7, 2011), 76 FR 12380 (Mar. 7, 2011).

providing the funds directly to the issuer.[600] Finally, some non-carrying broker-dealers act as finders by referring prospective purchasers of securities to issuers.[601]

While these amendments will impact investors and markets more generally, the broker-dealer industry is the primary industry directly affected by the rule amendments. In some cases, the amendments impose requirements on certain types of broker-dealers that engage in specific activities. For example, only carrying broker-dealers that carry free credit balances would be subject to the requirements regarding the treatment of free credit balances under paragraph (j) of Rule 15c3-3. All broker-dealers would be subject to the requirements to deduct from net worth certain liabilities or expenses assumed by third parties under Rule 15c3-1.

To establish a baseline for competition among broker-dealers, the Commission looked at the status of the broker-dealer industry detailed below. In terms of size, the following table provides the distribution of broker-dealers by total capital levels and the aggregate total capital within each capital bracket.

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600 See Books and Records Requirement for Brokers and Dealers Under the Securities Exchange Act of 1934, Exchange Act Release No. 44992 (Nov. 2, 2001) ("[T]he Commission recognizes that for some types of transactions, such as purchases of mutual funds or variable annuities, the customer may simply fill out an application or a subscription agreement that the broker-dealer then forwards directly to the issuer.").

601 See American Bar Association, Report and Recommendations of the Task Force on Private Placement Broker-Dealers 23–24 (2005); see also Net Capital Rule, Exchange Act Release No. 31511 (Nov. 24, 1992), 57 FR 56973 (Dec. 2, 1992).

Broker-Dealer Capital at Calendar Year End 2011[602]
($ millions)

Capital	Number of Firms	Aggregate Total Capital
Less than $500,000	2,506	$347
Greater than or equal to $500,000 and less than $5 million	1,320	$2,212
Greater than or equal to $5 million and less than $50 million	608	$10,520
Greater than or equal to $50 million and less than $100 million	80	$5,672
Greater than or equal to $100 million and less than $500 million	125	$26,655
Greater than or equal to $500 million and less than $1 billion	28	$19,248
Greater than or equal to $1 billion and less than $5 billion	27	$61,284
Greater than or equal to $5 billion and less than $10 billion	6	$41,175
Greater than or equal to $10 billion	9	$175,585
Total	**4,709**	**$342,698**

According to FOCUS Report data, as of December 31, 2011, there were approximately 4,709 broker-dealers registered with the Commission. Nine broker-dealers hold over half of broker-dealers' total capital. Further, based on FOCUS Report data, as of December 31, 2011, the Commission also estimates that there are approximately 287 broker-dealers that are clearing or carrying firms that do not claim exemptions pursuant to paragraph (k) of Rule 15c3-3. Based on FOCUS Report data, as of December 31, 2011, approximately 189 of these broker-dealers carry free credit balances, while 61 broker-dealers carry PAB accounts.

For the purposes of this economic analysis, the baseline is the current customer protection, net capital, books and records, and notification requirements for broker-dealers promulgated under the Exchange Act and existing interpretations thereunder, and how they affect broker-dealers.

As discussed above in section II.A.1. of this release, Rule 15c3-3 – the customer protection rule – in effect mandates a separation of customer assets from broker-dealer

602 The information in this chart is based on FOCUS Report data filed by broker-dealers in 2011. The information in the "Aggregate Total Capital" column is based on data reported on line 3530 of the FOCUS Report, which includes total capital and allowable subordinated liabilities.

assets through two fundamental requirements: (1) that a carrying broker-dealer must maintain physical possession or control over customers' fully paid and excess margin securities; and (2) that a carrying broker-dealer must maintain a reserve of cash or qualified securities[603] in an account at a bank that is at least equal in value to the net cash owed to customers, including cash obtained from the use of customer securities. These provisions are designed to require the broker-dealer to hold customer securities and cash in a manner that enables the prompt return of these assets in the event that the firm falls into financial difficulty or becomes insolvent. The goal of the rule is to place a broker-dealer in a position where it is able to wind down in an orderly self-liquidation without the need for financial assistance from SIPC through a formal proceeding under SIPA.[604]

As discussed above in section II.E. of this release, Rule 15c3-1 – the net capital rule – requires broker-dealers to maintain a minimum level of net capital (meaning highly liquid capital) at all times.[605] The rule requires that a broker-dealer perform two calculations: (1) a computation of the minimum amount of net capital the broker-dealer must maintain;[606] and (2) a computation of the amount of net capital the broker-dealer is maintaining.[607] The minimum net capital requirement is the greater of a fixed-dollar amount specified in the rule and an amount determined by applying one of two financial ratios: the 15-to-1 aggregate indebtedness to net capital ratio or the 2% of aggregate debit

603 Rule 15c3-3 defines qualified securities as securities issued by the United States or guaranteed by the United States with respect to principal and interest. 17 CFR 240.15c3-3(a)(6).

604 15 U.S.C. 78aaa et seq.

605 See 17 CFR 240.15c3-1.

606 See 17 CFR 240.15c3-1(a).

607 See 17 CFR 240.15c3-1(c)(2). The computation of net capital is based on the definition of net capital in paragraph (c)(2) of Rule 15c3-1. Id.

items ratio.[608] In computing net capital, the broker-dealer must, among other things, make certain adjustments to net worth, such as deducting illiquid assets, taking other capital charges, and adding qualifying subordinated loans.[609] The amount remaining after these adjustments is defined as tentative net capital.[610] The final step in computing net capital is to take prescribed percentage deductions ("standardized haircuts") from the mark-to-market value of the proprietary positions (e.g., securities, money market instruments, and commodities) that are included in its tentative net capital.[611]

As discussed above in section II.D. of this release, Rule 17a-3 and 17a-4 – the books and records rules – require broker-dealers to make and keep current certain records (e.g., trade blotters, asset and liability ledgers, income ledgers, customer account ledgers, etc.), which must be maintained in a specific manner for required retention periods.[612] Finally, Rule 17a-11 – the notification rule – requires a broker-dealer to notify the Commission and its DEA when certain events occur, such as if it fails to maintain certain levels of net capital.[613]

The specific requirements as well as the benefits and costs of each amendment and how broker-dealers will be affected are discussed in more detail in the sections below.

C. Discussion of General Comments Received

As stated above, in the proposing release, the Commission requested comment on estimates and views regarding the costs and benefits for particular types of market

608 See 17 CFR 240.15c3-1(a).

609 See 17 CFR 240.15c3-1(c)(2)(i)–(xiii).

610 See 17 CFR 240.15c3-1(c)(15).

611 See 17 CFR 240.15c3-1(c)(2)(vi).

612 17 CFR 240.17a-3; 17 CFR 240.17a-4.

613 17 CFR 240.17a-11.

participants, as well as any other costs and benefits that may result from the adoption of the proposed rules.[614] In response to this specific request, the Commission received two comment letters.[615] The first commenter who was explicitly addressing the Commission's Initial Regulatory Flexibility Analysis stated that the Commission should pay "explicit attention to regulatory trends in the rest of the world" because doing so "benefits not only small entities [the focus of the Initial Regulatory Flexibility Analysis] (by reducing their regulatory burden) but all entities, as larger entities can experience more consistent regulatory procedures around the world."[616] The commenter suggested that the Commission consider a "Basel II type approach to net capital requirements."[617] The second commenter requested that the Commission publish an update to all statistics and costs referenced in the proposing release.[618] The commenter further requested that, once published, the Commission reopen the comment period so that comments could be provided based on "current conditions and statistics."[619]

In response to the first commenter's request that the Commission should explicitly examine the alternatives used by regulators in other jurisdictions,[620] in adopting the final rule amendments today, as discussed throughout this section, the Commission considered reasonable alternatives, including alternatives in other jurisdictions, as well as the costs and benefits of the amendments. Moreover, the amendments relate to discrete areas of the broker-dealer financial responsibility rules (i.e., they do not establish new

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614 See Amendments to Financial Responsibility Rules, 72 FR at 12879.

615 See Angel Letter; NIBA 2 Letter.

616 See Angel Letter.

617 Id.

618 See NIBA 2 Letter.

619 Id.

620 See Angel Letter.

financial responsibility standards such as would be the case if the Commission were to adopt a "Basel II type approach to net capital requirements."). Consequently, the commenter's suggestion is beyond the scope of this rulemaking.[621]

In response to the second commenter, the Commission is publishing updated costs and statistics in this release. The Commission, however, believes that it is unnecessary to reopen the comment period to obtain comment on the updated statistics for several reasons. First, in proposing the rule changes, the Commission included then current estimates in the proposing release. Second, as noted above, the Commission reopened the comment period in 2012.[622] The reopening of the comment period afforded commenters an additional opportunity to comment on the proposed rules (including estimated costs and benefits), given the economic events since the rule amendments were proposed, the regulatory developments, the comments received on the proposed amendments, the continuing public interest in the proposed amendments, and the passage of time.[623] The Commission received a total of 97 comment letters on the proposed amendments.[624] As discussed below, in many cases, the revised data included in this release reflects a decrease in overall costs because of the decline in the total number of broker-dealers (including the number of broker-dealers that will be affected by each of these rule amendments). As of the 2004 year end, the number of registered broker-dealers was 6,339. As of the 2011 year end, the number of registered broker-dealers was

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621 The commenter cited the JP Morgan Letter in support of the suggestion to "consider regulatory trends in the rest of the world." Id. The JP Morgan Letter recommends that the Commission adopt a due diligence standard – citing a U.K. regulation – with respect to the amendments regarding customer reserve account cash deposits. See JP Morgan Letter. The Commission addresses this comment below in section V.D.1.i.b.(III) of this release.

622 Amendments to Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 66910 (May 3, 2012), 77 FR 27150 (May 9, 2012).

623 Id.

624 See supra note 6.

4,709, reflecting a net decrease of 1,630 (or 26%) in the number of registered broker-dealers. Consequently, many of the aggregate costs included in the proposing release have declined due to the decrease in the number of registered broker-dealers.

Further, the costs incurred by a broker-dealer to comply with the rule amendments will generally depend, among other factors, on the size and complexity of its business activities. Because the size and complexity of broker-dealers varies significantly, their costs also could vary significantly. In some cases, the Commission provided in the proposing release, and is providing here, estimates of the average cost per broker-dealer, taking into consideration the variance in size and complexity of the business activities of broker-dealers. In other cases, the cost impact to broker-dealers will depend on whether the broker-dealer is conducting activities that are subject to the rule amendments. For example, the amendments to Rule 15c3-3 will apply, for the most part, only to broker-dealers that carry PAB accounts (e.g., PAB account amendment), have a reserve deposit requirement (e.g., reserve bank account amendments), or carry free credit balances (e.g., free credit balance amendments). These amendments would have no direct cost impact on non-carrying broker-dealers, many of which are small broker-dealers. Moreover, given that some amendments are largely codifications of existing Commission and staff guidance (e.g., amendments related to PAB accounts, third parties assuming broker-dealer liabilities, temporary capital contributions, and fidelity bond deductions), any economic effects, including costs and benefits, should be compared to the baseline of current practice. Broker-dealers that are already complying with these requirements would not be expected to incur substantial costs to comply with these amendments.

The second commenter also stated that broker-dealers are dealing with relatively static commission and fee schedules in comparison to what they might charge customers, and, as such, broker-dealers will be unable to pass on any cost increases resulting from these rule amendments directly to customers.[625] The commenter stated that these cost increases over a relatively short period of time threaten the viability of all small broker-dealers, irrespective of their business line types or classes.[626] The commenter noted that the estimates provided by the Commission utilized only the number of broker-dealers in its estimate that the Commission justifiably considered to be affected by the proposals.[627] In contrast, the commenter believes that most, if not all broker-dealers will spend over 90 hours each analyzing the effects of these proposals and, if the rules are implemented, will spend much more than 90 hours each in implementing procedures to comply with the new rules. The commenter also believes that implementation will require broker-dealers to modify their written supervisory procedures and supervisory controls, and broker-dealers will spend in excess of 240 hours each in the monitoring of such rules on an ongoing basis. Consequently, the commenter believes that each broker-dealer will spend in excess of $15,000 for outside counsel and auditor opinions or work product.[628] This commenter did not provide additional detail about the basis for its view that the Commission's estimates were too low.

As stated above in section IV. of this release, the Commission agrees with the commenter that the broker-dealers directly affected by the rule amendments may be required to implement procedures or modify their written supervisory procedures to comply with the rule amendments. In cases where the rule amendments require a broker-dealer to directly implement or document certain policies and procedures, these hour burdens and costs already are incorporated into the PRA costs discussed above in section

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625 See NIBA 2 Letter.

626 Id.

627 Id.

628 Id.

IV. of this release, an ncorporated into the discussion below.[629] In response to the

commenter, the ssion also acknowledges that a broker-dealer may need to review

its operati ine whether it has any obligations under the rule amendments.

er is not affected by the rule amendments, such a review may

ect on its operations. These indirect costs are discussed in more

Eve ting these final rules, as discussed throughout the release, including

s, the Commission has sought to take into account the costs and

ith each particular rule amendment. The Commission has also

ct costs that a broker-dealer would incur to assess the impact of

ndments.

ission estimates that a broker-dealer likely will hire outside counsel to

mpact of the final rules on the broker-dealer's operations because all broker-

ers may be affected by the final rules, including non-carrying broker-dealers that may be affected by certain amendments, such as the Rule 15c3-1 amendments regarding third party liabilities or temporary capital contributions. Whether a broker-dealer determines to incur such assessment costs will depend on the nature and size of the broker-dealer's business and the range of activities the broker-dealer conducts. Therefore, while the Commission cannot estimate an aggregate assessment cost for all broker-dealers, the Commission estimates that these assessment costs would range approximately from $2,000 to $30,000[630] per broker-dealer.[631]

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629 See, e.g., paragraph (j)(1) of Rule 15c3-3 and paragraph (a)(23) of Rule 17a-3, as adopted.

630 These costs estimates include hour estimates in the range of 5 hours to 75 hours for outside counsel assessment review. A small broker-dealer may hire outside counsel to review only 1 or 2 of the final rule amendments for approximately 5 hours x $400 per hour = $2,000. See Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 64766, 76 FR 42396 (June 29, 2011), 76 FR 42396 (July 18, 2011) (applying the estimated cost of $400 for

D. Economic Analysis of the Amendments and Altern

This section discusses costs and benefits of the rule amendments parties against the economic baseline identified above, both in terms of ea specific changes from the baseline and in terms of the overall impact. In con costs, benefits, and overall impact, this discussion addresses comments receivea modifications made to the proposed amendments, and reasonable alternatives, whe applicable.

This section also discusses the Commission's considerations on the burden on competition, and the promotion of efficiency, competition, and capital formation.[632] In significant part, the effects of the final rules on efficiency and capital formation are linked to the effects of these rules on competition. Competitive markets are generally expected to promote an efficient allocation of capital. Rules that promote, or do not unduly restrict, investor participation and competition in the broker-dealer industry can

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legal services by outside counsel). See also Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", Exchange Act Release No. 66868 (Apr. 27, 2012), 77 FR 30596 (May 23, 2012) (noting that the review of the final rules by outside counsel for a large firm would generally cost more because the review would be more complex).

631 As discussed above, and in section IV. of this release, broker-dealers directly affected by a specific rule amendment may be required to implement procedures or modify their written supervisory procedures in order to comply with the rule amendments. The hours and related costs are discussed in section IV. of this release, and are incorporated into the specific sections below discussing each rule amendment. Therefore, while the range of hours is less than 90 hours (as suggested by the commenter), the Commission has adjusted other specific hour and cost estimates (in sections IV. and V. of this release) in response to the commenter's concerns, and believes these adjusted estimates, in totality, for the reasons discussed above, adequately address the estimated costs as well as the commenter's concerns. See NIBA 2 Letter.

632 In the proposing release, the Commission stated that its preliminary view was that the proposed amendments promote efficiency, competition, and capital formation and would not have any anti-competitive effects. See Amendments to Financial Responsibility Rules, 72 FR at 12887.

be accompanied by regulatory benefits that may reduce the risk of market failure and thus promote market efficiency and capital formation.

1. Amendments to the Customer Protection Rule

i. Economic Analysis

a. Proprietary Accounts of Broker-Dealers

(I). Summary of Amendments

Today's amendments to Rules 15c3-3 and 15c3-3a require carrying broker-dealers to: (1) perform a separate reserve computation for PAB accounts (in addition to the customer reserve computation currently required under Rule 15c3-3);[633] (2) establish and fund a separate reserve account for the benefit of the PAB account holders;[634] and (3) obtain and maintain physical possession or control of securities carried for a PAB account, unless the carrying broker-dealer has provided written notice to the PAB account holder that the securities may be used in the ordinary course of its securities business, and has provided opportunity for the PAB account holder to object.[635] In addition to the amendments to Rules 15c3-3 and 15c3-3a, the Commission is adopting amendments to Rule 15c3-1 that will require a broker-dealer to deduct from net capital cash and securities held in a securities account at a carrying broker-dealer except where the account has been subordinated to the claims of creditors of the carrying broker-dealer.[636]

As discussed above in section II.A.2. of this release, there is a disparity between the customer reserve requirements in Rule 15c3-3 and the treatment of customers in a

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633 17 CFR 250.15c3-3(e)(3).

634 17 CFR 240.15c3-3(e)(1).

635 17 CFR 240.15c3-3(b)(5).

636 17 CFR 240.15c3-1(c)(2)(iv)(E).

liquidation proceeding under SIPA.[637] Broker-dealers are not within the definition of customer for the purposes of Rule 15c3-3.[638] Accordingly, a carrying broker-dealer that carries PAB accounts is not required to treat these accounts as customer accounts for the purposes of Rule 15c3-3. However, the definition of customer in SIPA is broader than the definition in Rule 15c3-3 in that the SIPA definition does not exclude broker-dealers.[639]

SIPA customers are entitled to a number of protections if their broker-dealer fails and is liquidated in a SIPA proceeding, including the right to share pro rata with other SIPA customers in the customer property held by the broker-dealer and, if the fund of customer property is insufficient to make each SIPA customer whole, the entitlement to receive an advance from the SIPC fund of up to $500,000 (of which only $250,000 can be used to cover cash claims).[640] Broker-dealers that are SIPA customers have the right to share pro rata in customer property.[641] Consequently, when a carrying broker-dealer is liquidated in a SIPA proceeding, each customer (including a SIPA customer that is a broker-dealer) has a claim on the customer property. However, because the possession and control and customer reserve account provisions of Rule 15c3-3 do not apply to PAB account holders by virtue of the definition of customer in the rule, the carrying broker-

637 15 U.S.C. 78aaa et seq.

638 17 CFR 240.15c3-3(a)(1).

639 See 15 U.S.C. 78lll(a).

640 See 15 U.S.C. 78fff-2(c) and 15 U.S.C. 78fff-3(a), respectively. Under SIPA, the term customer property includes "cash and securities ... at any time received, acquired, or held by or for the account of the debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted." Therefore, customer property includes those securities positions that are held for customers and the cash that is owed to customers. 15 U.S.C. 78lll(4).

641 See 15 U.S.C. 78fff-2(c). Broker-dealers, however, are not entitled to receive an advance from the SIPC fund. 15 U.S.C. 78fff-3(a).

dealer is not restricted from using the securities and cash in these accounts for its business purposes.

The treatment of PAB account holders as customers for the purposes of SIPA but not as customers for the purposes of Rule 15c3-3 increases the risk that, in the event that a carrying broker-dealer is liquidated under SIPA, the claims of all SIPA customers will exceed the amount of customer property available and, thereby, expose the SIPC fund and potentially SIPA customers to losses. In addition, if the customer property is insufficient to satisfy fully all SIPA customer claims, and losses are incurred, the broker-dealer SIPA customers could be potentially placed in financial distress causing adverse effects to the securities markets, in addition to the adverse effects resulting from the failure of the carrying broker-dealer.[642]

The amendments address the disparity between the customer reserve requirements in Rule 15c3-3 and the treatment of customers in a liquidation proceeding under SIPA by requiring broker-dealers to reserve for the amount that credits exceed debits with respect to broker-dealer accounts. The amendments create a process that protects customers and PAB account holders of a failed carrying broker-dealer, and are designed to provide such protection by mitigating the risk that there will be insufficient customer property to fully satisfy all customer claims in a SIPA liquidation. By requiring the protection of PAB account holders (who qualify as customers under SIPA), the amendments to Rule 15c3-3 also reduce the risk that advances from the SIPC fund would be necessary to protect customer claims.

642 As noted above, while broker-dealers are customers for the purposes of SIPA, they are not entitled to the advances from the SIPC fund of up to $500,000 (limited to $250,000 for cash claims) allowed under SIPA to make up for potential shortfalls after the pro rata distribution of customer property. 15 U.S.C. 78fff-3(a).

The amendments to Rule 15c3-1 are intended to prevent broker-dealers from including in their net capital amount assets that may not be readily available to be returned to such broker-dealer account holders because the assets would not be subject to the PAB account provisions under Rules 15c3-3 and 15c3-3a. The amendments to Rule 15c3-1 also provide consistency with the exclusions from the definition of PAB account in paragraph (a)(16) of Rule 15c3-3.

Overall, the PAB-related amendments to Rules 15c3-3, 15c3-3a, and 15c3-1 should serve to reduce certain risks to investors and PAB account holders and, thereby, strengthen customer protection. The Commission requested comment on available metrics to quantify these benefits and any other benefits a commenter may identify. The Commission did not receive any comments in response to this request.

(II). Baseline and Incremental Economic Effects

Under the no-action relief set forth in the PAIB Letter,[643] discussed in section II.A.2 of this release, broker-dealers currently perform a reserve computation for domestic broker-dealer accounts and have obtained the necessary agreements and notices from the banks holding their PAIB reserve deposits. Therefore, as compared to the baseline of current Rule 15c3-1 and existing interpretations and guidance thereunder, including the no-action relief set forth in the PAIB Letter, the amendments will likely result only in small incremental benefits and costs because the final rule codifies many of the provisions of the PAIB Letter.[644]

Incorporation of certain aspects of the PAIB Letter into Rule 15c3-3 is intended to provide broker-dealers with more certainty with respect to the PAB requirements because

643 See PAIB Letter.

644 See section II.B. of this release. The PAIB Letter is being withdrawn as of the effective date of these rule amendments.

these requirements will be expressly stated in a Commission rule. Moreover, the PAB final rule amendments will not impose a significant additional burden on broker-dealers presently utilizing the interpretive relief provided in the PAIB Letter since the provisions of the final rule amendments are substantially similar. Relative to the baseline, there will be economic differences to the extent that carrying broker-dealers are currently not following the PAIB Letter, as compliance with conditions of the PAIB Letter are voluntary, while the PAB amendments to Rule 15c3-3 will be mandatory for the carrying broker-dealers subject to its requirements. Consequently, to the extent that carrying broker-dealers are not currently complying with the PAIB Letter, and to the extent the amendments as adopted differ from the PAIB Letter, they may incur incremental costs, including possible costs of capital as firms reallocate capital to comply with the rule amendments.

(III). Alternatives

In adopting these amendments, the Commission considered alternatives suggested by commenters on specific provisions of the rule, and incorporated some of these alternative approaches into the final rule amendments.

Two commenters raised concerns about the proposed definition of the term PAB account, because by including proprietary accounts of foreign broker-dealers and foreign banks acting as broker-dealers within the definition, the definition would differ from provisions in the PAIB Letter, which excluded such accounts from a PAIB computation.[645] The first commenter suggested allowing broker-dealers to "opt out" of the rule.[646] The second commenter stated that foreign broker-dealers and foreign banks acting as broker-dealers should be allowed to subordinate their claims to customers and

645 See Dresdner Kleinwort Letter; Deutsche Bank Securities Letter.

646 See Dresdner Kleinwort Letter.

creditors of the broker-dealer to remove their accounts from PAB account treatment because under SIPA foreign broker-dealers and foreign banks acting as broker-dealers, under certain circumstances, will not be deemed customers and, therefore, would not be entitled to a pro rata share of the estate of customer property in a SIPA liquidation.[647] More specifically, the commenter suggested that, to parallel the language in SIPA,[648] the Commission modify the definition of PAB account to exclude "any foreign broker-dealer and foreign bank, to the extent that such entity has a claim for cash or securities that is subordinated to the claims of creditors of the carrying broker-dealer." This commenter also recommended that the subordinating broker-dealer would need to follow the requirements for non-conforming subordinated loans to remove an account from being treated as a PAB account.[649]

In response to commenters' concerns and suggested alternatives, the Commission is excluding from the PAB account definition accounts that have been subordinated to the claims of creditors of the carrying broker-dealer. Consequently, this provision will provide flexibility to carrying broker-dealers and their broker-dealer affiliates to structure their PAB account relationships in a manner that permits operational efficiencies (i.e., the ability to exclude these accounts from the PAB reserve computation) while still promoting the goal of the amendments to have a consistent treatment of these accounts under Rule 15c3-3 and SIPA, and thereby protect accounts holders that are customers under SIPA. As discussed below, however, the requirement to enter into a subordination

647 See Deutsche Bank Securities Letter.

648 Id. The definition of customer in SIPA excludes any person, to the extent that "such person has a claim for cash or securities which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor, or is subordinated to the claims of any or all creditors of the debtor, notwithstanding that some ground exists for declaring such contract, agreement, or understanding void or voidable in a suit between the claimant and the debtor." 15 U.S.C. 78lll(2)(C)(ii).

649 See Deutsche Bank Securities Letter.

agreement with certain account holders to exclude them from the definition of PAB account may result in a one-time cost to broker-dealers.

In addition, in the proposing release, the Commission proposed to require that a carrying broker-dealer obtain written permission from a PAB account holder before it could use the securities of the PAB account holder in the ordinary course of its securities business. One commenter stated that this provision should be eliminated from the proposed amendments, arguing that it interferes unnecessarily in the contractual arrangements between broker-dealers, which are capable of understanding the terms of standard industry custodial relationships and that the PAIB Letter did not contain any such requirements. The Commission considered this alternative and believes that an appropriate level of protection for PAB account holders will be achieved by requiring the carrying broker-dealer to provide written notice to the PAB account holders that the firm may use their non-margin securities in the ordinary course of its securities business. The written notice requirement in the final rule will increase protection for PAB account holders from the status quo without imposing substantial burdens on existing account relationships. The revised rule will alert PAB account holders to the fact that the carrying broker-dealer may use their securities in its business for its own benefit, thereby reducing possible contractual ambiguity between the PAB account holder and the broker-dealer. The revised rule also will provide a PAB account holder the opportunity to seek to move the account to another broker-dealer or to negotiate different terms with regard to the use of its securities. Finally, this amendment will eliminate the need for, and the costs that would result from, carrying broker-dealers reworking existing contracts.

An alternative considered in adopting the PAB-related amendments to Rule 15c3-1 would have required a broker-dealer, when calculating net capital, to deduct from net worth cash and securities held in a securities account at another broker-dealer, if the other broker-dealer does not treat the account, and the assets in the account, in compliance with the applicable PAB requirements of the rule.[650] Although the proposing release stated that the Commission did not expect broker-dealers to audit or examine their carrying broker-dealers to determine whether such firms were in compliance with the proposed rule, commenters expressed concern that the proposed rule text suggested that broker-dealers in fact would have such an obligation.[651] There were also concerns expressed that a broker-dealer should not be deemed to have violated the net capital rule because its carrying firm fails to properly perform requirements solely applicable to the carrying firm and that Rule 15c3-1 should be modified to clarify that cash and securities held in a securities account at another broker-dealer are not subject to the deduction specified in paragraph (c)(2)(iv)(E) of Rule 15c3-1.[652] In response to these concerns, the Commission has modified the language in the Rule 15c3-1 to eliminate the proposed capital charge that would have resulted from a failure of a carrying broker-dealer to comply with the PAB requirements. Instead, the Commission has adopted amendments providing that a broker-dealer need not deduct cash and securities held in a securities account at another broker-dealer, with one exception. As discussed in section II.A.2. of this release, the exception generally parallels the exclusions from the definition of PAB account in Rule 15c3-3.

(IV). Compliance Cost Estimates

The Commission is mindful of the compliance costs associated with the final PAB rule amendments. In particular, the Commission recognizes that, though many requirements of the PAB rule amendments being adopted by the Commission today are

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650 See section II.A.2.v. of this release.

651 See SIFMA 2 Letter.

652 Id.

incorporated from the PAIB Letter, there may be incremental imposed costs. For example, as discussed above in section II.A.2. of this release, because the possession and control and customer reserve account provisions of Rule 15c3-3 do not apply to PAB account holders by virtue of the definition of customer in the rule, the carrying broker-dealer is not restricted from using the securities and cash in those accounts for its own business purposes. Broker-dealers carrying PAB accounts will be required to comply with the final PAB rule amendments, in contrast to the provisions of the PAIB Letter, which are voluntary.[653] To the extent that carrying broker-dealers are not currently complying with the PAIB Letter, or to the extent the amendments as adopted differ from the PAIB Letter, they may incur incremental costs, including possible costs of capital as firms reallocate capital to comply with the rule amendments.

The requirement to enter into a subordination agreement with certain account holders to exclude them from the definition of PAB account,[654] the requirement to provide written notice to PAB account holders that their securities may be used in the ordinary course of the carrying broker-dealer's securities business,[655] the requirement to amend the standard PAB agreement templates,[656] and the need to update systems to

653 See PAIB Letter.

654 The internal hours for this requirement would likely be performed by an in-house Attorney at $379 per hour. Therefore the estimated internal cost would be calculated as follows: $379 per hour x 13,420 hours = $5,086,180. See also section IV.D.3. of this release.

655 The internal hours required to draft the notice would likely be performed by an in-house Attorney at $379 per hour. The estimated internal cost would be calculated as follows: $379 per hour x 610 hours = $231,190. The internal hours required to send out the notices would likely be performed by a Compliance Clerk at $63 per hour, resulting in an internal estimated cost calculated as follows: $63 per hour x 259 hours = $16,317. See also section IV.D.4. of this release.

656 The internal hours would likely be performed by an in-house Attorney at $379 per hour, resulting in an internal estimated cost calculated as follows: $379 per hour x 1,220 hours = $462,380. See also section IV.D.4. of this release.

implement the necessary changes[657] may also impose one-time costs. In addition, a carrying broker-dealer will incur postage costs as a result of the requirement to send written notices to PAB account holders regarding the use of their non-margin securities, as well as outside counsel fees to review the notice and standard PAB agreement template.[658] Finally, the requirements to compute and establish a separate reserve for PAB accounts will result in annual costs to carrying broker-dealers to the extent that these requirements will lengthen the time needed to compute and establish the PAB reserve account under the PAIB Letter. The Commission estimates that these requirements would impose one-time and annual costs in the aggregate of approximately \$6,434,840[659] and \$2,709,210,[660] respectively.

As noted above, the Commission requested comment on the proposed cost estimates.[661] In particular, the Commission requested comment on whether there would be additional costs to broker-dealers as a consequence of these proposals. The Commission requested comment on whether these requirements would result in such costs and, if so, how to quantify the costs. The Commission also requested comment on whether these proposals would impose costs on other market participants, including

657 The internal hours would likely be performed by a Senior Programmer at \$282 per hour, resulting in the estimated internal cost calculated as follows: \$282 per hour x 1,830 hours = \$516,060. See also section IV.D.4. of this release.

658 The estimated postage costs are calculated as follows: 1,551 notices x \$0.46 = \$713.46. To review and comment on the notice and PAB templates, the estimated outside counsel burden is \$122,000, in aggregate. See also section IV.D.4. of this release.

659 See section IV.D.3 and 4. of this release (\$5,086,180 + \$231,190 + \$16,317 + \$462,380 + \$516,060 + \$713.46 + \$122,000 = \$6,434,840.46).

660 The internal hours would likely be performed by a Financial Reporting Manager at \$294 per hour, resulting in the estimated internal cost calculated as follows: \$294 per hour x 9,215 hours = \$2,709,210. See also section IV.D.4. of this release.

661 See Amendments to Financial Responsibility Rules, 72 FR at 12880. In the proposing release, the Commission estimated that the one-time and annual costs to broker-dealers resulting from these proposed amendments would be \$603,000 and \$2,599,399. Id.

broker-dealer customers. Commenters were also asked to identify the metrics and sources of any empirical data that support their cost estimates. The Commission did not receive any comments in response to these requests.

b. Banks Where Special Reserve Deposits May Be Held

(I). Summary of Amendments

As amended, paragraph (e) of Rule 15c3-3 requires carrying broker-dealers to deposit cash or qualified securities into their customer or PAB reserve account, which must be maintained at a "bank."[662] As adopted, the final rule excludes when determining whether a broker-dealer maintains the minimum deposits required under paragraph (e) of Rule 15c3-3: (1) cash deposited with an affiliated bank; and (2) cash deposited at a "non-affiliated bank to the extent that the amount of the deposit exceeds 15% of the bank's equity capital as reported by the bank in its most recent Call Report or any successor form the bank is required to file by its appropriate Federal banking agency (as defined by Section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813))."

Under paragraph (f) of Rule 15c3-3, a broker-dealer is currently required to obtain a written contract from the bank wherein the bank agrees not to re-lend or hypothecate the qualified securities deposited into the reserve account.[663] This means that the bank cannot use the qualified securities in its business, which provides a measure of protection by requiring that the securities will be available to the broker-dealer if the bank falls into

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662 The term qualified securities is defined in paragraph (a)(6) of Rule 15c3-3 to mean securities issued by the United States or guaranteed by the United States with respect to principal and interest. 17 CFR 240.15c3-3(a)(6). The term bank is defined in paragraph (a)(7) of Rule 15c3-3 as a "bank as defined in section 3(a)(6) of the Act and will also mean any building and loan, savings and loan or similar banking institution subject to the supervision by a Federal banking authority." See paragraph (a)(7) to Rule 15c3-3, as adopted.

663 17 CFR 240.15c3-3(f).

financial difficulty. Cash deposits, however, may be freely used in the course of the bank's commercial activities. Therefore, because they do not have that same type of protection, the amendments to Rule 15c3-3 enhance customer protection by prohibiting a carrying broker-dealer from holding customer cash deposits at its affiliated bank and establishing requirements designed to avoid the situation where a carrying broker-dealer's cash deposits constitute a substantial portion of the bank's deposits.

Customer cash deposits may be at risk if a carrying broker-dealer does not exercise due diligence when assessing the financial soundness of an affiliated bank with the same degree of impartiality and care as it would with an unaffiliated bank. The situation where a broker-dealer's cash constitutes a substantial portion of a bank's deposits also poses a risk that some or all of the cash deposits may not be readily available for quick withdrawal by the broker-dealer. Depending on the relative size of the deposit, a lost deposit that is large relative to the broker-dealer's capital could cause the firm to fail.[664] If the broker-dealer fails and the deposit is not recovered, the SIPC fund may not recover advances that it has made for the purpose of returning customer assets. To the extent that customer losses exceed the SIPA advance limits, customers may suffer permanent losses.

The amendment to Rule 15c3-3 should serve to reduce certain risks to investors in the event of a bank's failure and, thereby, enhance customer protection. The Commission requested comment on available metrics to quantify these benefits and any other benefits a commenter may identify. Commenters were also requested to identify sources of empirical data that could be used for the proposed metrics. The Commission did not receive any comments in response to these requests.

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664 See Amendment to the Financial Responsibility Rules for Broker-Dealers, 72 FR at 12880.

(II). Baseline and Incremental Economic Effects

The current baseline for the amendment to paragraph (e) of Rule 15c3-3 is the existing customer protection requirements under Rule 15c3-3 and interpretations of the rule. Under paragraph (e) of Rule 15c3-3, broker-dealers are currently required to deposit cash or qualified securities into the customer reserve account, which must be maintained at a "bank." Under current interpretations, broker-dealers are limited in their reserve account cash deposits at parent or affiliated banks to 50% of the broker-dealer's excess net capital or 10% of the bank's equity capital.[665] Current interpretations also place similar restrictions on certain types of products at unaffiliated banks, including restrictions on concentration in money market deposit accounts and time deposits.[666]

As compared to the baseline, the Commission estimates that the incremental costs resulting from this amendment will be limited. Using FOCUS Report data, as of December 31, 2011, the Commission estimates that approximately 224 broker-dealers report reserve deposits.[667] A considerable proportion of these broker-dealers, including some of the largest firms, meet their deposit requirements using mostly qualified securities as opposed to cash and, therefore, will be marginally impacted by this amendment. For example, based on FOCUS Report data, as of December 31, 2011, for the 224 broker-dealers with reserve deposits, 79% of the total customer reserve requirement was met using qualified securities that could still be deposited at affiliated banks to meet customer reserve requirements, under the rule, as adopted. The remaining customer reserve requirement could be met by using qualified securities (as opposed to

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665 FINRA Interpretation 15c3-3(e)(3)/051.

666 See FINRA Interpretation 15c3-3(e)(1)/01 and /011.

667 This estimate is based on FOCUS Report filings the 2011 year end. It is an update from the proposing release estimate of 216 broker-dealers. See Amendments to Financial Responsibility Rules, 72 FR at 12881.

cash) and/or opening one or more accounts at unaffiliated banks, which would hold the cash within the limits permitted under the rule.

Relative to the current baseline, broker-dealers may incur two types of costs. The first type of cost relates to the costs of opening a new account at an unaffiliated bank for broker-dealers that currently hold cash in a reserve account at an affiliated bank. It is difficult to estimate the number of broker-dealers that hold cash reserve deposits at an affiliated bank because FOCUS Report data does not include the names of banks at which broker-dealers maintain their reserve accounts. Therefore, this data is not readily available to the Commission and commenters did not provide it. Based on an analysis of FOCUS Report data as of December 31, 2011, as well as available bank data,[668] the Commission, however, estimates that there are approximately 50 broker-dealers[669] that have an affiliated bank and cash in their customer reserve accounts.

The second type of cost relates to the costs of opening and maintaining multiple bank accounts if the cash deposit exceeds the 15% bank equity capital threshold as defined in the final rule, the likelihood of which the Commission expects to decrease because, with the relaxation of the bank equity capital threshold in the final rule, fewer broker-dealers will be required to open multiple accounts, relative to the current baseline. Broker-dealers, however, may replace these types of cost with the costs of converting cash into qualified securities to meet some or all of their reserve deposit requirements under Rule 15c3-3.

Moreover, in an attempt to reduce search costs, the potential exists that broker-dealers will select one or a few large unaffiliated banks or create networks on the basis of

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668 Data regarding a bank's equity capital as of the 2011 year end is publicly available at http://www2.fdic.gov/sdi/.

669 This estimate is based on a review of broker-dealers and affiliated banks based on legal names, as well as customer reserve account data, from FOCUS Report data.

reciprocity between broker-dealers and banks. This could result in a potential concentration of reserve cash deposits at a few banks. If as a result of such concentration, the carrying broker-dealer's deposit constitutes a substantial portion of the bank's total deposits, the risk increases that the bank may not have the liquidity to quickly return the deposit to the broker-dealer. Finally, the affiliated banks that are currently holding and using broker-dealer reserve cash deposits in the course of their business may incur funding costs, resulting from the possible transfer of cash deposits in the reserve account by broker-dealers to unaffiliated banks. These incremental funding costs to the affiliated banks may potentially be offset by the benefit of receiving cash deposits from unaffiliated broker-dealers.

(III). Alternatives

In adopting the final rule, the Commission considered several alternative approaches suggested by commenters. For example, commenters urged the Commission not to adopt the proposed prohibition on broker-dealers maintaining cash in reserve accounts at banks that are affiliates, stating that affiliated banks should be treated the same as unaffiliated banks because both groups are subject to the same financial regulation. One commenter noted that if a broker-dealer must move their reserve accounts to an unaffiliated bank this may require the broker-dealer to enter into new or additional banking relationships to comply with the amendment, which would increase the costs and administrative burdens of those reserve account funds.[670]

Several commenters suggested that the Commission allow cash reserve deposits without percentage restrictions at unaffiliated banks that are well-capitalized or for which

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670 See Raymond James 2 Letter.

a broker-dealer has performed due diligence.[671] One of these commenters cited a U.K. regulation that requires a firm selecting a bank to hold customer deposits to undertake due diligence on the bank taking into consideration a number of factors including: (1) the capital of the bank; (2) the amount of client money placed, as a proportion of the bank's capital and deposits; (3) the credit rating of the bank (if available); and (4) to the extent the information is available, the level of risk in the investment and loan activities undertaken by the bank and its affiliated companies.[672]

One commenter suggested that the Commission consider higher percentages for cash deposits at large money-center banks.[673] This commenter also stated that the percentage thresholds would negatively impact small broker-dealers because they would cross the 50% of excess net capital threshold at lower deposit levels.[674] Another commenter suggested that the Commission reconsider the proposed limitation on the amount of reserve account cash deposits that may be held at any one bank because the limitation would result in significant costs for broker-dealers and could potentially adversely impact the customers of broker-dealers.[675]

In the final rule, the language excluding customer and PAB reserve cash deposits at affiliated banks from counting towards a broker-dealer's reserve requirement is being adopted as proposed. As discussed further below, relative to the proposed rule, in the final rule, the Commission eliminated the proposed language that would have excluded the amount of the deposit at an unaffiliated bank that exceeded 50% of a broker-dealer's

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671 See Raymond James Letter; JP Morgan Letter; The Clearing House Letter; ABASA Letter; PNC Letter; Deutsche Bank Securities Letter; E*Trade Letter; JP Morgan 2 Letter.

672 See JP Morgan Letter.

673 See SIFMA 2 Letter; see also NIBA Letter.

674 See SIFMA 2 Letter.

675 See Raymond James 2 Letter.

excess net capital and based on the Commission's expert judgment, increased the bank equity capital threshold from 10% to 15%.[676]

In response to comments on the proposed rule (including comments suggesting a due diligence standard instead of an objective threshold), the Commission modified the final rule text in ways that are designed to substantially mitigate the costs identified by commenters. While the final rule amendment excludes the amount of any cash on deposit at an affiliated bank from being used to meet a broker-dealer's reserve requirement, the Commission eliminated the provision that would have excluded the amount of a deposit that exceeds 50% of a broker-dealer's excess net capital. This provision would have impacted small and mid-size broker-dealers when they deposited cash into large commercial banks since the cash deposits of these firms would exceed the broker-dealer excess net capital threshold before exceeding the bank equity capital threshold.

The elimination of the broker-dealer excess net capital threshold, combined with the increase of the bank equity capital threshold from 10% to 15%, is intended to substantially mitigate the costs, burdens and inefficiencies that commenters believed would be imposed on small and mid-size broker-dealers if such firms had to open multiple bank accounts as a result of the proposed rule. The rule, as adopted, will allow small and mid-size broker-dealers to maintain reserve accounts at one bank if they so choose, provided that the bank equity capital threshold is not exceeded. In contrast to the proposed thresholds, the final rule amendments should reduce the costs associated with implementing the necessary changes to systems, operations, and contractual agreements related to a broker-dealer's reserve bank accounts.

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676 See Amendments to Financial Responsibility Rules, 72 FR at 12864.

Further, in response to comments, increasing the threshold from 10% to 15% of the bank's equity capital is intended to address concerns raised by large broker-dealers with large deposit requirements that the 10% threshold would have resulted in increased costs of having to spread out deposits over a number of banks. The decrease in the cost of opening and maintaining multiple accounts resulting from the increased threshold to 15% of the bank's equity capital may counterbalance the increase in the cost of transferring cash deposits to an unaffiliated bank. In summary, the rule, as adopted, with an increase to a 15% threshold will, in the Commission's expert judgment, substantially mitigate the cost concerns raised by commenters, while still providing adequate customer protection consistent with the goal of the rule to promote the broker-dealer's ability to have quick access to the deposit.

With respect to qualified securities, one commenter argued that if a broker-dealer elects to use qualified securities as opposed to cash to meet its reserve requirement, the broker-dealer will likely have a significant amount of additional operational and transactional costs.[677] In addition, this commenter stated that while large broker-dealers may be able to reallocate existing trading desk, operational, regulatory reporting, and treasury functions to assist in ongoing maintenance activities, small and mid-sized broker-dealers may be required to hire additional staff to manage and maintain a securities portfolio.[678] In response to the commenter, many large broker-dealers already hold large amounts of their reserve deposits in qualified securities. As the commenter

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677 See JP Morgan Letter. The commenter noted that "[c]ertain broker-dealers may be required to hire additional staff to manage and maintain a securities portfolio." Id. "Managing a pool of qualified securities involves a myriad of tasks such as monitoring income collection, redemption processing, marking the securities to market, collateral substitutions and collateral segregation amongst other tasks." Id. The commenter did not quantify the costs of managing a pool of qualified securities or the costs of additional staff to manage the securities portfolio.

678 Id.

noted, if a large broker-dealer needed to shift more of its reserve deposits into qualified securities as opposed to cash, then these firms would most likely reallocate existing functions to assist in ongoing maintenance activities, thus offsetting any costs associated with the shift of reserve deposits into qualified securities. Finally, with the elimination of the 50% excess net capital threshold in the rule as amended, most small and mid-sized firms likely would not have ongoing costs, because under the final rules, all firms will now only have to comply with the bank equity capital threshold, which as confirmed by comments, would be of concern primarily for the large firms. Therefore, under the final rule, broker-dealers should not incur significant operational or transactional costs in complying with the amendment.[679]

(IV). Compliance Cost Estimates

In the proposing release, in quantifying costs, the Commission estimated that, of the 216 firms with reserve deposit requirements, only 11 broker-dealers would need to open new bank accounts or substitute cash for qualified securities in an existing reserve account,[680] and that this would result in an estimated total one-time cost of approximately $2,630 per broker-dealer[681] and approximately $28,930 in the aggregate.[682] As noted above, the Commission requested comment on the proposed cost estimates. Commenters were asked to identify the metrics and sources of any empirical data that support their

679 See JP Morgan Letter.

680 The Commission estimated in the proposing release that it would take approximately 10 hours to implement these changes. See Amendments to Financial Responsibility Rules, 72 FR at 12881.

681 Id.

682 11 broker-dealers x $2,630 = $28,930. Id. at 12881.

cost estimates. The Commission received seven comment letters in response to the proposed cost estimates.[683]

One commenter stated that the estimate is inaccurate and arbitrary, and does not take into account situations where a broker-dealer will need to establish numerous banking relationships.[684] Commenters also stated that the Commission failed to consider the ongoing costs of maintaining and monitoring multiple bank accounts.[685] One commenter believes that limiting Rule 15c3-3 deposits at a single bank to 50% of a broker-dealer's excess net capital will require a significant number of broker-dealers to open a number of additional cash and/or securities accounts and devote ongoing operational resources to the management of such accounts.[686] This commenter stated that at any one time, approximately 10% to 15% of broker-dealer customers could be impacted by the proposed rule change and many of those customers would be required to open accounts at multiple institutions.[687]

Commenters also stated that the proposed amendments would impose requirements whose costs are not adequately justified by their benefits and that the Commission substantially underestimated the costs.[688] One commenter noted that there are significant costs associated with implementing the necessary changes to systems, operations, and contractual agreements that the Commission did not appear to take into

683 See Curian Clearing Letter; SIFMA 2 Letter; Clearing House Letter; ABASA Letter; Deutsche Bank Letter; E*Trade Letter; P Morgan Letter.

684 See Curian Clearing Letter.

685 See Curian Clearing Letter; SIFMA 2 Letter; ABASA Letter; The Clearing House Letter; E*Trade Letter; JP Morgan Letter.

686 See JP Morgan Letter.

687 Id.

688 See SIFMA 2 Letter; ABASA Letter.

account.[689] Another commenter stated that the proposal also fails to quantify the inherent inefficiency of forcing broker-dealers to set up numerous bank accounts to satisfy the restrictive broker-dealer net capital and bank equity capital requirements.[690] Another commenter suggested that the Commission consider higher percentage limits for cash deposits held at very large money center banks, stating that a higher percentage limit would strike a better balance between the Commission's concerns regarding the safety of cash deposits and the substantial costs imposed on broker-dealers by overly restrictive deposit limitations.[691] Two commenters believed that the upfront and ongoing cost to each broker-dealer is far higher than the one-time estimate of $2,630 that the Commission estimated in the proposing release.[692] One commenter stated that conducting due diligence and opening new accounts and the ongoing monitoring and periodic re-evaluation of such additional accounts would require much more time than the 10 hours originally estimated by the Commission.[693] One commenter, referencing the SIFMA 2 Letter, stated that it agreed with SIFMA that the Commission significantly underestimated the cost of the proposal to smaller firms.[694] Finally, commenters did not provide the Commission with revised cost estimates or data related to these amendments.

In quantifying costs, the Commission is increasing its estimate of the number of broker-dealers that will likely incur the cost of opening a new account at an unaffiliated bank (or substituting cash for qualified securities in their reserve accounts) from the estimated 11 broker-dealers in the proposing release to 50 broker-dealers, as described

689 See SIFMA 2 Letter.

690 See ABASA Letter.

691 See SIFMA 2 Letter.

692 See JP Morgan Letter; E*Trade Letter.

693 See SIFMA 2 Letter.

694 See NIBA Letter.

proposed. The Commission received one comment in response to these requests.[704] The commenter stated that the proposed amendments would "greatly increase the cost of proprietary and customer short positions that were established and maintained in accordance with all applicable short sale regulations at the time entered."[705] However, this commenter did not quantify its cost estimates in terms of dollars, nor did it provide data to support its conclusion.

In response to this comment, modifications were made to the final rule that should mitigate the commenter's concern because the changes were designed to reduce operational burdens and to more closely align the final rule with current regulations related to short sales. More specifically, as discussed in section II.A.4., as adopted, final paragraph (d)(4) of Rule 15c3-3 contains a uniform 30 calendar day period and clarifies that the 30 calendar day period with respect to a syndicate short position established in connection with an offering does not begin to run until the underwriter's participation in the distribution is complete as determined pursuant to Rule 100(b) of Regulation M. In addition, the proposed amendment was designed to require that the aging process commence at the time a deficit in securities allocating to a short position arises. These modifications clarify the rule amendment, while continuing to strengthen customer protections under Rule 15c3-3.

Three commenters argued that the credit item added to the reserve formula computation when a customer's fully paid or excess margin securities are allocated to a short position provides the customer with adequate protection.[706] The Commission considered this alternative, as well as the cost concerns raised above, in adopting these

704 See Raymond James 2 Letter.

705 Id.

706 See First Clearing Letter; Deutsche Bank Securities Letter; Citigroup Letter.

final rule amendments. It has been a long-standing industry practice for carrying broker-dealers to use securities of PAB account holders in their business activities. In contrast, as stated above in section II.A.4. of this release, customers under Rule 15c3-3, which include the carrying broker-dealer's retail customers, have an expectation that the fully paid and excess margin securities reflected on their account statements are, in fact, in the possession or control of the carrying broker-dealer. However, as described above, this expectation may be frustrated where the securities are allocated to a short position carried by the broker-dealer, as the securities are not in the possession or control of the carrying broker-dealer. This gap in the existing rule, in effect, permits the broker-dealer to partially monetize the Rule 15c3-3 customer's securities. Also, under some circumstances (e.g., a change in the market value of the securities), the amount the broker-dealer may have on deposit in the reserve account as a consequence of the credit item may be less than the value of the securities. Consequently, if the broker-dealer fails, sufficient funds may not be readily available to purchase the securities to return them to customers. The use of customer securities in this manner is contrary to the customer protection goals of Rule 15c3-3 and the expectations of a broker-dealer's customers.[707] Therefore, the Commission believes that any increased costs related to this final rule amendment are justified by the enhancements to the customer protection goals of Rule 15c3-3. For these reasons, and those discussed throughout this release, the Commission is adopting the amendment.

The Commission estimates this requirement will result in a one-time cost to firms that carry customer securities to update systems for complying with the possession or control requirements in Rule 15c3-3. Based on FOCUS Report data, as of December 31,

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[707] See section II.A.1. of this release.

2011, the Commission estimates that approximately 287 broker-dealers carry customer accounts.[708] The Commission further estimates these firms will spend, on average, approximately 40 hours of employee resources per firm updating their systems to implement changes that will be necessitated by the amendment.[709] Therefore, the Commission estimates that the average cost per firm to make these changes will be approximately $11,280.[710] The Commission estimates that the total one-time cost to broker-dealers will be approximately $3,237,360.[711]

In addition to systems costs, broker-dealers may incur other costs to comply with the rule amendment because they may be required to change their existing practices. For example, the amendment could result in some broker-dealers borrowing securities to cover proprietary short positions rather than using customer securities, resulting in increased borrowing costs. However, under the current baseline, when broker-dealers use customer securities to cover short positions they are required to add a credit item in the Rule 15c3-3 reserve formula equal to the value of the securities. This credit item can result in higher reserve deposit requirements, which must be made using the broker-dealer's own capital. Thus, in response to commenters concerns regarding the costs of this amendments,[712] the increased costs associated with having to borrow securities to cover a short position likely will be offset by decreased costs associated with devoting capital to customer reserve requirements.

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708 This is an update of the proposing release estimate of 350 broker-dealers. See Amendments to Financial Responsibility Rules, 72 FR at 12881.

709 For the purposes of this cost analysis, the Commission estimates that this work will be undertaken by a Senior Programmer at $282 per hour.

710 $282 per hour x 40 hours = $11,280.

711 287 broker-dealers x $11,280 = $3,237,360. In the proposing release, the Commission estimated that the total one-time cost to broker-dealers would be $3,752,000. See Amendments to Financial Responsibility Rules, 72 FR at 12881.

712 See First Clearing Letter; Deutsche Bank Securities Letter; Citigroup Letter.

d. Importation of Rule 15c3-2 Requirements into Rule 15c3-3

Today's amendment to Rules 15c3-2 and 15c3-3 imports requirements in Rule 15c3-2[713] to Rule 15c3-3 and eliminates Rule 15c3-2 as a separate rule in the Code of Federal Regulations.[714] Rule 15c3-2 requires a broker-dealer holding free credit balances to provide its customers (defined as any person other than a broker-dealer) at least once every three months with a statement of the amount due the customer and a notice that the funds are not being segregated, but rather are being used in the broker-dealer's business and that the funds are payable on demand. The Commission believes it is appropriate to eliminate Rule 15c3-2 because it is largely irrelevant in light of the requirements of Rule 15c3-3 (which was adopted after Rule 15c3-2).

This amendment will benefit broker-dealers by streamlining and consolidating relevant provisions of Rule 15c3-2 into Rule 15c3-3, promoting efficiency in the rulemaking process while not modifying the legal requirements. These provisions include the requirements that broker-dealers inform customers of the amounts due to them and that such amounts are payable on demand, which have been moved to new paragraph (j)(1) of Rule 15c3-3.[715] Finally, the definition of customer for purposes of the imported Rule 15c3-2 requirements will be the definition of customer in Rule 15c3-3,[716] which is somewhat narrower than the definition in Rule 15c3-2. The application of the

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713 17 CFR 240.15c3-2.

714 See Amendments to Financial Responsibility Rules, 72 FR at 12867.

715 The provisions in Rule 15c3-2 that are being re-codified in Rule 15c3-3, include the requirements that broker-dealers inform customers of the amounts due to them and that such amounts be payable on demand. In addition, Rule 15c3-2 contains an exemption for broker-dealers that are also banking institutions supervised by a Federal authority. This exemption will not be imported into Rule 15c3-3 because there are no broker-dealers that fit within this exemption.

716 17 CFR 240.15c3-3(a)(1).

narrower definition of customer in Rule 15c3-3 should not increase related costs. Alternatively, it may result in decreased costs because the narrowing of the rule's scope may reduce the compliance burden on broker-dealers.

The Commission considered reasonable alternatives with regard to the proposed deletion of Rule 15c3-2 and the importation of certain requirements into paragraph (j)(1) of Rule 15c3-3. Not adopting the rule amendment and thus leaving Rule 15c3-2 in the Code of Federal Regulations was a considered alternative. The Commission, however, believes consolidating the relevant provisions in Rule 15c3-3 is a more appropriate alternative because it promotes efficiency in the rulemaking process, and streamlines the Commission's customer protection rules.

The amendments – because they only re-codify provisions of Rule 15c3-2 into Rule 15c3-3[717] – should not be a new source of costs as compared to the baseline because these provisions are continuations of existing requirements. However, the re-codification and placement of these provisions into Rule 15c3-3 may cause broker-dealers to review and update their existing procedures from time-to-time and, therefore, could result in incremental costs.[718]

e. Treatment of Free Credit Balances

(I). Summary of Amendments

Today, the Commission is adopting the amendment to add new paragraph (j)(2) to Rule 15c3-3 that prohibits a broker-dealer from converting, investing, or transferring to another account or institution, free credit balances held in a customer's account except as provided in paragraphs (j)(2)(i) and (ii) of the rule. As adopted, the amendment defines a

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717 See paragraph (j)(1) of Rule 15c3-3.

718 Based on the estimated hour burdens in section IV.D.5. of this release, there could be one-time internal costs of $1,464,750 and annual internal costs of $585,900, if the review and update is performed by a Compliance Attorney at $310 per hour.

Sweep Program as "a service provided by a broker or dealer where it offers to its customer the option to automatically transfer free credit balances in the securities account of the customer to either a money market mutual fund product as described in § 270.2a-7 of this chapter or an account at a bank whose deposits are insured by the Federal Deposit Insurance Corporation."[719]

With regard to the treatment of free credit balances outside the context of a Sweep Program, paragraph (j)(2)(i) of Rule 15c3-3 permits a broker-dealer to invest or transfer to another account or institution free credit balances held in a customer's account only upon a specific order, authorization, or draft from the customer, and only in the manner, and under the terms and conditions, specified in the order, authorization, or draft.[720] Two commenters suggested that the proposal should be clarified to permit a broker-dealer to obtain a one-time consent to ongoing transfers of any free credit balances to a customer to another account, entity or product (outside of a Sweep Program). As discussed above, this scenario was covered by the proposed rule and is being adopted under paragraph (j)(2)(i) of Rule 15c3-3.

With regard to the treatment of free credit balances in the context of a Sweep Program, new paragraph (j)(2)(ii) of Rule 15c3-3 requires broker-dealers to meet conditions that vary depending on the date when a customer's account was opened. For accounts opened on or after the effective date of the rule, a broker-dealer must meet the conditions of (j)(2)(ii)(A) and (B) of the rule. For any account, the broker-dealer must meet the conditions in paragraphs (j)(2)(ii)(B) of the rule. Under paragraph (j)(2)(ii)(A), for accounts opened on or after the effective date of the rule, the amendment to Rule 15c3-3 requires a broker-dealer to obtain the written affirmative consent of a new

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719 See paragraph (a)(17) of Rule 15c3-3.

720 See Amendments to Financial Responsibility Rules, 72 FR at 12866.

customer to have free credit balances in the customer's securities account included in the Sweep Program. Under paragraph (j)(2)(ii)(B), a broker-dealer must comply with the remaining three conditions for any account: (1) providing the customer with the disclosures and notices regarding the Sweep Program required by each SRO of which the broker-dealer is a member; (2) providing notice to the customer, as part of the customer's quarterly statement of account, that the balance in the bank deposit account or shares of the money market mutual funds in which the customer has a beneficial interest can be liquidated on the customer's order and the proceeds returned to the securities account or remitted to the customer; and (3) providing the customer written notice at least 30 calendar days before the broker-dealer makes certain changes to the Sweep Program and describes the options available to the customer if the customer does not accept the new terms and conditions or product.[721]

Free credit balances constitute money that a broker-dealer owes its customers. Customers may maintain these balances at the broker-dealer in anticipation of future stock purchases. Under current practices, customer account agreements set forth how the broker-dealer will invest these balances. For example, the broker-dealer may sweep them into a money market fund or, alternatively, pay an amount of interest on the funds. On occasion, broker-dealers may change the product to which a customer's free credit balances are swept – most frequently from a money market fund to an interest bearing bank account. Because of differences in these two types of products, there may be investment consequences when changing from one to the other.[722]

[721] See new paragraph (j)(ii)(B)(1)–(3) of Rule 15c3-3, as adopted.

[722] Differences include the type of protection afforded the customer in the event of an insolvency, and the amount of interest or dividends earned on the product. See Amendments to Financial Responsibility Rules, 72 FR at 12866.

New paragraph (j)(2) to Rule 15c3-3 should serve to enhance customer protection by prohibiting a broker-dealer from transforming the credit risk faced by a customer through transfer of the broker-dealer's obligation to another entity without the required notice to, or approval from, the customer.

(II). Baseline and Incremental Economic Effects

In the absence of new paragraph (j)(2) of Rule 15c3-3, current practices represent the existing baseline. As compared to the baseline, new paragraph (j)(2) to Rule 15c3-3 will enhance customer protection by requiring broker-dealers to obtain the written affirmative consent of a new customer before including a customer's free credit balances in a Sweep Program, as well as to provide certain disclosures and notices to all customers with regard to the broker-dealer's Sweep Program. The Commission requested comment on available metrics to quantify these benefits and any other benefits a commenter may identify. The Commission did not receive any comments in response to this request.

Relative to the baseline, broker-dealers carrying free credit balances will incur incremental one-time and periodic costs (e.g., systems changes, outside counsel, and notification costs) to comply with new paragraph (j)(2) of Rule 15c3-3. The Commission requested comment on whether there would be additional costs to broker-dealers as a consequence of the proposals. The Commission also requested comment on whether the proposals would impose costs on other market participants, including broker-dealer customers. Commenters were requested to identify sources of empirical data that could be used for the metrics they proposed. The Commission did not receive any comments in response to these requests.

(III). Alternatives

As stated above in section II.A.5.ii. of this release, the Commission is adopting new paragraph (j)(2) to Rule 15c3-3 with substantial modifications from the proposed rule in response to comments and to clarify certain portions of the rule.

Commenters generally agreed with the fundamental principle embodied in the proposal – that customer free credit balances should not be transferred from an obligation of the broker-dealer to an obligation of another entity without the customer's authorization.[723] Other commenters supported the proposed disclosures but suggested additional disclosures be made to customers including clarification with respect to other protections available to the customer.[724] Two commenters stated that the practice of sweep programs should be banned entirely or that the Commission should adopt a "harder stance" and require more than just disclosure.[725] One commenter responded to the Commission's request for comment as to the cost burdens that would result if the first condition (set forth in proposed paragraph (j)(2)(ii)(A)) to obtain a new customer's prior agreement were to be applied to existing customers. The commenter stated that such costs would be substantial because broker-dealers would be required to amend their agreements with all existing customers.[726] One commenter stated that the amendments in the proposing release did not adequately address situations in which broker-dealers

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723 See SIFMA 2 Letter; First Clearing Letter; Pace Letter.

724 See SIPC Letter.

725 See Ellis Letter; Dworkin Letter. One commenter stated that broker-dealers profit from "excessive" fees charged to customers who opt out of the sweep programs. See Ellis Letter. The second commenter suggested that the broker-dealer's "customer has been effectively denied the opportunity to opt out of bank account sweeps by [the broker-dealer] preventing him or her from utilizing any other vehicle to park his or her free credit balances . . . ." See Dworkin Letter.

726 See SIFMA 2 Letter.

change customer account elections without first obtaining customer authorization.[727] Commenters also raised concerns about limitations on the types of products broker-dealers can use for sweep arrangements.[728]

The Commission considered alternatives, including whether to adopt the amendments and, in adopting the final rule, the Commission modified the language in the final rule in response to commenters and to clarify its application. In response to comments that the Commission should ban sweep programs or adopt a "harder stance," the Commission notes that sweep programs provide a mechanism for excess cash in a customer's securities account to be held in a manner that allows the customer to earn interest on the funds but retain the flexibility to quickly access that cash to purchase securities or withdraw it.[729] In effect, transferring this excess cash to a bank account or money market fund is an alternative to retaining a credit balance in the customer's securities account. The final rule is intended to appropriately balance commenters' concerns while providing broker-dealers with flexibility in the operation of sweep programs.[730]

In addition, in response to the comments that the Commission should not limit the types of products broker-dealers can use for sweep accounts to money market funds and bank deposit products,[731] as discussed above in section II.A.5.ii. of this release, the Commission does not view sweep accounts as a mechanism for investing customers' excess cash in longer term or more volatile assets without specific consent from

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727 See Waddell Letter.

728 See SIFMA 2 Letter; First Clearing Letter; Raymond James 2 Letter.

729 See Ellis Letter; Dworkin Letter.

730 See Ellis Letter; Dworkin Letter; Waddell Letter.

731 See SIFMA 2 Letter; First Clearing Letter; Raymond James 2 Letter.

customers. Therefore, the Commission believes that it is not appropriate to modify the final rule amendments to expand the permitted products for Sweep Programs.

In response to commenters' concern regarding cost burdens resulting from the application of the affirmative consent requirement to existing accounts, the final rule retains the proposed requirement to require a broker-dealer to obtain a customer's prior affirmative consent for accounts opened on or after the effective date of the rule before transferring the customer's free credit balance to a product in the firm's Sweep Program, and makes explicit that the consent must be in writing. This will provide new customers with the opportunity to evaluate the broker-dealer's Sweep Program before consenting to the transfer of the customer's free credit balances into such program. In the proposing release, the Commission requested comment as to the cost burdens that would result if the condition to obtain a new customer's prior agreement were to be applied to existing customers. One commenter stated that such costs would be substantial because broker-dealers would be required to amend their agreements with existing customers. The Commission considered this alternative and agrees with the commenter that requiring a broker-dealer to amend its existing agreements with customers would be substantial. Therefore, to address the burden that would have been associated with having broker-dealers re-paper existing account documentation, the prior affirmative consent requirement will continue to apply only to accounts opened on or after the effective date of the rule.

However, as discussed above in section II.A.5.ii. of this release, all customers will be provided written notice at least 30 days before a broker-dealer changes certain terms and conditions or products of its Sweep Program. This notice must also contain a description of the options available to the customer if the customer does not accept the new terms and conditions or product. This is intended to benefit new and existing customers by giving them sufficient opportunity to make an informed decision and evaluate the effects of changes in the terms and conditions or product of the sweep program and the options available.

(IV). Compliance Cost Estimates

Broker-dealers will incur one-time and periodic costs to implement the changes necessitated by the amendment. These changes include providing customers with the disclosures and notices (including the description of the options available if a customer does not accept the new terms or conditions or product) in order to have the flexibility to change the treatment of customers' free credit balances. This would require that broker-dealers update their systems (including processes for generating customer account statements) to incorporate the necessary changes.[732] Additionally, broker-dealers may incur one-time costs of outside counsel in implementing these system changes, particularly with respect to the language in the disclosures and notices required by paragraph (j)(2) of the rule.

The Commission further estimates that broker-dealers will incur costs to process an affirmative consent for new customers.[733] Specifically, the Commission estimates that broker-dealers may incur aggregate one-time and annual costs of approximately $14.4 million[734] and $23.2 million,[735] respectively related to the changes necessitated by these rule amendments.[736]

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732 The internal hours would likely be performed by a senior programmer. Therefore, the estimated internal costs for this hour burden would be calculated as follows: Senior Programmer at $282 per hours x 37,800 hours = $10,659,600. See section IV.D.6. of this release.

733 The internal hours would likely be performed by a compliance clerk. Therefore, the estimated internal costs for this hour burden would be calculated as follows: Compliance Clerk at $63 per hour x 368,311 hours = $23,203,593. See section IV.D.6. of this release.

734 See section IV.D.6. of this release. ($10,659,600 + $3,780,000 (outside counsel costs) = $14,439,600).

f. "Proprietary Accounts" under the Commodity Exchange Act

Some broker-dealers also are registered as futures commission merchants under the CEA. These firms carry both securities and commodities accounts for customers. The definition of free credit balances in paragraph (a)(8) of Rule 15c3-3 does not include funds carried in commodities accounts that are segregated in accordance with the requirements of the CEA.[737] However, regulations promulgated under the CEA exclude proprietary accounts from the CEA's segregation requirements.[738] This exclusion from the segregation requirements under the CEA has raised a question as to whether a broker-dealer must treat payables to customers in proprietary commodities accounts as "free credit balances" when performing a customer reserve computation.[739] For these reasons, the specific amendment to the definition of the term free credit balances in paragraph (a)(8) of Rule 15c3-3 clarifies that funds held in a commodities account meeting the definition of a proprietary account under CEA regulations are not to be included as free credit balances in the customer reserve formula.

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735 Id. ($23,203,593).

736 In the proposing release, the Commission estimated that broker-dealers would incur one-time costs of approximately $3.68 million ($2.68 million internal costs and $1.0 million for outside counsel) and annual costs of approximately $24.6 million. See Amendments to Financial Responsibility Rules, 72 FR at 12882.

737 17 CFR 240.15c3-3(a)(8).

738 Rule 1.20 requires a futures commission merchant to segregate customer funds. See 17 CFR 1.20. Rule 1.3(k) defines the term customer for this purpose. See 17 CFR 1.3(k). The definition of customer excludes persons who own or hold a proprietary account as that term is defined in Rule 1.3(y). See 17 CFR 1.3(y). Generally, the definition of proprietary account refers to persons who have an ownership interest in the futures commission merchant. Id.

739 See Part 241-Interpretive Releases Relating to the Securities Exchange Act of 1934 and General Rules and Regulations Thereunder, Exchange Act Release No. 9922 (Jan. 2, 1973), 38 FR 1737 (Jan. 18, 1973) (interpreting the credit balance used in Item 1 of the Rule 15c3-3a formula "to include the net balance due to customers in non-regulated commodities accounts reduced by any deposits of cash or securities with any clearing organization or clearing broker in connection with the open contracts in such accounts").

One commenter requested that the Commission clarify that the relevant definition of proprietary account for purposes of this amendment will be the definition contained in 17 CFR 1.3(y).[740] The Commission considered this alternative suggested by the commenter. While Rule 1.3(y) under the CEA currently contains the relevant definition of proprietary account for the purpose of the amendment, the definition could be codified in a different rule in the future. Consequently, the Commission is adopting the final rule amendment to paragraph (a)(8) of Rule 15c3-3, as proposed. Thus, the final rule does not include specific references to a specific rule. Rather, the amendment to paragraph (a)(8) to Rule 15c3-3, as adopted, more generally refers to a "proprietary account as that term is defined in regulations under the Commodity Exchange Act."

In addition, one commenter stated that, due to the changes to the swap markets mandated by Title VII of the Dodd-Frank Act, swap accounts (in addition to commodities accounts) are now subject to customer protection rules under the CEA. This commenter suggested that the Commission make it clear that funds in swap accounts also do not constitute free credit balances, whether those funds are required to be segregated by rules under the CEA (e.g., cleared swap accounts or uncleared swap accounts that have opted for segregation) or excepted from segregation under the CEA (e.g., cleared swaps proprietary accounts or uncleared swap accounts that have not opted for segregation). The commenter noted this treatment "would be consistent with the treatment of funds in commodities accounts and with the regulation of swap accounts under the CEA."[741] The Commission agrees there may be additional accounts under the CEA, as amended by the Dodd-Frank Act that should explicitly be excluded from the definition of free credit balances under Rule 15c3-3. However, the amendments today are designed to clarify the

[740] See SIFMA 2 Letter.

[741] Id.

specific question raised with respect to the treatment of funds in proprietary commodities accounts under the CEA and, consequently, the suggestions by this commenter are beyond the scope of this rulemaking.

The Commission considered reasonable alternatives in adopting the final rule amendment. These alternatives included adopting the proposed rule, with modifications suggested by commenters described above, as well as leaving the current rule in place without the amendments. The Commission believes that the adoption of the final rule is the more appropriate approach at this time because the final rule amendment will benefit broker-dealers that are registered as futures commission merchants by eliminating any ambiguity with respect to such accounts and avoiding situations where they unnecessarily increase reserve amounts.

The Commission does not anticipate that the amendments will result in any costs to broker-dealers and, as funds in certain commodities accounts are not protected under SIPA, will not expose the SIPC fund to increased liabilities. Because this amendment is intended to be a clarification of existing interpretations, broker-dealers are not expected to incur additional costs against the baseline of current Rule 15c3-3 and its existing interpretations. This clarification is designed to provide broker-dealers with more certainty as to the Commission's stated legal requirements.

ii. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

The amendments to the customer protection rule (Rule 15c3-3) regarding PAB accounts,[742] cash deposits at special reserve bank accounts,[743] allocation of short

[742] See section II.A.2. of this release.

[743] See section II.A.3. of this release.

positions,[744] the treatment of free credit balances,[745] and the clarification of the treatment of proprietary accounts under the CEA are designed to protect and preserve customer property held at broker-dealers.[746] These protections are primarily intended to reduce the risks borne by investors.

In particular, first, the final rule amendment on PAB accounts is intended to fill a gap in the definition of customer between Rule 15c3-3 and SIPA, reducing the risk that customers could face losses in the case of a liquidation of a carrying broker-dealer. The final rule codifies many of the provisions of the PAIB Letter. The Commission believes that it is prudent, and will provide greater regulatory clarity, to incorporate into Rule 15c3-3 specified provisions of the PAIB Letter. Further, the Commission understands that the relief in the PAIB Letter has been widely, if not universally, utilized by broker-dealers that carry customer accounts. Thus, the benefits associated with codifying specified provisions of the PAIB Letter will continue to provide SIPA customers with the protections currently provided by broker-dealers complying with the PAIB Letter. Setting forth these requirements in a Commission rule will benefit the securities markets by helping to diminish the risks and incidences of non-compliance.

Second, the final rule amendments regarding the banks where reserve deposits may be held are intended to protect customers' cash deposits by mitigating the risk that the funds in the customer reserve account will not be readily available to be withdrawn by the broker-dealer.

Third, the final rule amendments regarding the allocation of customers' fully paid and excess margin securities to a broker-dealer short position are designed to enhance the

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744 See section II.A.4. of this release.

745 See section II.A.5.ii. of this release.

746 See section II.A.6.i. of this release.

customer protection goals of Rule 15c3-3, which seek to ensure that broker-dealers do not use customer assets for proprietary activities.

Fourth, the final rule amendments regarding the importation of Rule 15c3-2 requirements into paragraph (j)(1) of Rule 15c3-3 and the elimination of Rule 15c3-2 streamline the regulatory requirements for broker-dealers. Also, the addition of new paragraph (j)(2) to Rule 15c3-3 is intended to protect a customer's free credit balances from being swept to products or programs without the appropriate approval, notice or disclosure.

Fifth, the final rule amendment establishing that the funds in certain commodities accounts need not be treated as free credit balances or other credit balances may enhance efficiency at the broker-dealers by freeing up cash that may have been required to be deposited into a broker-dealer's customer reserve account, and clarifying an ambiguity in Rule 15c3-3.

By strengthening requirements designed to protect customer assets, these amendments will mitigate potential exposure to the SIPC fund that is used to make advances to customers whose securities or cash are unable to be returned by a failed broker-dealer. To the extent that the amendments to Rule 15c3-3 achieve this goal, investors might be more willing to transact business in securities with broker-dealers. The possible positive effects on investor participation in the securities markets may promote capital formation as investor assets are able to be allocated more efficiently across the opportunity set.

As discussed above, the Commission recognizes that the amendments to Rule 15c3-3 adopted today may impose certain costs on broker-dealers that might place a burden on competition among broker-dealers. However, the Commission is of the opinion that these costs are justified by the significant benefits described in this economic analysis, as well as in the discussion of the rule amendments above. Amendments to Rule 15c3-3 should not place a burden on competition for non-carrying broker-dealers, which are generally small broker-dealers, because the amendments primarily affect broker-dealers that perform PAB and customer reserve computations, carry customer accounts, and carry free credit balances. In addition, for those carrying broker-dealers that already follow the PAIB Letter, any difference from the baseline with regard to cost burdens should be marginal. In sum, the costs of compliance resulting from the requirements in the amendments to Rule 15c3-3 should not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act in light of the benefits discussed above.

2. Holding Futures Positions in a Securities Portfolio Margining Account

i. Economic Analysis

As discussed in section II.B. of this release, the Commission is adopting amendments to Rule 15c3-3 to accommodate futures positions in a securities account that is margined on a portfolio basis. The amendments revise the definition of free credit balances and other credit balances in paragraphs (a)(8) and (a)(9) of Rule 15c3-3, respectively, by expanding these definitions to include funds in a portfolio margin account relating to certain futures and futures options positions. Consequently, as part of free credit balances and other credit balances, these funds will be included as a credit item on the credit side of the customer reserve formula. The Commission is also adopting, as proposed, an amendment to Rule 15c3-3a Item 14 that permits a broker-dealer to include as a debit item, on the debit side of the customer reserve formula, the amount of customer margin required and on deposit at a derivatives clearing organization related to futures positions carried in a portfolio margin account.

The amendments are designed to provide greater protection to customers with portfolio margin accounts, through the reserve requirements of Rule 15c3-3 and SIPA, by requiring a broker-dealer to include all cash balances (including portfolio margin cash balances) of its customers' securities accounts in the computation of the customer reserve. The customer reserve computation under Rule 15c3-3 is designed to ensure that the funds a broker-dealer owes to customers are available to be returned to customers in the event the broker-dealer fails.

Subsequent to the Commission's proposals, the Dodd-Frank Act amended the definitions of customer, customer property, and net equity in section 16 of SIPA to take into account futures and options on futures held in a portfolio margin account carried as a securities account pursuant to a Commission-approved portfolio margining program.[747] As a result, persons who hold futures positions in a portfolio margining account carried as a securities account are now entitled to SIPA protection.

While the Dodd-Frank Act addressed the protection under SIPA of futures and futures options held in a securities portfolio margin account, the Commission's amendments to Rule 15c3-3 and 15c3-3a will still serve an important purpose. In particular, they complement the Dodd-Frank SIPA amendments, and will provide additional protections to customers by requiring broker-dealers to treat these futures positions in accordance with the segregation requirements in Rules 15c3-3 and 15c3-3a. Consequently, the Commission is adopting the amendments with modifications to address, in part, comments. As noted above, the requirements of Rule 15c3-3 and Rule 15c3-3a are designed to enable the prompt return of customer securities and cash in the event the broker-dealer falls into financial difficulty or becomes insolvent. The goal is to

[747] See Pub. L. No. 111–203 § 983.

place a broker-dealer in a position where it is able to wind down in an orderly self-liquidation without the need for financial assistance from SIPC.

The Commission received six comments on the proposed amendments.[748] Three commenters generally supported the amendments.[749] One commenter supported the development of rules for portfolio margining and the Commission's effort to provide greater legal certainty regarding the SIPA treatment of futures positions in a portfolio margin account.[750] This commenter, however, in a subsequent comment letter, stated that this amendment is no longer necessary in light of the Dodd-Frank Act amendments, and recommended that the Commission withdraw it.[751] Another commenter stated that the Commission's proposal is premature in that the inclusion of futures in a portfolio margin account, which is a securities account, would conflict with the segregation provisions under the CEA[752] and that SIPC has not determined that protection should be extended to futures.[753] Commenting in 2007 before the adoption of the Dodd-Frank Act, SIPC stated that the proposed rules seek to extend SIPC protection to all positions in the portfolio margin account, irrespective of whether the positions are securities under SIPA or are on deposit in connection with a securities transaction.[754]

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748 See SIFMA 2 Letter; CME Letter; SIPC Letter; Citigroup Letter; American Bar Association Letter; SIFMA 4 Letter.

749 See SIFMA 2 Letter; Citigroup Letter; American Bar Association Letter.

750 See SIFMA 2 Letter.

751 See SIFMA 4 Letter.

752 See, e.g., 17 CFR 1.20-1.29.

753 See CME Letter; see also SIPC Letter (expressing "grave concerns" about potential conflict between the proposed amendments and SIPA).

754 See SIPC Letter. SIPC also urged the Commission to reconsider its adoption of the portfolio margin proposals, stating that if the changes are in order, the Commission should seek to have them made by legislative amendment and not rulemaking.

The Commission agrees, in part, with the commenter who stated that the Dodd-Frank Act SIPA amendments make the Commission's proposed amendments to Rules 15c3-3 and 15c3-3a unnecessary.[755] As noted above, the definitions of customer, customer property, and net equity in section 16 of SIPA were amended by the Dodd-Frank Act to take into account futures and options on futures held in a portfolio margin account carried as a securities account pursuant to a Commission-approved portfolio margining program.[756] Consequently, in a proceeding under SIPA, futures and options on futures positions held in a portfolio margin account carried as a securities account would be included in determining a customer's net equity claim.[757] Therefore, the proposed amendment relating to the unrealized value of a futures option is not necessary to achieve the objective of providing SIPA protection for such positions. As a result, the Commission is modifying the final rule to delete the proposed language in paragraph (a)(8) of Rule 15c3-3 that would have treated the unrealized value of a futures option in a portfolio margin account on the filing date of a SIPA proceeding as a free credit balance for purposes of Rule 15c3-3.[758]

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755 See SIFMA 4 Letter.

756 See Pub. L. No. 111–203 § 983.

757 Under the Dodd-Frank Act SIPA amendments, a customer's net equity now includes all positions in futures contracts and options on futures contracts held in a portfolio margining account carried as a securities account pursuant to a portfolio margining program approved by the Commission, including all property collateralizing such positions, to the extent that such property is not otherwise included herein. See 15 U.S.C. § 78lll(11)(A)(ii). Further, the amendments provided that a claim for a commodity futures contract received, acquired, or held in a portfolio margining account pursuant to a portfolio margining program approved by the Commission or a claim for a security futures contract, shall be deemed to be a claim with respect to such contract as of the filing date, and such claim shall be treated as a claim for cash. See 15 U.S.C. § 78lll(11).

758 Specifically, the final rule does not include the proposed language: ", and, in the event the broker-dealer is the subject of a proceeding under SIPA, the market value as of the "filing date" as that term is defined in SIPA (15 U.S.C. 78lll(7)) of any long options on futures contracts."

While the legislation provides additional certainty with respect to how futures in a portfolio margin account would be treated in a SIPA liquidation, the Commission's amendments will require that positions are subject to the protections of Rule 15c3-3, thus enhancing customer protection. Therefore, while the Commission has considered the suggested alternatives in developing the final rule amendments (including not adopting the amendments), the Commission has determined that adopting the portfolio margining amendments was a more appropriate approach in furtherance of enhancing customer protection.

The Commission requested comment on available metrics to quantify these benefits and any other benefits a commenter may identify, including the identification of sources of empirical data that could be used for such metrics. The Commission did not receive any comments in response to these requests.

Current SRO portfolio margin rules permit futures to be held in a securities portfolio margin account.[759] However, pending further regulatory action by the Commission and the CFTC, the ability to combine securities and futures products into a single portfolio margin account will be unavailable.[760] Therefore, under the current baseline of SRO portfolio margin rules, with the inclusion of only securities positions in the securities account, this amendment would have no effect as compared to the baseline

759 See, e.g., FINRA Rule 4210.

760 See Section 713 of the Dodd-Frank Act. Section 713 of the Dodd-Frank Act amends the Exchange Act and CEA to facilitate portfolio margining by allowing cash and securities to be held in a futures account and futures and options on futures and related collateral to be held in a securities account by a dually-registered broker-dealer and futures commission merchant pursuant to an approved portfolio margin program, subject to certain requirements, including regulatory action by the Commission and CFTC (pursuant to an exemption, or by rule or regulation). See generally, A Joint Report of the SEC and the CFTC on Harmonization of Regulation (Oct. 19, 2009).

until the Commission and CFTC take such further action with respect to portfolio margining.[761]

The requirements imposed by the portfolio margin amendments will be elective. The requirements will apply only to broker-dealers choosing to offer their customers portfolio margin accounts. The Commission estimates that approximately 35 broker-dealers will elect to offer their customers portfolio margin accounts that will include futures and futures options.[762] The amendment to the definition of free credit balances in Rule 15c3-3 will require broker-dealers to include in the reserve formula credit balances related to futures positions in a portfolio margin account. The amendment to Rule 15c3-3a Item 14 in the reserve formula will enable broker-dealers to include as a debit item the amount of customer margin required and on deposit at a derivatives clearing organization. Accordingly, these amendments will require changes to the systems broker-dealers use to compute and account for their reserve requirements. Consistent with the proposing release,[763] the Commission assumes that the responsibility for updating these systems will be undertaken by a Senior Programmer.[764] Therefore, the Commission estimates that the program and systems changes would result, on average, in

761 See generally, A Joint Report of the SEC and the CFTC on Harmonization of Regulation (Oct. 19, 2009).

762 This estimate is based on OCUS Report data. This is an update from the estimate in the proposing release of 33 broker-dealers. See Amendments to Financial Responsibility Rules, 72 FR at 12883.

763 See Amendments to Financial Responsibility Rules, 72 FR at 12883.

764 The SIFMA 2012 Report as Modified indicates the average hourly cost of this position is approximately $282. Consistent with the proposing release, the Commission estimates the Senior Programmer will spend approximately 130 hours modifying software to conform it to the requirements of the amendments. See Amendments to Financial Responsibility Rules, 72 FR at 12883.

a one-time cost of approximately $36,660 per broker-dealer.[765] Thus, the Commission estimates the total one-time cost to broker-dealers will be approximately $1,283,100.[766]

The Commission requested comment on the proposed cost estimates. In particular, the Commission requested comment on additional costs to broker-dealers that would arise from the proposals, such as system costs in addition to those discussed above (e.g., costs associated with purchasing new software and updates to existing software). The Commission also requested comment on whether these proposals would impose costs on other market participants, including broker-dealer customers. Commenters were asked to identify the metrics and sources of any empirical data that supported their costs estimates. The Commission did not receive any comments in response to these requests.

ii. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

The final rule amendments to Rule 15c3-3 to accommodate futures positions in a securities account margined on a portfolio basis[767] should complement the Congressional amendments and provide additional protections to portfolio margin customers through the strengthened reserve requirements of Rule 15c3-3. These additional protections may reduce the risk of loss of collateral to securities customers, promote participation in the securities markets, and enhance competition and price discovery. Moreover, these additional protections may make portfolio margining more attractive to investors. Portfolio margining may significantly reduce customer margin requirements by offsetting

765 130 hours x $282 = $36,660. In the proposing release, the Commission estimated this cost would be $34,840. See Amendments to Financial Responsibility Rules, 72 FR at 12883.

766 35 broker-dealers x $36,660 = $1,283,100. In the proposing release, the Commission estimated this cost would be $1,149,720. See Amendments to Financial Responsibility Rules, 72 FR at 12883.

767 See section II.B. of this release.

positions involving securities and futures products, which in turn reduces the costs of trading such products and enhances efficiency. Portfolio margining may also promote better price discovery across securities and futures products by allowing customers to offset a position assumed in one market with a product traded in another market. The enhanced efficiencies as a result of increases in the use of portfolio margin accounts may facilitate capital formation through the availability of additional capital for customers as a result of reduced margin costs.

While today's amendments promote efficiency within the securities markets, the increased costs associated with the rule amendments may impose a burden on competition among broker-dealers. However, the Commission is of the opinion that these costs are justified by the significant benefits described in this economic analysis. In sum, the costs of compliance resulting from the requirements in the portfolio margining amendments to Rule 15c3-3 should not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act in light of the benefits discussed above.

3. Amendments With Respect to Securities Lending and Borrowing and Repurchase/Reverse Repurchase Transactions

i. Economic Analysis

The Commission is adopting amendments to Rules 15c3-1 and 17a-11 to strengthen the financial responsibility of broker-dealers engaging in a securities lending business. First, the amendment to subparagraph (c)(2)(iv)(B) of Rule 15c3-1 clarifies that broker-dealers providing securities lending and borrowing settlement services are deemed, for purposes of the rule, to be acting as principals and are subject to applicable capital deductions. Under the amendment, these deductions could be avoided if a broker-dealer takes certain steps to disclaim principal liability. Second, the amendment to paragraph (c)(5) of Rule 17a-11 requires a broker-dealer to: (1) file a notice with the Commission and its DEA whenever the total money payable against all securities loaned, subject to a reverse repurchase agreement or the contract value of all securities borrowed or subject to a repurchase agreement exceeds 2,500% of tentative net capital; or, alternatively, (2) report monthly its securities lending and repurchase activities to its DEA in a form acceptable to its DEA.

Both amendments are intended to strengthen the financial responsibility of broker-dealers engaged in a securities lending or repurchase business. The first amendment to subparagraph (c)(2)(iv)(B) of Rule 15c3-1 will help eliminate the legal uncertainty among counterparties as to the role played by broker-dealers in such transactions and clarify the nature of the services that securities lending intermediaries provide their counterparties.

Thus, a broker-dealer will be considered a principal unless the broker-dealer has disclosed the identity of each party to the other, and the parties have agreed in writing that the obligations of the broker-dealer do not include a guarantee of performance by the other party and that in the event of default, neither party shall have the right of setoff against the obligations, if any, of the broker-dealer. In addition, this amendment will help avoid ambiguity regarding the applicability to a particular broker-dealer of the stock loan charges in the net capital rule.

In response to comments that standard legal documents currently used in securities lending transactions provide sufficient legal certainty with respect to the status of the parties,[768] the Commission considered whether to adopt the proposed approach or whether to rely on existing industry practice. The Commission considered the

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768 See section II.C. of this release. See also SIFMA 2 Letter; Citigroup Letter.

alternatives and believes that the rule as adopted appropriately balances the commenters' objections to the proposal with the Commission's concerns about stock lending practices, particularly with regard to the failure of MJK.[769] In recognition of standard stock loan agreement templates, the Commission designed the amendment to accommodate the continued use of these industry model agreements by incorporating their use into the rule's requirements.

The second amendment to paragraph (c)(5) of Rule 17a-11 will help identify broker-dealers with highly leveraged non-government securities lending and borrowing and repo activity.[770] This new provision requires that a broker-dealer notify the Commission whenever the total amount of money payable against all securities loaned or subject to a repurchase agreement, or the total contract value of all securities borrowed or subject to a reverse repurchase agreement exceeds 2,500% of tentative net capital; provided that, for purposes of this leverage threshold, transactions involving government securities, as defined in Section 3(a)(42) of the Exchange Act, are excluded from the calculation.[771] The notice provision is designed to alert regulators to a sudden increase in a broker-dealer's stock loan and repo positions, which could indicate that the broker-dealer is taking on new or additional risk that it may have limited experience or increased difficulty in managing. This amendment will assist securities regulators in monitoring such activities and responding to situations where a broker-dealer experiences financial difficulty due to a large securities lending or repo position. This may help prevent

769 See section II.C. of this release.

770 17 CFR 240.17a-11(c)(5).

771 15 U.S.C. 78c(a)(42). Government securities generally present less market risk than other types of securities used in securities lending and repo transactions. Consequently, they are excluded from the scope of this rule.

significant losses to the broker-dealer's customers and other broker-dealers, and reduce systemic financial risk.

As adopted, new paragraph (c)(5) of Rule 17a-11 also permits a broker-dealer to report monthly its stock loan and repo activity to its DEA in a form acceptable to its DEA in lieu of the notices required by paragraph (c)(5). This approach will provide each DEA with the flexibility to prescribe how the monthly reports are to be made and will accommodate a DEA that opts to use the FOCUS report as the reporting mechanism.[772] This provision will also accommodate large broker-dealers that are active in this business and regularly maintain stock loan and repo balances that exceed the threshold. The Commission expects that these broker-dealers have experience in managing the risks associated with these types of transactions and have established controls to address those risks. Consequently, notice under Rule 17a-11 from these broker-dealers will not be as useful to regulators. On the other hand, the monthly reports will provide securities regulators with information useful, for example, to develop trend analysis, if deemed appropriate. This analysis can be used to identify leverage levels that are outside the normal trend range and that may be indicative of a material change in the firm's business model (e.g., taking on higher levels of leverage, branching into new products, or experiencing operational or financial difficulties).

The Commission requested comment on available metrics to quantify these benefits and any other benefits a commenter may identify. Commenters were requested to identify sources of empirical data that could be used for the metrics they propose. The Commission did not receive any comments in response to these requests.

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772 As proposed, the amendment to Rule 17a-11 would have provided that a broker-dealer that submitted a monthly report of its stock loan and repo activity to its DEA not be required to file the Rule 17a-11 notices required by paragraph (c)(5). See Amendments to Financial Responsibility Rules, 72 FR at 12870.

The Commission expects that broker-dealers may incur costs related to the implementation of the rule amendments. Using current Rule 15c3-1 and Rule 17a-11 as a baseline, the Commission expects that some broker-dealers may incur costs in connection with the implementation of these rule amendments.

With regard to the amendment to subparagraph (c)(2)(iv)(B) of Rule 15c3-1, the Commission understands that most existing standard securities lending master agreements in use today already contain language requiring agent lenders to disclose principals and for principals to agree not to hold the agents liable for a counterparty default. Thus, the standard agreement used by the vast majority of broker-dealers should contain the representations and disclosures required by the proposed amendment. However, a small percentage of broker-dealers may need to modify their standard agreements. The Commission estimates that the total one-time cost to broker-dealers for this change will be approximately $45,480.[773]

The Commission requested comment on the cost estimates. In particular, the Commission requested comment on additional costs to broker-dealers that would arise from the proposals, such as costs arising from making systems changes. The Commission also requested comment on whether these proposals would impose costs on other market participants, including broker-dealer customers. Commenters were also asked to identify the metrics and sources of any empirical data that support their costs estimates. The Commission did not receive any comments in response to these requests.

With regard to the amendment to Rule 17a-11, the Commission received several suggested alternatives from commenters which contributed to the modification of the

773 In the proposing release, the Commission estimated that the total one-time cost to broker-dealers would be approximately $62,604. See Amendments to Financial Responsibility Rules, 72 FR at 12884. The internal hours would likely be performed by an in-house Attorney at $379 per hour, resulting in the estimated internal cost calculated as follows: 120 hours at $379 per hour = $45,480. See section IV.D.1. of this release.

final rule from the proposal. Three commenters addressed the proposed monthly notification requirement. They stated that the monthly report in lieu of the notification should be provided as part of the monthly FOCUS report many broker-dealers file with their DEA.[774] The Commission agrees that the FOCUS report may be an appropriate mechanism for reporting stock loan and repo positions in lieu of the proposed monthly notification requirement.[775] Consequently, the Commission modified the final rule amendment to delete the phrase "submits a monthly report of" and replace it with the phrase "reports monthly." In addition, as adopted, in order to provide that the monthly report shall be sent to a broker-dealer's DEA, the Commission added the phrase "to its designated examining authority in a form acceptable" before "to its designated examining authority." This approach, as adopted, is intended to provide each DEA with the flexibility to tailor the reporting requirements.

Based on FOCUS Report data, the Commission estimates that approximately one notice per year will be sent pursuant to this amendment.[776] Therefore, approximately one broker-dealer per year will incur costs to prepare and send the notice.[777] Consequently, the Commission estimates that the costs to broker-dealers associated with this requirement will be de minimis.

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774 See Abbey National Letter; Citigroup Letter; SIFMA 2 Letter.

775 Carrying broker-dealers are generally required to submit FOCUS reports on a monthly basis.

776 This estimate is derived from FOCUS Report data, and adjusted based on staff experience. This estimate has been updated from the proposing release estimate of 11. No comments were received on this estimate.

777 The internal hours would likely be performed by junior stock loan manager for 10 minutes at \$134 per hour x 1 notice = \$22.33. See section IV.D.8. of this release.

In addition, the Commission estimates that six broker-dealers will choose the option of reporting monthly[778] and will incur a one-time cost to update their systems to generate the information for the report.[779] The Commission also estimates that these broker-dealers will incur annual costs generating and filing the monthly reports or preparing the information to include in monthly FOCUS Reports (as applicable).[780] Therefore, the Commission estimates that the total one-time cost and annual costs to broker-dealers will be approximately $169,200[781] and $9,648[782] respectively. The Commission's total one-time and annual cost estimates have decreased from the proposing release primarily due to an overall decrease in the number of broker-dealers.

As noted above, the Commission requested comment on the proposed cost estimates. In particular, the Commission requested comment on additional costs to broker-dealers that would arise from the proposals. The Commission also requested comment on whether these proposals would impose costs on other market participants, including market participants active in the securities lending and repurchase markets. Commenters were asked to identify the metrics and sources of any empirical data that

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778 This is an update from the proposing release estimate of 21 broker-dealers. See Amendments to Financial Responsibility Rules, 72 FR at 12884.

779 The internal hours would likely be performed by a senior programmer. Therefore, the estimated internal costs for this hour burden would be calculated as follows: Senior Programmer for 100 hours at $282 per hour = $28,200. See section IV.D.8. of this release. This is an update from the proposing release estimate of $26,800. See Amendments to Financial Responsibility Rules, 72 FR at 12884.

780 The internal hours would likely be performed by a junior stock loan manager. Therefore, the estimated internal costs for this hour burden would be calculated as follows: Junior Stock Loan Manager for 12 hours at $134 per hour = $1,608. See section IV.D.8. of this release. This is an update from the proposing release estimate of $2,496 per firm. See Amendments to Financial Responsibility Rules, 72 FR at 12884.

781 6 firms x $28,200 = $169,200. This is an update from the proposing release estimate of $562,800. See Amendments to Financial Responsibility Rules, 72 FR at 12884.

782 6 firms x $1,608 = $9,648. This is an update from the proposing release estimate of $52,416. See Amendments to Financial Responsibility Rules, 72 FR at 12884.

supported their cost estimates. The Commission did not receive any comments in response to these requests.

ii. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

As described above, the amendment to subparagraph (c)(2)(iv)(B) of Rule 15c3-1 and new paragraph (c)(5) of Rule 17a-11 are designed to address two areas of concern that emerged from the Commission's experience with the failure of MJK.[783] First, broker-dealers with principal liability in a stock loan transaction may be deemed to be acting in an agency capacity and therefore not taking appropriate capital charges. Second, broker-dealers that historically have not been very active in stock loan activities may rapidly expand their balance sheets and increase leverage to a level that poses significant financial risk to the firm and counterparties. Either potential event could result in significant, adverse consequences for customers and counterparties of the broker-dealer. For the customers, the fact that the broker-dealer could avoid taking appropriate capital charges would imperil the broker-dealer's ability to self-liquidate, thereby impeding the ability of customers to be promptly paid in full. For the counterparties, the fact that the broker-dealer could rapidly escalate its leverage increases the likelihood that the broker-dealer could fail and its counterparties could experience, losses of value associated with the rapid unwinding of positions with the failing broker-dealer.

Overall, the amendments to Rule 15c3-1 and Rule 17a-11 will help enhance the monitoring of securities lending or repurchase activities by securities regulators, thereby reducing the effect on customers and counterparties of the potential impact of a financial

[783] See section II.C. of this release.

collapse of the broker-dealer.[784] This will strengthen the securities markets and make them more attractive to investors, thereby enhancing efficiency and capital formation. Moreover, the language in the final rule that provides each DEA with the flexibility to prescribe how the monthly reports are to be made may enhance efficiencies for broker-dealers by providing the ability for a DEA to tailor the reporting requirements. Finally, the costs of compliance with the amendments to Rules 15c3-1 and 17a-11 should not impose a burden on competition not necessary or appropriate in the furtherance of the purposes of the Exchange Act in light of the benefits discussed above.

4. Documentation of Risk Management Procedures

i. Economic Analysis

As discussed in section II.D. of this release, the Commission is adopting new paragraph (a)(23) to Rule 17a-3 to require certain broker-dealers to make and keep current a record documenting the credit, market, and liquidity risk management controls established and maintained by certain broker-dealers to assist them in analyzing and managing the risks associated with their business activities, including, for example, securities lending and repo transactions, OTC derivative transactions, proprietary trading, and margin lending.[785] The amendment will apply only to broker-dealers that have more than $1,000,000 in aggregate credit items as computed under the customer reserve formula of Rule 15c3-3, or $20,000,000 in capital including debt subordinated in accordance with Appendix D to Rule 15c3-1.

These amendments require large broker-dealers to document the controls they have implemented to address the risks they face as a result of their business activities. As proposed, the amendment would have required a broker-dealer to create a record

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784 Id.

785 17 CFR 240.17a-3(a)(23).

documenting its "internal risk management controls," rather than its market, credit, and liquidity risk controls. Commenters generally raised concerns with the proposed amendment stating, for example, that the proposed documentation of internal management controls over risks arising from the broker-dealer's business activities was overly broad and ambiguous.[786] The Commission considered the proposed approach and, as discussed above, in part in response to comments, the Commission narrowed the application of the amendment so that the final rule now requires the documentation of internal risk management controls established to manage market, credit, and liquidity risk.[787] The final rule benefits firms and their customers by mitigating the risk of losses associated with a firm's normal activities, while at the same time placing an increased recordkeeping burden on broker-dealers by requiring them to document certain risks in writing.

A well-documented system of internal controls designed to manage material risk exposures related to market, credit, and liquidity risk reflects the expectations of a firm's management as to how its business activities should be conducted in light of such exposures. Written risk management procedures enable management to better identify, analyze, and manage the risks inherent in the firm's business activities with a view to preventing material losses and to review whether the firm's activities are being conducted in a manner that is consistent with such procedures and controls. This will likely benefit market participants and reduce systemic financial risk.

In addition, by making the documented controls a required record under Rule 17a-3, a broker-dealer's regulator likely will have better access to them, as this benefit will only be realized to the extent that a broker-dealer has existing market, credit, and

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786 See E*Trade Letter; Citigroup Letter.

787 See section II.D. of this release.

liquidity risk management controls in place because the rule does not specify the type of controls a broker-dealer must establish to manage these risks. It simply requires documentation of the procedures that the broker-dealer has established. The final rule amendment will require any such records of the market, credit, and liquidity risk management controls to be available to the broker-dealer's regulators so that they can review whether the broker-dealer is adhering to these controls.

The Commission requested comment on available metrics to quantify these benefits and any other benefits a commenter may identify. Commenters were requested to identify sources of empirical data that could be used for the metrics they proposed. The Commission did not receive any comments in response to these requests.

These amendments apply to a limited number of broker-dealers, namely, those firms with more than $1 million in customer credits or $20 million in capital and amend recordkeeping requirements in Rules 17a-3 and 17a-4. Therefore, against the existing baseline of these current rules, the Commission expects that the requirement will result in a one-time cost to some of these firms to the extent that they have established controls that have not been documented. However, since most firms are expected to be already compliant, the incremental costs are expected to be small. For example, broker-dealers that are approved to compute capital using internal models are already subject to Rule 15c3-4, which requires these firms to establish, document, and maintain a system of internal risk controls to assist them in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.[788]

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788 17 CFR 240.15c3-4; 17 CFR 240.15c3-1(a)(7)(iii). Based on staff experience monitoring broker-dealer risk management procedures, the internal hours would likely be coordinated by a broker-dealer's in-house attorney (19,600 hours), working with operation specialists (24,500 hours), and overseen by an associate general counsel (4,900 hours). Therefore, the estimated internal costs for this hour burden would be calculated as follows: [(Attorney for 19,600 hours at $379 per hour) + (Operations Specialist for

These firms would most likely incur no or minimal costs to comply with the final rule. In addition, this rule amendment does not mandate any specific control, procedure, or policy be established; rather, the Commission is requiring that a control, procedure, or policy be documented if it is in place. For these reasons, the Commission estimates that the one-time hourly burden to meet the requirements of these rules will range from zero hours for some firms to hundreds of hours for other firms. Taking this into account, the Commission estimates that the total one-time cost to broker-dealers to document controls in compliance with this amendment will be approximately $13,783,700.[789] The Commission also estimates that the annual cost to broker-dealers to ensure compliance with the amendment to Rule 17a-3 will be approximately $8,356,950.[790]

As noted above, the Commission requested comment on the proposed cost estimates. In particular, the Commission requested comment on additional costs to broker-dealers that would arise from the proposals, such as costs arising from making changes to systems and costs associated with maintaining these records. The Commission also requested comment on whether the proposals would impose costs on other market participants, including broker-dealer customers. Commenters were also asked to identify the metrics and sources of any empirical data that support their cost estimates. The Commission did not receive any comments in response to these requests.

24,500 hours at $126 per hour) + (Associate General Counsel for 4,900 hours at $467) = $12,803,700. Broker-dealers are also expected to incur one-time outside counsel costs of $980,000 for a total one-time cost of $13,783,700. See section IV.D.7. of this release.

789 See section IV.D.7. of this release. In the proposing release, the Commission estimated this cost would be approximately $14,201,990. See Amendments to Financial Responsibility Rules, 72 FR at 12885.

790 The internal hours would likely be performed by a broker-dealer's in-house attorney. Therefore, the estimated internal costs for this hour burden would be calculated as follows: Attorney at $379 per hour x 22,050 hours = $8,356,950. See section IV.D.7. of this release.

ii. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

The amendments to Rules 17a-3 and 17a-4 require firms to document their market, credit, and liquidity risk management controls. The amendments will help strengthen broker-dealer internal controls. Documenting internal controls will encourage enhanced consideration of, and thus a firmer grasp upon, the risks attendant to a broker-dealer's business activities. This is designed to reduce the risks inherent to the business of operating as a broker-dealer. The final approach the Commission has taken with these rule amendments – encouraging effective internal controls while preserving flexibility – will enhance a broker-dealer's financial soundness and, consequently, may help to reduce the likelihood of broker-dealer failures with possible positive effects on investor participation, competition, and capital formation. The amendments may also increase efficiencies in broker-dealer examinations through the ready availability of records for examiners.

Finally, the Rule 17a-3 and 17a-4 amendments are not expected to place a burden on competition for small non-carrying broker-dealers because such firms would not be subject to these amendments.[791] As discussed above, there will be some incremental costs to compliance related to these amendments for carrying broker-dealers but the costs of compliance should not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act and in light of the benefits discussed above.

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791 The amendments only apply to broker-dealers that have more than $1,000,000 in aggregate credit items as computed under the customer reserve formula of Rule 15c3-3, or $20,000,000 in capital including debt subordinated in accordance with Appendix D to Rule 15c3-1.

5. Amendments to the Net Capital Rule

i. Economic Analysis

a. Requirement to Deduct From Net Worth Certain Liabilities or Expenses Assumed By Third Parties

(I). Summary of Amendments

The amendments to Rule 15c3-1 add a new paragraph (c)(2)(i)(F) requiring a broker-dealer to adjust its net worth when calculating net capital by including any liabilities that are assumed by a third party if the broker-dealer cannot demonstrate that the third party has the resources, independent of the broker-dealer's income and assets, to pay the liabilities. This amendment is intended to assist investors and regulators by requiring broker-dealers to provide a more accurate picture of their financial condition. This should help regulators react more quickly if a broker-dealer experiences financial difficulty and benefit customers of the troubled broker-dealer as well as its counterparties.

The purpose of the requirement in new paragraph (c)(2)(i)(F) of Rule 15c3-1 is to address the practices of a broker-dealer that raise concerns when a broker-dealer shifts liabilities to an entity with no revenue or assets independent of the broker-dealer to inappropriately increase its reported net capital, by excluding the liability from the calculation of net worth. The final rule is designed to prohibit a practice that could misrepresent a broker-dealer's actual financial condition, mislead the firm's customers, and hamper the ability of regulators to monitor the firm's financial condition.

The Commission requested comment on available metrics to quantify these benefits and any other benefits a commenter may identify. Commenters were requested to identify sources of empirical data that could be used for the metrics they proposed. The Commission did not receive any comments in response to these requests.

(II). Baseline and Incremental Economic Effects

As discussed in section II.E.1. of this release, the baseline of this rule amendment is current Rule 15c3-1 and existing guidance and interpretations. The Commission staff has provided guidance with respect to the treatment and recording of certain broker-dealer expenses and liabilities that is consistent with the rule amendment.[792] Consequently, as against the current baseline, the Commission does not expect significant incremental benefits and costs to the extent that they already comply with existing guidance and interpretations.[793]

While the amendments apply to all broker-dealers, they will impact only those few that shift liabilities to entities with no revenue or assets independent of the broker-dealer (i.e., shell corporations) to boost the broker-dealer's reported net capital. Based on staff experience in supervising broker-dealer compliance with Rule 15c3-1, the vast majority of broker-dealers likely either do not seek to transfer responsibility for their liabilities to a third party or, if they do so, rely on a third party that has the financial resources – independent of the assets and revenue of the broker-dealer – to pay the obligations as they become due. Because of this, it is difficult to quantify the benefits and costs impact of this rule amendment.

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792 See, e.g., Third Party Expense Letter; see also FINRA Notice to Members 03-6, Expense Sharing Agreements.

793 Under this amendment, some broker-dealers may request permission in writing from their DEA to withdraw capital within one year of contribution under the rule, resulting in annual costs to broker-dealers of approximately $144,150 (465 hours x $310 per hour for a Compliance Attorney). See section IV.D.2. of this release.

The Commission conservatively estimates that the amendment may impact all broker-dealers that do not report any liabilities. FOCUS Report data, as of December 31, 2011, indicates that approximately 289 broker-dealers report having no liabilities. While this number is likely at the upper boundary of the total number of broker-dealers affected by this amendment, the number of broker-dealers reporting no liabilities likely represents a reasonable sample of broker-dealers on which to base the cost estimates.

Requiring these broker-dealers to book liabilities will decrease the amount of equity capital held by the firms and in some cases may require them to obtain additional capital. The majority of broker-dealers reporting no liabilities are introducing broker-dealers that have a $5,000 minimum net capital requirement, while the reported average of total liabilities is approximately $491,355 per broker-dealer. Therefore, conservatively estimating that each of the 289 broker-dealers will have to raise $491,355 in additional capital as result of the requirement, the total aggregate amount of additional capital that will need to be raised is $142 million.[794]

Further, relative to the proposing release, the Commission is revising the cost of capital from approximately 5%, which was determined based on historical interest rates published by the Federal Reserve, to 12% as the average cost of equity capital determined using the capital asset pricing model ("CAPM").[795] Therefore, the Commission

794 289 broker-dealers x $491,355 = $142,001,595. This is an update from the proposing release estimate of 702 broker-dealers with aggregate liabilities of $280,354 per firm, resulting in an estimated amount of additional capital that would have to be raised in the amount of $196,808,508 (702 broker-dealers x $280,354 = $196,808,508). See Amendments to Financial Responsibility Rules, 72 FR at 12885, n.189 and accompanying text.

795 The CAPM is a central model in modern financial theory and is widely used in applications, such as estimating the cost of capital for firms and evaluating the performance of managed portfolios. Based on conventional assumptions and historical stock price data available on Bloomberg, the Commission estimates a risk-free rate of 2.5% and an equity risk premium of 7.8%. Using, five-year, as well as two-year,

conservatively estimates that the total annual cost to broker-dealers will be approximately $17 million,[796] which is an increased estimate relative to the proposing release. For the broker-dealers to whom this increased estimate applies, the Commission expects that there would be greater costs imposed. However, the Commission expects that the benefits outlined above would also accrue to the customers of these broker-dealers.

The Commission requested comment on the proposed cost estimates. In particular, the Commission requested comment on additional costs to broker-dealers that would arise from the proposals. The Commission also requested comment on whether these proposals would impose costs on other market participants, including broker-dealer customers. Commenters were also asked to identify the metrics and sources of any empirical data that support their costs estimates. The Commission received five comments in response to this request for comment.[797]

One commenter noted that the Commission has provided no evidence that the public has been endangered or has been left financially unprotected as a result of the practice of having another entity book some or all of a member's liabilities.[798] This commenter asserted that the amendment will affect 14% of total member firms and that member firms may be shut down, sold or merged as an unintended consequence of the

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monthly returns for a sample of listed broker-dealers, the Commission estimates an adjusted beta of approximately 1.25.

796 $142,001,595 x 12.25% = $17,395,195. In the proposing release, the Commission estimated that this cost would be approximately $10 million. See Amendments to Financial Responsibility Rules, 72 FR at 12885.

797 See Beer Letter; Beer 2 Letter; Lowenstein Letter; Levene Letter; NIBA 2 Letter.

798 See Lowenstein Letter.

amendment.[799] The commenter questioned how many member firms will fail as a result of this proposal.[800]

Another commenter stated that the true costs of the amendment should be calculated and verified before a proposed amendment is offered and that the true costs of these amendments were given little time, research, and consideration.[801] This commenter also argued that the estimated 5% cost of capital has no basis and a firm would be fortunate to borrow funds for double the estimate of 5%.[802] This same commenter also stated that the proposal would require 702 debt-free introducing broker-dealers to needlessly take on debt of approximately $280,354.[803] Another commenter stated that it is unclear and unlikely how this amendment would achieve any of the desired results and may conversely impair a firm's ability to continue as a going concern.[804] None of the commenters provided the Commission with revised cost estimates.

One commenter stated that if small firms were required to raise over $300,000 in capital each, there would be the largest dissolution of small broker-dealers in the history of the regulated securities industry.[805] This commenter also stated that the Commission's estimate of a gross cost of capital of 7.5% (5% + 2.5%) is a totally unrealistic cost of capital for small broker-dealers and that these broker-dealers will categorically have costs significantly higher than 7.5%.[806] Finally, the commenter stated that, until the Commission convenes a small broker-dealer representative panel to assist it with

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799 Id.

800 Id.

801 See Beer 2 Letter.

802 Id.

803 See Beer Letter; Lowenstein Letter.

804 See Levene Letter.

805 See NIBA 2 Letter.

806 Id.

establishing such costs, the Commission is speculating on such costs, and is therefore without adequate information to consider the effects of such costs and changes on small firms.[807]

(III). Alternatives

The Commission considered all comments received[808] and the alternative of not adopting the rule, and decided to adopt the amendments substantially as proposed. In response to the comment regarding the unrealistic cost of capital,[809] the Commission has increased the cost of capital to 12% as an average cost of equity capital for broker-dealers. As discussed in section II.E.1 of this release, the baseline of this amendment is current Rule 15c3-1 and existing guidance and interpretations. The Commission staff has provided guidance with respect to the treatment and recording of certain broker-dealer expenses and liabilities that is consistent with the rule amendment.[810] Existing broker-dealer recordkeeping rules require a broker-dealer to record its income and expenses.[811] For example, paragraph (a)(2) of Rule 17a-3 requires a broker-dealer to make and keep current ledgers (or other records) reflecting all assets and liabilities, income and expense and capital accounts.[812] Consequently, as against the current baseline, the above estimates are intended to be conservative. The Commission expects that broker-dealers will incur costs to comply with this amendment, including costs to obtain additional capital, only to the extent they are not currently complying with existing guidance and interpretations.

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807 Id.

808 See Beer Letter; Beer 2 Letter; Lowenstein Letter; Levene Letter; NIBA 2 Letter.

809 See NIBA 2 Letter.

810 See, e.g., Third Party Expense Letter; see also FINRA Notice to Members 03-6, Expense Sharing Agreements.

811 17 CFR 240.17a-3; 17 CFR 240.17a-4.

812 17 CFR 240.17a-3(a)(2).

In response to comments,[813] the Commission does not expect broker-dealers to incur significant costs to comply with this amendment to the extent that they are appropriately recording their assets and liabilities under current Commission rules and interpretive guidance, because these items will already appear on a broker-dealer's balance sheet and be included in its net capital computation. Consequently, the rule amendment, as adopted, should not: (1) cause firms to be classified as "a going concern;"[814] (2) cause firms to fail, dissolve, or otherwise close;[815] (3) impose undue burdens; or (4) present serious implementation difficulties to firms (small or large) if they are appropriately recording their assets and liabilities under current Commission rules and interpretive guidance.[816] Further, as stated above, the estimates are intended to be conservative, and therefore, the Commission expects that the "true" costs[817] that may be incurred by broker-dealers should be less than the maximum estimated. Therefore, the Commission does not believe a longer time period for compliance or the formation of a small broker-dealer advisory cost committee is necessary.[818]

b. Requirement to Subtract From Net Worth Certain Non-Permanent Capital Contributions

(I). Summary of Amendments

As discussed in section II.E.2. of this release, the amendment adds paragraph (c)(2)(i)(G) to Rule 15c3-1, requiring a broker-dealer to treat as a liability any capital that is contributed under an agreement giving the investor the option to withdraw it. The rule,

813 See Beer Letter; Beer 2 Letter; Lowenstein Letter; Levene Letter; NIBA 2 Letter.

814 See Levene Letter.

815 See NIBA 2 Letter.

816 See, e.g., Third Party Expense Letter; see also FINRA Notice to Members 03-6, Expense Sharing Agreements.

817 See Beer 2 Letter.

818 See NIBA 2 Letter.

as adopted, also requires that a broker-dealer treat as a liability any capital contribution that is withdrawn within a year of its contribution unless the broker-dealer receives permission in writing from its DEA.[819] The amendment to Rule 15c3-1 is intended to assist investors and regulators by requiring broker-dealers to provide a more accurate picture of their financial condition. This amendment will help regulators react more quickly if a broker-dealer experiences financial difficulty and benefits customers of a troubled broker-dealer as well as its counterparties.

The Commission requested comment on available metrics to quantify these benefits and any other benefits a commenter may identify. Commenters were requested to identify sources of empirical data that could be used for the metrics they proposed. The Commission did not receive any comments in response to these requests.

(II). Baseline and Incremental Economic Effects

As discussed in section II.E.2. of this release, the baseline of this rule amendment is current Rule 15c3-1 and existing guidance and interpretations. The Commission estimates that the amendments requiring broker-dealers to treat certain capital contributions as liabilities should not result in significant incremental benefits and costs, as compared to the baseline. Because of existing Commission and staff guidance

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819 One commenter suggested that the rule be amended to explicitly exclude any withdrawals that would fall under paragraph (e)(4)(iii) of Rule 15c3-1. See American Bar Association Letter. It is unnecessary to explicitly exclude any withdrawals that would fall under paragraph (e)(4)(iii) of Rule 15c3-1because these requirements will not apply to withdrawals covered by paragraph (e)(4)(iii) of Rule 15c3-1, namely, withdrawals used to make tax payments or to pay reasonable compensation to partners. 17 CFR 240.15c3-1(e)(4)(iii). These types of payments are ordinary business expenditures and do not raise the types of concerns the proposed rule is designed to address. See Amendments to Financial Responsibility Rules, 74 FR at12872, n.79.

regarding the permanency of capital,[820] broker-dealers typically do not enter into agreements permitting an owner to withdraw capital at any time. To the extent some firms may have engaged in this practice, they may need to raise capital to meet the rule requirement.

While the amendments apply to all broker-dealers, they will impact only the few broker-dealers that provide investors with the option to withdraw capital at any time or within one year. Because of existing Commission and staff interpretations related to temporary capital contributions,[821] most broker-dealers likely do not accept capital contributions under agreements permitting the investor to withdraw the capital at any time or within one year. Therefore, it is difficult to quantify the cost impact of this rule amendment.

Based on staff experience with the treatment of capital contributions and the application of Rule 15c3-1, the Commission estimates that no more than $100 million in capital at broker-dealers is subject to such agreements.[822] Further, with regard to the treatment of temporary capital contributions, in the proposing release, the Commission assumed an incremental cost of capital of 2.5%,[823] and estimated that the amendment would result in an annual cost of approximately $2.5 million.[824]

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820 See Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991). See also Net Capital Requirements for Brokers and Dealers Exchange Act Release No. 18417 (Jan. 13, 1982), 47 FR 3512 (Jan. 25, 1982). See also Temporary Capital Letter; Study of Unsafe and Unsound Practices of Broker-Dealers, Report and Recommendations of the Securities and Exchange Commission, H.R. Doc. No. 92–231 (1971) (recommending improvement of adequacy and permanency of capital); and Letter from Nelson Kibler, Assistant Director, Division of Market Regulation to John Pinto, National Association of Securities Dealers, Inc. (Sept. 8, 1980).

821 See Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991), 56 FR 9124 (Mar. 5, 1991); and Temporary Capital Letter.

822 See Amendments to Financial Responsibility Rules, 72 FR at 12885.

823 Id. at 12886–12887.

824 $100,000,000 x 2.5% = $2,500,000.

The Commission requested comment on the proposed cost estimates. In particular, the Commission requested comment on additional costs to broker-dealers that would arise from the proposals. The Commission also requested comment on whether these proposals would impose costs on other market participants, including broker-dealer customers. Commenters were also asked to identify the metrics and sources of any empirical data that support their costs estimates.

The Commission received three comments.[825] One commenter stated that the Commission's estimate that no more than $100 million of capital at broker-dealers is subject to agreements permitting an owner to withdraw capital at any time greatly underestimates the impact of the proposed rule.[826] The commenter stated that the Commission makes no case for deviating from the already established standards.[827] Another commenter believed that the proposal would raise its cost of capital to such an extent that it would be impossible for the firm to raise capital from unrelated third parties.[828]

One commenter stated that the Commission's estimate of a gross cost of capital of 7.5% (5% + 2.5%) is a totally unrealistic cost of capital for small broker-dealers and that these broker-dealers will categorically have costs significantly higher than 7.5%.[829] Finally, the commenter stated that, until the Commission convenes a small broker-dealer representative panel to assist it with establishing such costs, the Commission is "speculating" on such costs, and is therefore without adequate information to consider the effects of such costs and changes on small firms.[830]

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825 See Chicago Capital Management Letter; SIG Letter; NIBA 2 Letter.

826 See SIG Letter.

827 Id.

828 See Chicago Capital Management Letter.

829 See NIBA 2 Letter.

830 Id.

In response to comments,[831] the Commission is revising this estimate in the final rule to an estimated cost of capital of approximately 12%, which is determined as the average cost of equity capital of broker-dealers using the CAPM. The overall estimated cost of capital is not incremental to the amendment discussed above regarding third party liabilities. The estimated cost of capital would be 12% for a broker-dealer seeking additional equity capital. Therefore, with regard to the treatment of temporary capital contributions, the Commission estimates the amendment will result in an annual cost of approximately \$12.0 million,[832] which is an increased estimate relative to the proposing release. For the broker-dealers to whom this increased estimate applies, and who may not be complying with the rule amendments, the Commission expects that there would be greater costs imposed. However, the Commission expects that the benefits outlined above would also accrue to the customers of these broker-dealers.[833]

(III). Alternatives

The Commission considered all comments discussed above and the alternative of not adopting the rule, and decided to adopt the amendments substantially as proposed. In response to commenters' concerns about the impact on capital and the \$100 million estimate,[834] as discussed above, the final rule amendment is a codification of existing Commission staff guidance,[835] and thus should not represent a change for broker-dealers with respect to capital withdrawals. Moreover, with respect to commenters' concerns about obtaining capital,[836] the rule does not prohibit an investor from withdrawing capital

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831 See NIBA 2 Letter.

832 \$100,000,000 x 12.25% = \$12,250,000.

833 \$100,000,000 x 12.25% = \$12,250,000.

834 See Chicago Capital Management Letter; SIG Letter; NIBA 2 Letter.

835 See Temporary Capital Letter. See also section II.E.2. of this release.

836 See Chicago Capital Management Letter; SIG Letter; NIBA 2 Letter.

at any time. Rather, it prohibits a broker-dealer from treating temporary cash infusions as capital for purposes of the net capital rule. Finally, the final rule amendment provides a mechanism for a broker-dealer to apply to its DEA to make a withdrawal within one year of the capital contribution without triggering the deduction under certain circumstances.

In the final rule, the Commission has increased the estimated cost of capital from 2.5% to 12%, in response to comments regarding the unrealistic cost of capital, and because the estimated cost of capital is not incremental to the estimated cost of capital to the amendment to Rule 15c3-1 regarding third party liabilities.[837] The estimated cost of capital would be 12% for a broker-dealer seeking a loan for any additional capital. In addition, based on staff experience with the treatment of capital contributions and for the reasons discussed above, the Commission continues to believe that the estimate of $100 million regarding the temporary capital contributions is reasonable.[838]

Further, the final rule amendments relating to temporary capital contributions have been revised to clarify that a withdrawal of capital made within one year of its contribution to the broker-dealer is deemed to have been intended to be withdrawn within one year, unless the withdrawal has been approved in writing by the broker-dealer's DEA.[839] The Commission made this change to eliminate a potential ambiguity as to whether a withdrawal of capital within one year could ever be approved by a broker-dealer's DEA. The final rule amendment clarifies the intent to provide a mechanism for broker-dealers to apply for approval to withdraw capital within one year and to be granted such approval where appropriate.

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837 See NIBA 2 Letter.

838 See SIG Letter.

839 See section II.E.2. of this release.

While owners of most broker-dealers have the option of withdrawing capital, most owners likely do not have agreements that provide the option of withdrawing capital at any time.[840] Paragraph (e) of Rule 15c3-1 contains mechanisms to permit a broker-dealer to make capital withdrawals for specified purposes.[841] If there is a specific need for a broker-dealer to seek permission to make a capital withdrawal within one year of contribution, the final rule already provides a mechanism for the broker-dealer to seek permission in writing from its DEA to make such a withdrawal.[842] Based on the discussion above, the Commission believes the final cost estimates are appropriate.[843]

c. Requirement to Deduct the Amount by which a Fidelity Bond Exceeds SRO Limits

As discussed in section II.E.3. of this release, this amendment requires broker-dealers to deduct from net capital, with regard to fidelity bonding requirements prescribed by a broker-dealer's examining authority, the excess of any deductible amount over the amount permitted by SRO rules.

Under SRO rules, certain broker-dealers that do business with the public or are required to become SIPC members must comply with mandatory fidelity bonding requirements.[844] SRO rules typically permit a broker-dealer to have a deductible

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840 See SIG Letter.

841 See paragraphs (e)(1)(iii)(B) and (e)(4)(iii) of Rule 15c3-1. See also Amendments to Financial Responsibility Rules, 72 FR at 12872, n.79 ("These requirements would not apply to withdrawals covered by paragraph (e)(4)(iii) of Rule 15c3-1, namely, withdrawals used to make tax payments or pay reasonable compensation to partners. These types of payments are ordinary business expenditures and do not raise the types of concerns the proposed rule is designed to address.")

842 See paragraph (c)(2)(i)(G)(2) of Rule 15c3-1.

843 See NIBA 2 Letter.

844 See, e.g., FINRA Rule 4360, CBOE Rule 9.22, and NASDAQ OMX PHLX Rule 705. SRO fidelity bonding requirements typically contain agreements covering the following areas: a "Fidelity" insuring clause to indemnify against loss of property through dishonest or fraudulent acts of employees; an "On Premises" agreement insuring against losses resulting from crimes such as burglary and theft and from misplacement of property of

provision included in the bond; however, such rules provide that the deductible must not exceed certain amounts. With regard to firms that maintain deductible amounts over certain specified amounts, a number of SRO rules provide that the broker-dealer must deduct this specified amount from net worth when calculating net capital under Rule 15c3-1.[845]

Rule 15c3-1, however, does not specifically reference the SRO deductible requirements as a charge to net worth, meaning that a broker-dealer would not be required for the purposes of Commission rules to show the impact of the deduction in the net capital computation required by an SRO on the FOCUS Report.[846] To address the reporting inconsistency, the Commission is amending Rule 15c3-1 to add paragraph (c)(2)(xiv), which will require broker-dealers to deduct the amount specified by rule of the Examining Authority of the broker-dealer with respect to a requirement to maintain fidelity bond coverage. This rule amendment will provide consistency in broker-dealer reporting requirements.[847]

This amendment will also codify in a Commission rule capital charges that broker-dealers are currently required to take pursuant to the rules of various SROs. Consequently, any economic effects, including costs and benefits, should be compared to a baseline of current practices. The amendment should not impose additional costs on broker-dealers with respect to the purchasing or carrying of fidelity bond coverage. Nor

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the insured; an "In Transit" clause indemnifying against losses occurring while property is in transit; a "Forgery and Alteration" agreement insuring against loss due to forgery or alteration of various kinds of negotiable instruments; and a "Securities Loss" clause protecting against losses incurred through forgery and alteration of securities. Id.

845 See, e.g., FINRA Rule 4360 and CBOE Rule 9.22.

846 See 17 CFR 240.17a-5.

847 Conversely, not adopting this rule amendment would have resulted in continued inconsistency among existing SRO rules and Rule 15c3-1.

will the amendment cause broker-dealers to incur additional costs in determining or reporting excess deductible amounts over the deductible permitted. Broker-dealers already make such determinations under SROs rules, and the manner in which such excesses are typically reported (i.e., through periodic FOCUS Reports and other reports) would remain the same.

The Commission received one comment opposing the fidelity bond amendment, stating that FINRA Rule 4360 and the Commission's amendment would result in a de facto increase in minimum net capital requirements for some broker-dealers.[848] Any increase in net capital cited by the commenter would result from existing SRO rules.[849] Stated differently, broker-dealers that are members of an SRO with such a fidelity bonding rule must already account for the deduction in complying with the net capital requirements of SROs and nothing in the Commission's amendment to paragraph (c)(2)(xiv) of Rule 15c3-1 would alter this status quo. Consequently, while there is currently no deduction required under the baseline of current Rule 15c3-1 relating to fidelity bond deductibles, because SRO rules currently require this deduction, the adoption of this amendment under Rule 15c3-1 should not impose any additional costs on broker-dealers that they are not already incurring under existing SRO rules.

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848 See NIBA 2 Letter.

849 For example, the Commission approved FINRA Rule 4360 through the SRO rule filing process. See Order Approving Proposed Rule Change to Adopt FINRA Rule 4360 (Fidelity Bonds) in the Consolidated FINRA Rulebook, Exchange Act Release No. 63961 (Feb. 24, 2011), 76 FR 11542 (Mar. 2, 2011). Pursuant to Section 19(b)(1) of the Exchange Act, each SRO must file with the Commission any proposed change in, addition to, or deletion from the rules of the exchange electronically on a Form 19b-4 through the Electronic Form 19b-4 Filing System, which is a secure website operated by the Commission. 15 U.S.C. 78s(b)(1) and 17 CFR 240.19b-4.

d. Broker-Dealer Solvency Requirement

As discussed in section II.E.4., the amendment to paragraph (a) of Rule 15c3-1 states that no broker-dealer shall be "insolvent" as that term is defined under paragraph (c)(16) of the rule. The companion amendment to paragraph (b)(1) of Rule 17a-11 requires insolvent broker-dealers to provide notice to regulatory authorities.

Allowing an insolvent broker-dealer to continue conducting a securities business during the period of its insolvency, notwithstanding its net capital position, could jeopardize customers and other market participants because a broker-dealer that has made an admission of insolvency, or is otherwise deemed insolvent or entitled to protection from creditors, does not possess the financial resources necessary to operate a securities business. Continuing to operate in such circumstances poses a significant credit risk to counterparties and to the clearance and settlement system, and, in the event the firm ends up in a liquidation proceeding under SIPA, may impair the ability of the SIPA trustee to make the customers of the broker-dealer whole and satisfy the claims of other creditors out of the assets of the general estate.[850]

Consequently, the amendment to Rule 15c3-1 benefits the securities markets, and indirectly, all other market participants, by removing risks associated with the continued operation of a financially unstable firm. For example, the amendment will limit the potential that an insolvent firm would take on new customers and place their assets at risk. Furthermore, the broker-dealer will not be able to enter into proprietary transactions with other broker-dealers and place them or clearing agencies at further risk of counterparty default. The broker-dealer's existing customers also will benefit from

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850 See Amendments to Financial Responsibility Rules, 72 FR at 12872.

preservation of any remaining capital of the firm, which could be used to facilitate an orderly liquidation.

The amendment to Rule 17a-11 also benefits the securities markets in that it will provide regulators with the opportunity to more quickly take steps to protect customers and counterparties at the onset of the insolvency, including, if appropriate, notifying SIPC of the need to commence a SIPA liquidation.

The baseline for this proposed amendment is current Rules 15c3-1 and 17a-11, which currently do not contain requirements to cease conducting a securities business (or to notify the Commission) if certain insolvency events were to occur. The amendments generally will have no impact on broker-dealers when compared to the current baseline. Should a broker-dealer become subject to an insolvency proceeding, it will incur the cost of sending notice of that fact to the Commission and its DEA. The Commission estimated in the PRA that it will occur approximately two[851] times a year for all broker-dealers.[852] For these reasons, the Commission estimates that any costs arising from this amendment will be de minimis.

One commenter stated that involuntary bankruptcy proceedings do not necessarily indicate that the broker-dealer is insolvent, as such proceedings can be frivolous, malicious, or otherwise lacking in merit, and noted standard industry forms generally provide a grace period for a party to such a proceeding to obtain a stay or dismissal before an event of default is deemed to have occurred. The Commission considered this alternative approach and notes that if a firm believes that it is the subject of an

851 This estimate is based on the 2012 SIPC Annual Report, which indicates that over the last ten year-period, the annual average of new customer protection proceedings was three. A copy of the 2012 Annual Report is available at http://www.sipc.org/.

852 The internal hours would likely be performed by a compliance clerk. Therefore, the estimated internal costs for this hour burden would be calculated as follows: Compliance Clerk at $63 per hour x 20 minutes = $21.00. See section IV.D.8. of this release.

unwarranted involuntary bankruptcy proceeding and that its case will not be dismissed within the 30 day timeframe, as is the case with existing net capital requirements, pursuant to Rule 15c3-1(b)(3), the Commission may, upon written application, exempt the broker-dealer from the requirement.

In addition, one commenter objected to the amendments as unnecessary, citing the Rule 15c3-1 prohibition on broker-dealers effecting securities transactions if their net capital is below certain minimums.[853] The commenter stated that the net capital of an insolvent broker-dealer would, by definition, be below those minimums.[854] The Commission considered the commenter's view and the alternative of not adopting the amendments. The purpose of the amendment is to address cases where the broker-dealer is subject to an insolvency event but maintains that it is in compliance with the net capital rule. Therefore, the Commission is adopting this amendment, because, while such instances may be rare, an insolvent broker-dealer could seek the protection of the bankruptcy laws but continue to effect transactions with the public, potentially jeopardizing customers and other creditors of the broker-dealer, including counterparties.

As noted above, the Commission requested comment on this cost estimate. In particular, the Commission requested comment on whether there would be costs to broker-dealers as a consequence of the proposal. The Commission also requested comment on whether this proposal would impose costs on other market participants, including broker-dealer customers. Commenters were asked to identify the metrics and sources of any empirical data that supported their costs estimates. The Commission did not receive any comments in response to these requests.

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853 See St. Bernard Financial Services Letter.

854 Id.

e. Amendment to Rule Governing Restrictions of Withdrawals of Capital

As discussed in section II.E.5. of this release, paragraph (e) of Rule 15c3-1, which places certain conditions on a broker-dealer when withdrawing capital,[855] also allows the Commission to issue an order temporarily restricting a broker-dealer from withdrawing capital or making loans or advances to stockholders, insiders, and affiliates under certain circumstances.[856] The rule, however, limits such orders to withdrawals, advances, or loans that, when aggregated with all other withdrawals, advances, or loans on a net basis during a 30 calendar day period, exceed 30% of the firm's excess net capital.[857]

The Commission has determined that the requirement is difficult to enforce, as it generally would not be clear when the 30% threshold had been reached, due to the inherent unreliability of a troubled broker-dealer's books and records. The Commission considered retaining the 30% threshold, but determined that a more appropriate approach would be to eliminate the 30% threshold requirement from the rule, rather than retain a provision that is difficult to enforce. Consequently, the Commission proposed, and is adopting, a change to delete this provision and instead to allow the Commission to restrict all withdrawals, advances, and loans so long as the other conditions under the rule (all of which remain unchanged) were met.

The amendment to paragraph (e) of Rule 15c3-1 benefits the securities markets by protecting customers and counterparties of a financially stressed broker-dealer. For example, by prohibiting unsecured loans to a stockholder or withdrawal of equity capital while the order is outstanding, the amendment will help to preserve the assets and

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855 See 17 CFR 240.15c3-1(e).

856 See 17 CFR 240.15c3-1(e)(3).

857 Id.

liquidity of the broker-dealer and enable the Commission and its staff, as well as other regulators, to examine the broker-dealer's financial condition, net capital position, and the risk exposure to the customers and creditors of the broker-dealer.

The current rule permitting the Commission to restrict withdrawals of capital from a financially distressed broker-dealer was adopted in 1991.[858] This rule is the baseline for purposes of this economic analysis. When the Commission adopted this paragraph of Rule 15c3-1 more than twenty years ago, the Commission stated that it was intended to be an emergency provision, applicable only to the most exigent of circumstances where the continued viability of the broker-dealer appears to be at stake.[859] In the ensuing years, the Commission has only utilized this provision one time.[860] Based on this experience with the rule, and the fact that the rule is intended as an emergency provision only, as compared to the current baseline, the Commission estimates that the amendment will result in no or de minimis costs to broker-dealers.

As noted above, the Commission requested comment on this cost estimate. The Commission also requested comment on whether the proposal would impose costs on other market participants. Commenters were asked to identify the metrics and sources of any empirical data that support their cost estimates. One commenter supported the amendment but believed that the rule is intended to protect the capitalization of large firms while ignoring small firms, and proposed that the Commission state all the conditions that need to exist for a firm to withdraw, repay or redeem any amount that

858 See Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991), 56 FR 9124 (Mar. 5, 1991).

859 Net Capital Rule, Exchange Act Release No. 28927, 56 FR 9124, 9128.

860 Order Regarding Withdrawals, Unsecured Loans or Advances from Refco Securities, LLC and Refco Clearing, LLC, Exchange Act Release No. 52606 (Oct. 13, 2005).

does not endanger the firm or its customers.[861] The commenter also stated that it opposes regulation that arbitrarily reduces the value of small broker-dealers and their competitive position relative to larger broker-dealers. A second commenter noted that the proposed amendment would impose additional compliance burdens on broker-dealers and would significantly limit broker-dealers' flexibility in the event of a liquidity crisis.[862]

In adopting the final rule, the Commission considered the alternatives and modifications suggested by commenters. In response to these comments, the Commission notes that the amendment would eliminate the 30% threshold from paragraph (e)(3)(i) of Rule 15c3-1, which relates to the Commission's authority to temporarily restrict withdrawals of net capital. It cannot impose these restrictions without concluding that "such withdrawal, advance or loan may be detrimental to the financial integrity of the broker or dealer, or may unduly jeopardize the broker or dealer's ability to repay its customer claims or other liabilities which may cause a significant impact on the markets or expose the customers or creditors of the broker or dealer to loss without taking into account the application of the Securities Investor Protection Act of 1970."[863] While paragraph (e)(3)(i) of Rule 15c3-1 would apply to all broker-dealers, the stringent conditions under which the Commission may exert its authority under the rule to temporarily restrict a broker-dealer's withdrawals of net capital would apply to only the circumstances where the continued viability of the broker-dealer appears to be at stake.[864] The Commission, however, agrees with the importance of maintaining flexibility in the context of ordering restrictions on withdrawals, advances, and loans.

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861 See NIBA 2 Letter.

862 See Raymond James 2 Letter.

863 See 17 CFR 240.15c3-1(e)(3)(i).

864 Net Capital Rule, Exchange Act Release No. 28927, 56 FR 9124, 9128.

Therefore, the Commission modified the amendment, as adopted, to add language to paragraph (e)(3)(i) to state (following the phrase "employee or affiliate") that such orders will be issued, "under such terms and conditions as the Commission deems necessary or appropriate in the public interest or consistent with the protection of investors . . . ."[865]

In summary, the Commission does not believe that the deletion of the 30% threshold will affect the competitiveness or unduly restrict the ongoing business operations of small broker-dealers as compared to larger firms. All broker-dealers remain subject to the other notice and withdrawal limitations on equity capital set forth in paragraphs (e)(1) and (e)(2) of Rule 15c3-1, which are not the subject of this rule amendment.

f. Amendment to Rule 15c3-1 Appendix A

As discussed in section II.E.6.i. of this release, the amendment to paragraph (b)(1)(vi) of Rule 15c3-1a will make permanent the reduced net capital requirements that apply to listed option positions in major market foreign currencies and high-capitalization and non-high-capitalization diversified indexes in non-clearing option specialist and market maker accounts. This change will benefit the broker-dealers that have been calculating charges under a temporary amendment the Commission originally adopted in 1997.[866] The temporary amendment expired on September 1, 1997, subject to extension.[867] The Commission staff subsequently issued a no-action letter on January 13, 2000, which stated that the staff would not recommend enforcement action if broker-

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865 See paragraph (e) of Rule 17a-3, as adopted. See generally, 15 U.S.C. 78mm(a)(1).

866 See Net Capital Rule, Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997).

867 See 17 CFR 15c3-1a(b)(1)(iv)(B).

dealers continued to rely on the temporary amendment.[868] The Commission considered whether to keep the amendment temporary but determined that making the temporary amendment permanent, as proposed, was the more appropriate alternative because it creates certainty for broker-dealers relying on the rule.

Because this amendment seeks to match capital requirements with actual risks, it should not have an adverse impact on the financial strength of broker-dealers. Moreover, because broker-dealers are already operating under the temporary relief, which is the current baseline, the amendment should not result in any costs for broker-dealers as compared to the current baseline.

The Commission requested comment on available metrics to quantify the benefits identified above and any other benefits the commenter may identify. In addition, the Commission requested comment on whether the proposal would result in any costs. Commenters were asked to identify the metrics and sources of any empirical data that support their cost estimates. The Commission did not receive any comments in response to these requests.

ii. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

Rule 15c3-1 is designed to help ensure that a broker-dealer holds at all times liquid assets sufficient to pay its non-subordinated liabilities and retain a "cushion" of liquid assets used to pay customers without delay in the event that the broker-dealer fails. For example, a broker-dealer that inappropriately excludes certain liabilities when

[868] Letter from Michael Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Richard Lewandowski, Vice President, Regulatory Division, The Chicago Board Options Exchange, Inc. (Jan. 13, 2000) (stating that the Division of Trading and Markets "will not recommend . . . enforcement action if non-clearing option specialists and market-makers continue to rely on subparagraph (b)(1)(iv) of Appendix A to Rule 15c3-1 under the Exchange Act until such time as the Commission has determined whether it should be extended").

presenting its financial position[869] or includes non-permanent capital contributions in its financial statements[870] distorts the view of the firm's financial condition and undermines the rule. In either event, such practices jeopardize the broker-dealer's ability to self-liquidate and promptly pay customers.

The Commission's experience with the broker-dealer financial responsibility rules, underscored by the 2008 financial crisis, highlights the effects that the failure of a broker-dealer, particularly a large carrying broker-dealer, could have on customers and other market participants. Losses resulting from the disorderly winding down of a broker-dealer may often undermine the participation of investors in the U.S. capital markets, with possible negative effects on capital formation and market efficiency. Thus, it is imperative that broker-dealers operate in compliance with Rule 15c3-1 and that the Commission takes the necessary steps to help ensure that broker-dealers are prohibited from engaging in practices that obscure noncompliance.

The amendments to Rule 15c3-1 are designed to reduce the risk of a disorderly failure of a broker-dealer and lessen the potential that market participants may seek to rapidly withdraw assets and financing from broker-dealers during a time of market stress. These Rule 15c3-1 amendments may affect efficiency and capital formation through their positive impact on competition among broker-dealers. Specifically, markets that are competitive can, all other things equal, be expected to promote an efficient allocation of capital.[871]

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869 See section II.E.1. of this release.

870 See section II.E.2. of this release.

871 See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071 (Oct. 18, 2012), 77 FR 70213, 70315 (Nov. 23, 2012).

The amendments to Rule 15c3-1 – (1) requiring a broker-dealer to account for certain liabilities or treat certain capital contributions as liabilities,[872] (2) requiring a broker-dealer to deduct certain fidelity bond deductibles,[873] (3) requiring an insolvent broker-dealer to cease conducting a securities business and provide notice under the amendment to Rule 17a-11,[874] (4) eliminating the qualification on Commission orders restricting withdrawals, advances, and unsecured loans to instances where recent withdrawals, advances or loans, in the aggregate, exceed 30% of the broker-dealer's excess net capital,[875] and (5) making permanent the reduced net capital requirements under Appendix A for market makers[876] – are consistent with promoting efficiency, competition, and capital formation in the market place.

First, a broker-dealer that fails to include liabilities that depend on the broker-dealer's assets and revenues and accepts temporary capital contributions is obscuring its true financial condition. This also interferes with the process by which regulators monitor the financial condition of broker-dealers and, thereby, impedes their ability to take proactive steps to minimize the harm resulting from a broker-dealer failure to customers, counterparties, and clearing agencies.

Second, requiring broker-dealers to take net capital charges for excess fidelity bond deductibles imposed under SRO rules will promote efficiency by providing consistency among Rule 15c3-1 and SRO rules. Because fidelity bond requirements provide a safeguard with regard to broker-dealer financial responsibility, the amendment will enhance competition through the operation of more financially sound firms.

872 See sections II.E.1. and 2. of this release.

873 See section II.E.3. of this release.

874 See section II.E.4. of this release.

875 See section II.E.5. of this release.

876 See section II.E.6.i. of this release.

Third, the continued operation of an insolvent broker-dealer or the withdrawal of capital from a broker-dealer that may jeopardize such broker-dealer's financial integrity poses financial risk to its customers, counterparties, and the registered clearing agencies. These risks increase costs and decrease efficiency of the marketplace.

Fourth, the elimination of the limitation on Commission orders restricting capital withdrawals under paragraph (e)(3) of Rule 15c3-1 from a financially troubled broker-dealer will provide greater protection to customers and counterparties of the firm and registered clearing agencies. While such orders are expected to be infrequent, when issued they should lower costs to these entities associated with having an outstanding obligation from the troubled broker-dealer, thereby promoting efficiency and facilitating capital formation.

One commenter expressed concern that the proposed amendments to Rule 15c3-1 would be particularly burdensome on small broker-dealers, negatively impacting capital formation for small issuers and increasing the cost of capital for small broker-dealers.[877] For example, the commenter stated that it believed that the proposed changes requiring a broker-dealer to subtract from net worth certain non-permanent capital contributions and to deduct from net worth certain liabilities or expenses assumed by third parties would negatively impact capital formation for small issuers and increase the cost of capital for small broker-dealers.[878]

While the Commission is cognizant that the Rule 15c3-1 amendments may impose burdens on broker-dealers, including non-carrying broker-dealers, the commenter is treating the amendments as entirely new additions to the net capital rule. Yet, as discussed in section II.E. of this release, the Commission has emphasized that capital

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877 See NIBA 2 Letter.

878 Id.

contributions to broker-dealers should not be temporary. Further, the Commission staff has explained that a capital contribution should be treated as a liability if it is made with the understanding that such contribution can be withdrawn at the option of the investor.[879] Based on the Commission's experience with the application of Rule 15c3-1, the majority of broker-dealers operate consistent with past Commission and staff rules and guidance regarding the nature of capital and, thus, the Rule 15c3-1 amendments should not represent a substantial change for most broker-dealers. Therefore, the final rule should not negatively impact capital formation for small issuers, nor increase the cost of capital for small broker-dealers, to the extent that these firms already comply with current guidance and interpretations.[880] For those firms that will need to raise capital to comply with the amendments to Rule 15c3-1, the rule amendments potentially may negatively impact capital formation. However, the potential costs to some broker-dealers could be offset by the aggregate increase in capital formation related to heightened confidence in broker-dealer financial requirements.

Finally, the Commission recognizes that, as discussed above, the amendments to Rule 15c3-3 adopted today impose certain costs on broker-dealers that could affect competition among broker-dealers. However, the Commission is of the opinion that these costs are justified by the significant benefits described in this economic analysis. In sum, the costs of compliance resulting from the requirements in the amendments to Rule 15c3-3 should not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act in light of the benefits discussed above.

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879 See section II.E.2. of this release.

880 See NIBA 2 Letter.

VI. FINAL REGULATORY FLEXIBILITY ANALYSIS

The Commission proposed amendments to Rules 15c3-1, 15c3-1a, 15c3-2, 15c3-3, 15c3-3a, 17a-3, 17a-4, and 17a-11 under the Exchange Act. An Initial Regulatory Flexibility Analysis ("IRFA") was included in the proposing release.[881] This Final Regulatory Flexibility Analysis ("FRFA") has been prepared in accordance with the provisions of the RFA.[882]

The Commission requested comment with regard to matters discussed in the IRFA, including comments with respect to the number of small entities that may be affected by the proposed rule amendments.[883] The Commission also requested that commenters specify the costs of compliance with the proposed amendments, and suggest alternatives that would accomplish the goals of the amendments.[884] The Commission received one general comment on the IRFA.[885] In addition, the Commission received a number of comments regarding the impact on small entities with respect to specific aspects of the proposed rule amendments, including comments relating to amendments under Rule 15c3-3 with respect to where special reserve deposits may be held, and amendments under Rule 15c3-1 relating to the requirement to subtract from net worth certain liabilities or expenses assumed by third parties.[886] The general comment on the IRFA is discussed directly below. The specific comments are discussed in the applicable sections below.

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881 See Amendments to Financial Responsibility Rules, 72 FR 12862.

882 5 U.S.C. 604(a).

883 See Amendments to Financial Responsibility Rules, 72 FR at 12888.

884 Id.

885 See Angel Letter.

886 These comments are discussed in the applicable section below.

A. General Issues Raised by Public Comments

The commenter stated that the Commission should pay "explicit attention to regulatory trends in the rest of the world" because doing so "benefits not only small entities (by reducing their regulatory burden) but all entities, as larger entities can experience more consistent regulatory procedures around the world."[887] The commenter suggested that the Commission consider a "Basel II type approach to net capital requirements."[888] In response to the commenter, the Commission notes that the amendments relate to discrete areas of the broker-dealer financial responsibility rules (i.e., they do not establish new financial responsibility standards such as would be the case if the Commission were to adopt a "Basel II type approach to net capital requirements."). As noted above, the commenter's suggestion is beyond the scope of this rulemaking.[889]

B. Amendments to the Customer Protection Rule

1. Need for and Objectives of the Rule Amendments

The final rule amends certain provisions of Rule 15c3-3.[890] The amendment that requires broker-dealers to perform a PAB reserve computation is designed to address a disparity between Rule 15c3-3 and the SIPA, and to incorporate provisions of the PAIB Letter into Commission rules.[891] The amendment that will require broker-dealers to

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887 See Angel Letter.

888 Id.

889 The commenter cited the JP Morgan Letter in support of the suggestion to "consider regulatory trends in the rest of the world." Id. The JP Morgan Letter recommends that the Commission adopt a due diligence standard – citing a U.K. regulation – with respect to the amendments regarding customer reserve account cash deposits. See JP Morgan Letter. The Commission addresses this comment above in section V.D.1.i.b.(III) of this release.

890 17 CFR 240.15c3-3.

891 See section II.A.2. of this release.

exclude cash deposited at an affiliated bank and cash deposited with an unaffiliated bank to the extent that the amount exceeds 15% of the bank's equity capital from being used to meet a broker-dealer's reserve requirements is designed to avoid the situation where a carrying broker-dealer's cash deposits constitute a substantial portion of the bank's deposits.[892] The amendment that will require broker-dealers to obtain possession and control of customers' fully paid and excess margin securities allocated to a short position is designed to address the fact that Rule 15c3-3 currently permits a broker-dealer to monetize customer securities, which is contrary to the customer protection goals of Rule 15c3-3, which seeks to ensure that broker-dealer's do not use customer assets for proprietary purposes.[893] The amendment that will require broker-dealers to provide certain notices and disclosures before changing the terms and conditions under which the broker-dealer treats customer free credit balances is intended to help ensure that the use of customer free credit balances accords with customer preferences.[894] The importation of certain provisions of Rule 15c3-2 into Rule 15c3-3 streamlines the customer protection rules and eliminates irrelevant provisions in Rule 15c3-2 due to Rule 15c3-3.[895] The amendments clarifying that funds in certain commodities accounts are not to be treated as free credit balances or other credit balances are intended to remove uncertainty with respect to their treatment under Rule 15c3-3.[896]

The amendments to Rule 15c3-3 are intended to strengthen the protections afforded to customer assets held at a broker-dealer. The amendments are designed to

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892 See section II.A.3. of this release.

893 See section II.A.4. of this release.

894 See section II.A.5. of this release.

895 Id.

896 See section II.A.6. of this release.

minimize the risk that customer assets will be lost, tied-up in a liquidation proceeding, or held in a manner that is inconsistent with a customer's expectations.

2. Significant Issues Raised by Public Comment

The Commission received numerous comments with respect to the amendment under paragraph (e)(5) of Rule 15c3-3 that will require broker-dealers to exclude cash deposited at an affiliated bank and cash deposited with an unaffiliated bank to the extent that the amount exceeds 15% of the bank's equity capital from being used to meet a broker-dealer's reserve requirements.[897] As proposed, new paragraph (e)(5) of 15c3-3 would have provided that, in determining whether a broker-dealer maintains the minimum reserve deposits required (customer and PAB), the broker-dealer must exclude any cash deposited at an affiliated bank. In addition, the proposed amendment would have required a broker-dealer to also exclude cash deposited at an unaffiliated bank to the extent the cash deposited exceeds (1) 50% of the broker-dealer's excess net capital (based on the broker-dealer's most recently filed FOCUS Report),[898] or (2) 10% of the bank's equity capital (based on the bank's most recently filed Call Report or Thrift Financial Report).[899]

With respect to the proposed limits on the amounts that could be deposited in unaffiliated banks, some commenters argued that the percentages were too restrictive while other commenters suggested alternative approaches to the proposed percentage limitations.[900] One commenter stated that the percentage thresholds would negatively impact smaller broker-dealers because these firms would still be required under the

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897 See section II.A.3. of this release.

898 Under Rule 17a-5 broker-dealers must file FOCUS Reports. 17 CFR 240.17a-5.

899 See Amendments to Financial Responsibility Rules, 72 FR at 12864.

900 See Deutsche Bank Securities Letter; SIFMA 2 Letter; First Clearing Letter; ICI Letter; BlackRock Letter.

proposed rule to maintain at least two reserve bank accounts at different banks.[901] This commenter noted that limiting Rule 15c3-3 deposits at a single bank to 50% of a broker-dealer's excess net capital could impact 10 to 15% of its broker-dealer customers in that many of these customers would be required to open accounts at multiple institutions.[902] This commenter suggested the Commission consider higher percentages for cash deposits at large money-centered banks, since the proposed percentage thresholds would negatively impact small broker-dealers because they would exceed the 50% of excess net capital threshold at lower deposit levels.[903] This commenter also noted that conducting due diligence and opening new accounts and the ongoing monitoring and periodic re-evaluation of such additional accounts would require much more time than the 10 hours originally estimated by the Commission.[904] A second commenter concurred with this cost assessment, stating that the Commission significantly underestimated the cost of the proposal to smaller firms.[905]

With respect to the use of qualified securities to meet reserve requirements, one commenter noted that broker-dealers will "likely have a significant amount of additional operational and transactional costs."[906] The commenter believes that "[w]hile larger broker-dealers may be able to reallocate existing trading desk, operational, regulatory reporting and treasury functions to assist in ongoing maintenance activities, midsized and

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901 See SIFMA 2 Letter ("[T]he [percentage] tests could prevent a smaller firm from maintaining reserve account deposits at any single bank, even though those deposits are relatively small compared to the size of the bank – e.g., a broker- dealer with excess net capital of $500,000 could not maintain more than $250,000 in reserve account cash deposits at any one bank, regardless of the ratio between such bash deposits and the overall size or equity capital of the bank.").

902 Id.

903 Id.; see also SIFMA 4 Letter.

904 See SIFMA 2 Letter.

905 See NIBA 2 Letter.

906 See JP Morgan Letter.

smaller broker-dealers may be required to hire additional staff to manage and maintain a securities portfolio."[907]

In response to commenters concerns, the Commission has eliminated the provision that would have excluded the amount of a deposit that exceeds 50% of the broker-dealer's excess net capital. After review of the comment letters, the Commission believes that this provision likely would have disproportionately impacted small and mid-size broker-dealers when they deposited cash into large commercial banks since they would exceed the excess net capital threshold well before exceeding the bank equity capital threshold.[908] The bank equity capital threshold is the more important metric since it relates directly to the financial strength of the bank, which is the entity holding the account. In particular, if the carrying broker-dealer's deposit constitutes a substantial portion of the bank's total deposits, the bank may not have the liquidity to quickly return the deposit to the broker-dealer. The elimination of the excess net capital threshold should mitigate concerns expressed by small broker-dealers that they would need to open multiple bank accounts to make cash deposits or hire additional staff, if they sought to deposit qualified securities in a reserve account in order to avoid opening multiple accounts. This is because the excess net capital threshold likely would have impacted smaller broker-dealers, which – consistent with their size – maintain less net capital than larger firms.

Second, with respect to the bank equity capital threshold, in response to comments, the Commission has increased the trigger level from 10% to 15% of the

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907 Id. The commenter noted that managing pools of qualified securities involves various tasks, such as "monitoring income collection, redemption processing, marking the securities to market, collateral substitutions and collateral segregation amongst other tasks." Id.

908 See SIFMA 2 Letter; JP Morgan 2 Letter.

bank's equity capital. The increase of the threshold to 15% is designed to address concerns raised by commenters that the proposed percentage tests were unduly restrictive in certain respects and should be modified, particularly with respect to large broker-dealers with large deposit requirements. Consequently, the increase from 10% to 15% is designed to mitigate commenters concerns that the 10% threshold would require broker-dealers to spread out deposits over an excessive number of banks, while still providing adequate protection against undue concentrations of deposits, particularly where smaller banks are concerned.

The elimination of the 50% of excess net capital threshold and increase of the bank capital threshold from 10% to 15% is designed to appropriately address concerns raised by commenters that they would have to substantially alter their current cash deposit practices in light of the goal of the rule to promote the broker-dealer's ability to have quick access to the deposit.

With the elimination of the broker-dealer excess net capital threshold, and the increase in the bank equity capital threshold, it is likely that very few broker-dealers (including small broker-dealers) would be required to maintain reserve accounts at multiple banks, unless they chose to do so for operational, business or other reasons. Therefore for the reasons discussed above, as adopted, paragraph (e)(5) of Rule 15c3-3, should not significantly impact a substantial number of small entities.

3. Small Entities Subject to the Rule

Paragraph (c)(1) of Rule 0-10[909] states that the term small business or small organization, when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the

909 17 CFR 240.0-10(c)(1).

prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d);[910] and is not affiliated with any person (other than a natural person) that is not a small business or small organization.

Based on FOCUS Report data, as of December 31, 2011, the Commission estimates there are approximately 5 broker-dealers that performed a customer reserve computation pursuant to Rule 15c3-3 and were "small" for the purposes Rule 0-10.

4. Reporting, Recordkeeping, and other Compliance Requirements

The amendments (1) require broker-dealers to perform a PAB reserve computation, (2) limit the amount that a broker-dealer may deposit in a reserve account at any individual bank in the form of cash, (3) require broker-dealers to obtain possession and control of customers' fully paid and excess margin securities allocated to a short position by borrowing equivalent securities or through other means within a specified period of time, and (4) require broker-dealers to obtain the written affirmative consent of a new customer before including a customer's free credit balances in a Sweep Program, as well as provide certain disclosures and notices to all customers with regard to the broker-dealer's Sweep Program.

5. Agency Action to Minimize Effect on Small Entities

The RFA directs the Commission to consider significant alternatives that would accomplish the stated objectives, while minimizing any significant adverse impact on small entities. In connection with adopting the final rules, the Commission considered, as alternatives, establishing different compliance or reporting requirements that take into account the resources available to smaller entities, exempting smaller entities from

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910 17 CFR 240.17a-5(d).

coverage of the disclosure requirements, and clarifying, consolidating, or simplifying disclosure for small entities.[911]

As discussed above, the impact on individual small broker-dealers, as well as all small broker-dealers, should be minimal, and thus the Commission is not establishing different compliance or reporting requirements or timetables; clarifying, consolidating, or simplifying compliance and reporting requirements under the rule for small entities; or exempting small entities from coverage of the rule, or any part thereof. The amendments impose performance standards and do not dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the amendments.

C. Holding Futures Positions in a Securities Portfolio Margining Account

1. Need for and Objectives of the Amendments

The amendments to Rule 15c3-3 and 15c3-3a are designed to accommodate futures positions in a securities account that is margined on a portfolio basis.[912] Under SRO portfolio margin rules, a broker-dealer can combine securities and futures positions in a portfolio margin securities account to compute margin requirements based on the net market risk of all positions in the account. The amendments to Rule 15c3-3 and 15c3-3a complement the amendments to SIPA in the Dodd-Frank Act, as well as provide additional protections to customers through the strengthened reserve requirements of Rule 15c3-3. In particular, the changes will apply the protections in Rules 15c3-3 and Rule 15c3-3a to all positions in a portfolio margin account.

These additional protections should make portfolio margining more attractive to investors. Portfolio margining can significantly reduce customer margin requirements for

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[911] 5 U.S.C. 604(a)(5).

[912] See Amendments to Financial Responsibility Rules, 72 FR at 12868–12870.

offsetting positions involving securities and futures products, which in turn reduces the costs of trading such products.

2. Significant Issues Raised by Public Comments

The Commission did not receive any specific comments with respect to this portion of the IRFA.

3. Small Entities Subject to the Rules

As discussed above in section V.D.2. of this release, based on FOCUS Report data, as of December 31, 2011, the Commission estimates that approximately 35 broker-dealers will elect to offer their customers portfolio margin accounts that will include futures and futures options. None of these broker-dealers are "small" for purposes of Rule 0-10.

4. Reporting, Recordkeeping, and other Compliance Requirements

These amendments (1) revise the definition of free credit balances and other credit balances in Rule 15c3-3 to include funds in a portfolio margin account relating to certain futures and futures options positions, and (2) add a debit line item to the customer reserve formula in Rule 15c3-3a consisting of margin posted by a broker-dealer to a derivatives clearing organization.

5. Agency Action to Minimize Effect on Small Entities

As stated above, the Commission does not believe that any of the broker-dealers that will elect to offer portfolio margining are "small" for purposes of Rule 0-10. Further, the requirements imposed by the portfolio margin amendments will be elective. Therefore, the Commission does not believe it is necessary or appropriate to establish different compliance or reporting requirements or timetables; clarify, consolidate, or simplify compliance and reporting requirements under the rule for small entities; or exempting small entities from coverage of the rule, or any part thereof. The amendments also contain performance standards and do not dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the proposed amendments.

D. Securities Lending and Borrowing and Repurchase/Reverse Repurchase Transactions

1. Need for and Objectives of the Amendments

These rules amend subparagraph (c)(2)(iv)(B) of Rule 15c3-3 to clarify that broker-dealers providing securities lending and borrowing settlement services are deemed, for purposes of the rule, to be acting as principals and are subject to applicable capital deductions, unless the broker-dealer takes certain steps to disclaim principal liability.[913] In addition, the Commission is adopting paragraph (c)(5) to Rule 17a-11 to require that a broker-dealer notify the Commission whenever the total amount of money payable against all securities loaned or subject to a repurchase agreement exceeds 2,500 percent of tentative net capital.[914] The final rule also exempts a broker-dealer from this 17a-11 notice requirement if it reports monthly its securities lending and borrowing and repurchase and reverse repurchase activity to its DEA in a form acceptable to its DEA.

In 2001, MJK Clearing, a broker-dealer with a substantial number of customer accounts, failed when it could not meet its securities lending obligations. This failure has highlighted the risks associated with securities lending and repurchase and reverse repurchase agreements and the need to manage those risks. More specifically, two concerns arose from the failure of MJK, namely, (1) that broker-dealers with principal liability in a stock loan transaction may erroneously be considering themselves as acting

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913 See section II.C. of this release.

914 Id.

in an agency capacity and, consequently, not taking appropriate capital charges; and (2) that broker-dealers that have historically not been very active in stock loan transactions may be rapidly expanding their balance sheets with such transactions, and thereby, increase leverage to a level that poses significant financial risk to the firm and its counterparties.

These amendments are intended to strengthen the documentation controls broker-dealers employ to manage their securities lending and borrowing and securities repurchase and reverse repurchase activities and to enhance regulatory monitoring. The intended result of the amendments is to avoid ambiguity regarding the applicability of the stock loan charges in the net capital rule to a particular broker-dealer. As the failure of MJK illustrated, disputes can arise over whether a broker-dealer is acting as a principal or agent in a stock loan transaction.[915]

The amendments to paragraph (c)(5) to Rule 17a-11 will help identify broker-dealers with highly leveraged non-government securities lending and borrowing and repo operations and make it easier for regulators to respond more quickly and protect customers in the event a firm is approaching insolvency.[916] This notice provision is designed to alert regulators to a sudden increase in a broker-dealer's stock loan and repo positions, which could indicate that the broker-dealer is taking on new risk that it may have limited experience in managing, as well as to help identify those broker-dealers highly active in securities lending and repos. Finally, the objective of the exemption from the notice provision of paragraph (c)(5) of Rule 17a-11 through monthly reporting is designed to accommodate large broker-dealers that are active in this business and regularly maintain stock loan and repo balances that exceed the threshold.

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915 See, e.g., Nomura v. E*Trade, 280 F.Supp.2d 184 (S.D.N.Y. 2003).

916 17 CFR 240.17a-11(c)(5).

2. Significant Issues Raised by Public Comments

The Commission did not receive any specific comments with respect to this portion of the IRFA.

3. Small Entities Subject to the Rule

Based on FOCUS Report data, as of December 31, 2011, the Commission estimates that none of the broker-dealers that engage in securities lending and borrowing or securities repurchase and reverse repurchase activity are "small" for the purposes Rule 0-10. Therefore, the amendments should not affect "small" broker-dealers.

4. Reporting, Recordkeeping, and Other Compliance Requirements

These amendments require broker-dealers to (1) disclose the principals and obtain certain agreements from the principals in a transaction where they provide settlement services in order to be considered an agent (as opposed to a principal) for the purposes of the net capital rule, and (2) provide notice to the Commission and other regulatory authorities if the broker-dealer's securities lending or repo activity reaches a certain threshold or, alternatively, report monthly the broker-dealer's securities lending and repo activity to the broker-dealer's DEA, in a form acceptable to the DEA.

5. Agency Action to Minimize Effect on Small Entities

As noted above, the Commission estimates that this amendment will have no impact on small entities. Thus, the Commission does not believe it is necessary or appropriate to establish different compliance or reporting requirements or timetables, nor is it clarifying, consolidating, or simplifying compliance and reporting requirements under the rule for small entities; or exempt small entities from coverage of the rule, or any part thereof. The amendments also use performance standards and do not dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the proposed amendments.

E. Documentation of Risk Management Procedures

1. Need for and Objectives of the Amendments

Requiring certain large broker-dealers to document and preserve their internal credit, market, and liquidity risk management controls under paragraph (a)(23) to Rule 17a-3 and (e)(9) to Rule 17a-4 will assist firms in evaluating and adhering to their established internal risk management controls and regulators in reviewing such controls.[917]

These amendments are intended to strengthen the controls certain large broker-dealers employ to manage risk. These amendments are designed to lower systemic risk primarily in the securities markets by enhancing risk management through reinforcement of documentation practices and making it easier for regulators to access a broker-dealer's procedures and controls, to ensure a broker-dealer is adhering to such documented controls.

Additionally, by making the documented controls a required record under Rule 17a-3, a broker-dealer's regulator likely will have better access to them, as this benefit will only be realized to the extent a broker-dealer has existing market, credit and liquidity risk management controls in place because the rule does not specify the type of controls a broker-dealer must establish to manage these risks. It simply requires the documentation of the procedures the broker-dealer has established. The final rule amendment will require any such records of the market, credit, and liquidity risk management controls be

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[917] See section II.D. of this release.

available to the broker-dealer's regulators so they can review whether the broker-dealer is adhering to these controls.

2. Significant Issues Raised by Public Comments

The Commission did not receive any specific comments with respect to this portion of the IRFA.

3. Small Entities Subject to the Rule

These amendments apply to a limited number of broker-dealers, namely, those firms with more than $1 million in customer credits or $20 million in capital. Based on FOCUS Report data, as of December 31, 2011, the Commission estimates that none of the broker-dealers that will be subject to this amendment will be "small" for the purposes Rule 0-10.

4. Reporting, Recordkeeping, and Other Compliance Requirements

These amendments will require broker-dealers to document any credit, market, and liquidity risk management controls established and maintained by the broker-dealer to assist it in analyzing and managing the risks associated with its business activities. The Commission is not mandating any specific controls, procedures, or policies that must be established by a broker-dealer to manage market, credit, or liquidity risk. Rather, the Commission is requiring that a control, procedure, or policy be documented if it is in place.

5. Agency Action to Minimize Effect on Small Entities

As noted above, these amendments will have no impact on "small" broker-dealers. Thus, the Commission is not establishing different compliance or reporting requirements or timetables; clarifying, consolidating, or simplifying compliance and reporting requirements under the rule for small entities; nor exempting small entities from coverage of the rule, or any part thereof.

The amendments also use performance standards and do not dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the amendments.

F. Amendments to the Net Capital Rule

1. Need for and Objectives of the Amendments

The amendments to Rule 15c3-1 are designed to address several areas of concern regarding the financial responsibility requirements for broker-dealers. Some broker-dealers have excluded from their regulatory financial reports certain liabilities that have been shifted to third parties that lack the resources – independent of the assets and revenue of the broker-dealer – to pay the liabilities, or have utilized infusions of temporary capital. These practices may misrepresent the true financial condition of the broker-dealer and, thereby, impede the ability of regulators to take proactive steps to reduce the harm to customers, counterparties and clearing agencies that may result from the broker-dealer's failure. To address these issues, the Commission is adopting an amendment to Rule 15c3-1 to add a new paragraph (c)(2)(i)(F) requiring a broker-dealer to adjust its net worth when calculating net capital by including any liability or expense for which a third party has assumed the responsibility, unless the broker-dealer can demonstrate that the third party has adequate resources, independent of the broker-dealer to pay the liability or expense.[918] In addition, the Commission is adopting amendments to paragraph (c)(2)(i)(G)(2) of Rule 15c3-1, to require a broker-dealer to subtract from net worth any contribution of capital to the broker-dealer: (1) under an agreement that

[918] See section II.E.1. of this release.

provides the investor with the option to withdraw the capital; or (2) that is intended to be withdrawn within a period of one year of its contribution. Under the final rule, any withdrawal of capital made within one year of its contribution is deemed to have been intended to be withdrawn within a period of one year, unless the withdrawal has been approved in writing by the broker-dealer's DEA.[919]

Further, currently, broker-dealers are required to take net capital charges pursuant to SRO rules relating to fidelity bond deductibles, but Rule 15c3-1 does not explicitly incorporate such charges for purposes of computing net capital. To address this inconsistency, the Commission is adopting paragraph (c)(2)(xiv) to Rule 15c3-1.[920]

In addition, a number of broker-dealers have sought to obtain protection under the bankruptcy laws while still engaging in a securities business. Permitting an insolvent broker-dealer to continue to transact a securities business endangers its customers and counterparties and places securities clearing agencies at risk. To address this concern, the Commission is adopting an amendment to paragraph (a) of Rule 15c3-1 to require a broker-dealer to cease its securities business activities if certain insolvency events were to occur, as defined in new paragraph (c)(16) to Rule 15c3-1.[921]

Finally, an important goal of the Commission is to protect the financial integrity of the broker-dealer so that if the firm must liquidate it may do so in an orderly fashion. Allowing a capital withdrawal that may jeopardize the financial integrity of a broker-dealer exposes customers and creditors of the broker-dealer to unnecessary risk. Paragraph (e) of Rule 15c3-1, which places certain conditions on a broker-dealer when

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919 See section II.E.2. of this release.

920 See section II.E.4. of this release.

921 See section II.E.5. of this release.

withdrawing capital,[922] allows the Commission to issue an order temporarily restricting a broker-dealer from withdrawing capital or making loans or advances to stockholders, insiders, and affiliates under certain circumstances.[923] The rule, however, limits such orders to withdrawals, advances, or loans that, when aggregated with all other withdrawals, advances, or loans on a net basis during a thirty calendar day period, exceed 30% of the firm's excess net capital. The Commission is amending paragraph (e) to remove the 30% of excess net capital limitation because the Commission has determined that the requirement is difficult to enforce, as it generally would not be clear when the 30% threshold had been reached, due to the inherent unreliability of a troubled broker-dealer's books and records.[924]

Finally, the Commission is making permanent a temporary amendment to Appendix A of Rule 15c3-1, which permits broker-dealers to employ theoretical option pricing models to calculate haircuts for listed options and related positions that hedge those options.[925] The temporary amendment decreased the range of pricing inputs to the approved option pricing models, which effectively reduced the haircuts applied by the carrying firm with respect to non-clearing option specialist and market maker accounts.[926]

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922 See 17 CFR 240.15c3-1(e).

923 See 17 CFR 240.15c3-1(e)(3).

924 See section II.E.6. of this release.

925 17 CFR 240.15c3-1a; See Net Capital Rule, Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997). See also Letter from Michael Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Richard Lewandowski, Vice President, Regulatory Division, The Chicago Board Options Exchange, Inc. (Jan. 13, 2000) (stating that the Division of Market Regulation "will not recommend . . . enforcement action if non-clearing option specialists and market-makers continue to rely on subparagraph (b)(1)(iv) of Appendix A to Rule 15c3-1 under the Exchange Act until such time as the Commission has determined whether it should be extended"). The letter did not grant any other relief.

926 See Net Capital Rule, Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997).

The amendment is intended to better align the capital requirements with the risks these requirements are designed to address.

2. Significant Issues Raised by Public Comments

The Commission received three comments in response to requests for comment related to the amendments to the net capital rule requiring broker-dealers to add back to its net worth certain liabilities assumed by third parties and treat certain temporary capital contributions as liabilities.[927]

One commenter noted that there should be no circumstance in which a broker-dealer accepted a capital contribution for net capital purposes that could be withdrawn at the option of the investor.[928] This commenter also noted that if small firms were required to raise over $300,000 in capital each, there will be the largest dissolution of small broker-dealers in the history of the regulated securities industry.[929] The commenter requested that the Commission state a reasonable time period for broker-dealers to raise capital to meet these new standards.[930] This commenter also stated that the Commission's estimate of a gross cost of capital of 7.5% (5% + 2.5%) is a totally unrealistic cost of capital for small broker-dealers and that these broker-dealers will categorically have costs significantly higher than 7.5%.[931]

Further, the commenter stated that, until the Commission convenes a small broker-dealer representative panel to assist it with establishing such costs, the Commission is "speculating" on such costs, and is therefore without adequate

927 See Beer Letter; Levene Letter; NIBA 2 Letter.

928 See NIBA 2 Letter.

929 Id.

930 Id.

931 Id.

information to consider the effects of such costs and changes on small firms.[932] This commenter specifically requested the Commission consider the needs of small firms that will likely require additional net capital over the next decade.[933]

Additionally, this commenter believed that the rule is intended to protect the capitalization of large firms while ignoring small firms. The commenter also noted that it opposes regulation that arbitrarily reduces the value of small broker-dealers and their competitive position relative to larger broker-dealers.[934] Finally, the commenter expressed concern that the proposed amendments to Rule 15c3-1 would be particularly burdensome on small broker-dealers, negatively impacting capital formation for small issuers and increasing the cost of capital for small broker-dealers.[935]

Another commenter stated that this proposal will require the 702 mentioned debt-free introducing broker-dealers to needlessly take on debt of approximately $280,354.[936] Further, the commenter stated that, if the proposed is approved, it would force the majority of small firms out of business and ultimately deny investors the right and opportunity to deal with smaller, more personalized and debt-free member firms.[937] One

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932 Id.

933 Id. The commenter stated that any rule that would "restrict small broker-dealers from raising capital as a result of uncertainty of investors or owner-operators related to the return of their capital in a reasonable time frame will create a disproportionate and impossible hurdle for small broker-dealers to overcome." See NIBA 2 Letter.

934 See NIBA 2 Letter.

935 Id. The commenter noted that broker-dealers "are dealing with a relatively static commission and fees matrix versus what they may charge customers." Consequently, the commenter believes "broker-dealers will be unable to pass any of these costs increases directly to customers, irrespective of the type of customer or type of business that they are conducting with small broker-dealers, which further threatens the financial profit potential and return on equity of small broker-dealers." Id. The commenter further believes that the cost increases over a short period of time will threaten the viability of all small broker-dealers. Id.

936 See Beer Letter.

937 Id.

commenter stated that it also must be considered that any implementation and enforcement of these proposed changes should not be made retroactive, because to subject firms to a new set of rules and guidelines will effectively penalize small firms that have been in full compliance with the rules and regulations.[938]

The Commission considered all comments discussed above and the potential impact on small broker-dealers.[939] The Commission continues to believe that the estimated cost of capital is not unrealistic for small broker-dealers. However, as discussed above in section V. of this release, in response to comments, the Commission increased the estimated cost of capital for these amendments is 12%.

Moreover, as discussed in section II.E.1 and 2. of this release, the baseline of these rules is current Rule 15c3-1 and existing guidance and interpretations. The Commission staff has provided guidance with respect to the treatment and recording of certain broker-dealer expenses and liabilities that is consistent with the rule amendment.[940] In addition, existing broker-dealer recordkeeping rules require that a broker-dealer record its income and expenses.[941] For example, paragraph (a)(2) of Rule 17a-3, requires a broker-dealer to make and keep current ledgers (or other records) reflecting all assets and liabilities, income and expense and capital accounts.[942] Therefore, the Commission does not expect small broker-dealers to incur significant costs

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938 See Levene Letter.

939 See Beer Letter; Levene Letter; NIBA 2 Letter.

940 See, e.g., Third Party Expense Letter; see also FINRA Notice to Members 03-6, Expense Sharing Agreements.

941 17 CFR 240.17a-3; 17 CFR 240.17a-4.

942 17 CFR 240.17a-3(a)(2).

or burdens to comply with the amendment regarding broker-dealers and payment of expenses by third parties.[943]

At the same time, the purpose of the requirement in new paragraph (c)(2)(i)(F) of Rule 15c3-1 is to address the practices of a broker-dealer that raise concerns when a broker-dealer shifts liabilities to an entity with no revenue or assets independent of the broker-dealer to inappropriately increase its reported net capital, by excluding the liability from the calculation of net worth. Therefore, the final rule, as discussed above in section II.E.1. of this release, is designed to prohibit a practice that could misrepresent a broker-dealer's actual financial condition, deceive the firm's customers, and hamper the ability of regulators to monitor the firm's financial condition.

Moreover, in response to comments,[944] the rule amendment, as adopted, should not impose burdens or present serious implementation difficulties to small broker-dealers[945] that are appropriately recording their assets and liabilities under current Commission rules and interpretive guidance.[946] These broker-dealers also should not be required to obtain loans to increase their capital as a result of the Rule 15c3-1 amendments. Therefore, the Commission does not believe a longer time period for compliance or the formation of a small broker-dealer advisory cost committee is necessary.[947]

In response to the commenters' concerns about the negative impact of the rule amendments on the capital of small broker-dealers,[948] as discussed above, the final rule

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943 See NIBA 2 Letter.

944 Id.

945 See Beer Letter; Levene Letter; NIBA 2 Letter.

946 See, e.g., Third Party Expense Letter.

947 See NIBA 2 Letter.

948 See Beer Letter; Levene Letter; NIBA 2 Letter.

amendment is a codification of existing Commission staff guidance,[949] and thus should not represent a change for small broker-dealers with respect to capital withdrawals. Moreover, with respect to commenters' concerns about obtaining capital,[950] the rule does not prohibit an investor from withdrawing capital at any time. Rather, it prohibits a broker-dealer from treating temporary cash infusions as capital for purposes of the net capital rule. Finally, the final rule amendments provide a mechanism for a broker-dealer to apply to its DEA to make a withdrawal within one year of the capital contribution without triggering the deduction under certain circumstances (e.g., de minimis withdrawals).

3. Small Entities Subject to the Rule

Based on FOCUS Report data, as of December 31, 2011, the Commission estimates that there are approximately 2,506 introducing and carrying broker-dealers that are "small" for the purposes Rule 0-10. The amendments relating to certain subtractions from net worth and the restrictions on the withdrawal of capital will apply to all "small" broker-dealers in that they will be subject to the requirements in the amendments. The amendment to Appendix A of Rule 15c3-1 likely should have no, or little, impact on "small" broker-dealers, because based on staff experience, most, if not all, of these firms do not carry non-clearing option specialist or market maker accounts.

4. Reporting, Recordkeeping, and Other Compliance Requirements

The amendments will require an "insolvent" broker-dealer to cease conducting a securities business and provide the securities regulators with notice of its insolvency. The amendments also will require broker-dealers to deduct from net worth certain

949 See Temporary Capital Letter. See also section II.E.2. of this release.

950 See Beer Letter; NIBA 2 Letter.

liabilities and certain temporary capital contributions, as well as require broker-dealers to deduct from net capital, certain specified amounts as required by SRO fidelity bond rules. Finally, under the amendment to the rule on Commission orders restricting withdrawals of capital, a broker-dealer subject to an order will not be permitted to withdraw capital. Finally, the amendments will make permanent a temporary rule that reduced the haircut for non-clearing options specialist and market maker accounts under Appendix A to Rule 15c3-1.

5. Agency Action to Minimize Effect on Small Entities

As discussed in detail above, the Commission considered all comments received and adopted the amendment substantially as proposed.[951] The Commission understands the concerns relating to small broker-dealers raised by commenters[952] and reiterates that the rule is designed to address situations where there is no legitimate reason to book liabilities to a separate legal entity that otherwise would accrue to the broker-dealer. Moreover, the final rule is consistent with current staff interpretations regarding third-party expense sharing and thus should not represent a change for broker-dealers. The Commission also notes that the final rule is designed to prohibit a practice that could misrepresent a broker-dealer's actual financial condition, deceive the firm's customers, and hamper the ability of regulators to monitor the firm's financial condition. Moreover, the rule change, as adopted, should not impose undue burdens or present serious implementation difficulties for large or small broker-dealers. As the Commission explained in the proposing release, a broker-dealer can demonstrate the adequacy of the third party's financial resources by maintaining records such as the third party's most

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951 See section II.E.1. of this release.

952 See Beer Letter; Beer 2 Letter; Levene Letter; Lowenstein Letter; NIBA 2 Letter. See also discussion in section II.E.1. of this release.

recent (i.e., as of a date within the previous twelve months) audited financial statements, tax returns, or regulatory filings containing financial reports.[953] Given that the entity to which the broker-dealer is seeking to shift one or more liabilities typically is an affiliate, the staff's experience is that such records should be available to the broker-dealer. Further, because the proposed rule change is consistent with prior staff guidance regarding the need to be able to demonstrate the third party's financial adequacy, the broker-dealer seeking to shift a liability to a third party already would, under existing staff interpretations, expect to be ready to provide such evidence of the third party's financial resources. Taken together, these realities should mitigate the implementation and burden concerns raised by commenters as they relate to small broker-dealers.

One or more of these record types are generally readily available. The general availability of a satisfactory measure of financial resources should mitigate the implementation and burden concerns raised by the commenters.

As discussed above, given the minimal impact these amendments will have on small entities, the Commission is not establishing different compliance or reporting requirements or timetables; clarifying, consolidating, or simplifying compliance and reporting requirements under the rule for small entities; nor exempting small entities from coverage of the rule, or any part thereof.

The amendments use performance standards and do not dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the amendments.

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953 Amendments to Financial Responsibility Rules, 72 FR at 12872. The Commission specifically requested comment regarding the records by which a broker-dealer could demonstrate financial resources. It received no comments in response to this request.

VII. STATUTORY AUTHORITY

The Commission is adopting amendments to Rules 15c3-1, 15c3-3, 17a-3, 17a-4 and 17a-11 under the Exchange Act pursuant to the authority conferred by the Exchange Act, including Sections 15, 17, 23(a) and 36.[954]

Text of Final Rules

List of Subjects

17 CFR Part 240

Brokers, Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, the Commission hereby proposes that Title 17, Chapter II of the Code of Federal Regulation be amended as follows.

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

1. The general authority for Part 240 continues to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78o-10, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, 7201 et. seq., and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; and Pub. L. 111-203, 939A, 124 Stat. 1376, (2010), unless otherwise noted.

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2. Section 240.15c3-1 is amended by:

a. Revising the first sentence of the introductory text of paragraph (a);

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[954] 15 U.S.C. 78o, 78q, 78w and 78mm.

b. Removing from paragraph (a)(6)(iii)(A) the phrase "paragraph (c)(2)(x)(A)(1) through (9) of this section" and in its place adding the phrase "Appendix A (§ 240.15c3-1a)";

c. Revising the introductory heading of paragraph (c)(2)(i);

d. Adding paragraphs (c)(2)(i)(F) and (G);

e. Revising paragraphs (c)(2)(iv)(B), (c)(2)(iv)(E), and (c)(2)(vi)(D)(1);

f. Adding paragraph (c)(2)(xiv);

g. Adding paragraph (c)(16) and an undesignated center heading;

h. Revising paragraph (e)(3)(i); and

i. Removing from the second sentence in paragraph (e)(3)(ii) the text "The hearing" and in its place adding the phrase "A hearing on an order temporarily prohibiting the withdrawal of capital".

The revisions and additions read as follows:

§ 240.15c3-1 Net capital requirements for brokers or dealers.

(a) Every broker or dealer must at all times have and maintain net capital no less than the greater of the highest minimum requirement applicable to its ratio requirement under paragraph (a)(1) of this section, or to any of its activities under paragraph (a)(2) of this section, and must otherwise not be "insolvent" as that term is defined in paragraph (c)(16) of this section. * * *

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(c) * * *

(2) * * *

(i) Adjustments to net worth related to unrealized profit or loss, deferred tax provisions, and certain liabilities.* * *

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(F) Adding to net worth any liability or expense relating to the business of the broker or dealer for which a third party has assumed the responsibility, unless the broker or dealer can demonstrate that the third party has adequate resources independent of the broker or dealer to pay the liability or expense.

(G) Subtracting from net worth any contribution of capital to the broker or dealer:

(1) Under an agreement that provides the investor with the option to withdraw the capital; or

(2) That is intended to be withdrawn within a period of one year of contribution. Any withdrawal of capital made within one year of its contribution is deemed to have been intended to be withdrawn within a period of one year, unless the withdrawal has been approved in writing by the Examining Authority for the broker or dealer.

* * * * *

(iv) * * *

(B) All unsecured advances and loans; deficits in customers' and non-customers' unsecured and partly secured notes; deficits in omnibus credit accounts maintained in compliance with the requirements of 12 CFR 220.7(f) of Regulation T under the Act, or similar accounts carried on behalf of another broker or dealer, after application of calls for margin, marks to the market or other required deposits that are outstanding 5 business days or less; deficits in customers' and non-customers' unsecured and partly secured accounts after application of calls for margin, marks to market or other required deposits that are outstanding 5 business days or less, except deficits in cash accounts as defined in 12 CFR 220.8 of Regulation T under the Act for which not more than one extension respecting a specified securities transaction has been requested and granted, and deducting for securities carried in any of such accounts the percentages specified in paragraph (c)(2)(vi) of this section or Appendix A, § 240.15c3-1a; the market value of stock loaned in excess of the value of any collateral received therefor; receivables arising out of free shipments of securities (other than mutual fund redemptions) in excess of $5,000 per shipment and all free shipments (other than mutual fund redemptions) outstanding more than 7 business days, and mutual fund redemptions outstanding more than 16 business days; and any collateral deficiencies in secured demand notes as defined in Appendix D, § 240.15c3-1d; a broker or dealer that participates in a loan of securities by one party to another party will be deemed a principal for the purpose of the deductions required under this section, unless the broker or dealer has fully disclosed the identity of each party to the other and each party has expressly agreed in writing that the obligations of the broker or dealer do not include a guarantee of performance by the other party and that such party's remedies in the event of a default by the other party do not include a right of setoff against obligations, if any, of the broker or dealer.

* * * * *

(E) <u>Other Deductions</u>. All other unsecured receivables; all assets doubtful of collection less any reserves established therefor; the amount by which the market value of securities failed to receive outstanding longer than thirty (30) calendar days exceeds the contract value of such fails to receive; and the funds on deposit in a "segregated trust account" in accordance with 17 CFR 270.27d-1 under the Investment Company Act of 1940, but only to the extent that the amount on deposit in such segregated trust account exceeds the amount of liability reserves established and maintained for refunds of charges required by sections 27(d) and 27(f) of the Investment Company Act of 1940; <u>Provided</u>, That the following need not be deducted:

(<u>1</u>) Any amounts deposited in a Customer Reserve Bank Account or PAB Reserve Bank Account pursuant to § 240.15c3-3(e),

(2) Cash and securities held in a securities account at a carrying broker or dealer (except where the account has been subordinated to the claims of creditors of the carrying broker or dealer), and

(3) Clearing deposits.

* * * * *

(vi) * * *

(D)(1) In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets consist of cash or money market instruments and which is described in § 270.2a-7 of this chapter, the deduction will be 2% of the market value of the greater of the long or short position.

* * * * *

(xiv) Deduction from net worth for excess deductible amounts related to fidelity bond coverage. Deducting the amount specified by rule of the Examining Authority for the broker or dealer with respect to a requirement to maintain fidelity bond coverage.

* * * * *

INSOLVENT

(16) For the purposes of this section, a broker or dealer is insolvent if the broker or dealer:

(i) Is the subject of any bankruptcy, equity receivership proceeding or any other proceeding to reorganize, conserve, or liquidate such broker or dealer or its property or is applying for the appointment or election of a receiver, trustee, or liquidator or similar official for such broker or dealer or its property;

(ii) Has made a general assignment for the benefit of creditors;

(iii) Is insolvent within the meaning of section 101 of title 11 of the United States Code, or is unable to meet its obligations as they mature, and has made an admission to such effect in writing or in any court or before any agency of the United States or any State; or

(iv) Is unable to make such computations as may be necessary to establish compliance with this section or with § 240.15c3-3.

* * * * *

(e) * * *

(3)(i) Temporary restrictions on withdrawal of net capital. The Commission may by order restrict, for a period of up to twenty business days, any withdrawal by the broker or dealer of equity capital or unsecured loan or advance to a stockholder, partner, sole proprietor, member, employee or affiliate under such terms and conditions as the Commission deems necessary or appropriate in the public interest or consistent with the protection of investors if the Commission, based on the information available, concludes that such withdrawal, advance or loan may be detrimental to the financial integrity of the broker or dealer, or may unduly jeopardize the broker or dealer's ability to repay its customer claims or other liabilities which may cause a significant impact on the markets or expose the customers or creditors of the broker or dealer to loss without taking into account the application of the Securities Investor Protection Act of 1970.

* * * * *

3. Section 240.15c3-1a is amended by:

a. Removing paragraph (b)(1)(iv)(B); and

b. Redesignating paragraphs (b)(1)(iv)(A), (b)(1)(iv)(A)(1), (b)(1)(iv)(A)(2), and (b)(1)(iv)(A)(3) as paragraphs (b)(1)(iv), (b)(1)(iv)(A), (b)(1)(iv)(B), and (b)(1)(iv)(C) respectively.

4. Section 240.15c3-2 is removed and reserved.

5. Section 240.15c3-3 is amended by:

a. Removing from paragraph (a)(1), third sentence, the citation "220.19" and in its place adding the citation "220.12";

b. In paragraph (a)(1)(iii), after the phrase "(15 U.S.C. 78aaa et seq.)" adding "(SIPA)";

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

d. Revising paragraphs (a)(3), (a)(4), (a)(7), (a)(8) and (a)(9);

e. Adding paragraphs (a)(16) and (a)(17);

f. In paragraph (b)(2):

(i) in the first sentence, removing the phrase "his physical possession or under his control" and in its place adding "the broker's or dealer's physical possession or under its control";

(ii) in the second sentence, removing the word "he" and in its place adding "it"; and

(iii) in the second sentence, removing the word "his" and in its place adding "its";

g. Removing from paragraphs (b)(3)(iv) and (b)(4)(i)(C) the phrase "the Securities Investor Protection Act of 1970" and in its place adding "SIPA";

h. At the end of paragraph (b)(4)(i)(C) adding the word "and,";

i. In paragraph (b)(4)(v), removing the word "his" and in its place adding "the person's";

j. Adding paragraph (b)(5);

k. In paragraph (c)(2):

(i) removing "a special omnibus" and in its place adding "an omnibus credit";

(ii) removing the text "section 4(b) of Regulation T under the Act (12 CFR 220.4(b))" and in its place adding "section 7(f) of Regulation T (12 CFR 220.7(f))"; and

(iii) removing the word "he" and in its place adding "it";

l. In paragraph (c)(3), removing the words "him" and "he" wherever they appear and in their place adding "the broker or dealer";

m. In the first sentence of paragraph (d) introductory text, removing the word "his" wherever it appears and in its place adding "its";

n. In paragraph (d)(2), removing the word "his" and in its place adding "the broker's or dealer's";

o. Removing the period at the end of paragraph (d)(3) and in its place adding "; or";

p. Redesignating paragraph (d)(4) as paragraph (d)(5);

q. Adding a new paragraph (d)(4);

r. Revising paragraphs (e) and (f);

s. Revising the first sentence of paragraph (g);

t. Removing from paragraph (i) the text "his reserve bank account" and in its place adding "its Customer Reserve Bank Account, PAB Reserve Bank Account";

u. Adding paragraph (j);

v. In paragraph (k)(1)(i), removing the phrase "His dealer transactions" and in its place adding "The broker's or dealer's transactions as dealer", and removing the word "his" the second and third time the word "his" appears and in its place adding "its";

w. In paragraph (k)(1)(ii), removing the word "His" and in its place adding "The broker's or dealer's";

x. In paragraph (k)(1)(iii), removing the word "He" and in its place adding "The broker or dealer" and removing the word "his" and in its place adding "its";

y. In paragraph (k)(2)(i), removing the word "his" and in its place adding "its" wherever it appears;

z. Revising paragraph (l)(2);

aa. Removing from the last sentence in paragraph (m) before the Note, the text "a special omnibus" and in its place adding "an omnibus credit" and removing the text "section 4(b) of Regulation T [12 CFR 220.4(b)]" and in its place adding "section 7(f) of Regulation T (12 CFR 220.7(f))";

bb. Resdesignate the Note following paragraph (m) as "Note to paragraph (m).";

cc. Removing from the first sentence in paragraph (n) the phrase "paragraphs (d) (2) and (3)" and in its place adding "paragraphs (d)(2), (3) and (4)"; and

dd. Removing from paragraph (o)(2)(i)(A) the phrase "the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa et seq.)" and in its place adding "SIPA";

The revisions and additions read as follows:

§ 240.15c3-3 Customer protection–reserves and custody of securities.

(a) * * *

(3) The term fully paid securities means all securities carried for the account of a customer in a cash account as defined in Regulation T (12 CFR 220.1 et seq.), as well as securities carried for the account of a customer in a margin account or any special account under Regulation T that have no loan value for margin purposes, and all margin equity securities in such accounts if they are fully paid: Provided, however, that the term fully paid securities does not apply to any securities purchased in transactions for which the customer has not made full payment.

(4) The term margin securities means those securities carried for the account of a customer in a margin account as defined in section 4 of Regulation T (12 CFR 220.4), as well as securities carried in any other account (such accounts hereinafter referred to as "margin accounts") other than the securities referred to in paragraph (a)(3) of this section.

* * * * *

(7) The term bank means a bank as defined in section 3(a)(6) of the Act and will also mean any building and loan, savings and loan or similar banking institution subject to supervision by a Federal banking authority. With respect to a broker or dealer that maintains its principal place of business in Canada, the term "bank" also means a Canadian bank subject to supervision by a Canadian authority.

(8) The term free credit balances means liabilities of a broker or dealer to customers which are subject to immediate cash payment to customers on demand, whether resulting from sales of securities, dividends, interest, deposits or otherwise, excluding, however, funds in commodity accounts which are segregated in accordance with the Commodity Exchange Act or in a similar manner, or which are funds carried in a proprietary account as that term is defined in regulations under the Commodity Exchange Act. The term "free credit balances" also includes, if subject to immediate cash payment to customers on demand, funds carried in a securities account pursuant to a self-regulatory organization portfolio margining rule approved by the Commission under section 19(b) of the Act (15 U.S.C. 78s(b)) ("SRO portfolio margining rule"), including variation margin or initial margin, marks to market, and proceeds resulting from margin paid or released in connection with closing out, settling or exercising futures contracts and options thereon.

(9) The term other credit balances means cash liabilities of a broker or dealer to customers other than free credit balances and funds in commodity accounts which are

segregated in accordance with the Commodity Exchange Act or in a similar manner, or funds carried in a proprietary account as that term is defined in regulations under the Commodity Exchange Act. The term "other credit balances" also includes funds that are cash liabilities of a broker or dealer to customers other than free credit balances and are carried in a securities account pursuant to an SRO portfolio margining rule, including variation margin or initial margin, marks to market, and proceeds resulting from margin paid or released in connection with closing out, settling or exercising futures contracts and options thereon.

* * * * *

(16) The term PAB account means a proprietary securities account of a broker or dealer (which includes a foreign broker or dealer, or a foreign bank acting as a broker or dealer) other than a delivery-versus-payment account or a receipt-versus-payment account. The term does not include an account that has been subordinated to the claims of creditors of the carrying broker or dealer.

(17) The term Sweep Program means a service provided by a broker or dealer where it offers to its customer the option to automatically transfer free credit balances in the securities account of the customer to either a money market mutual fund product as described in § 270.2a-7 of this chapter or an account at a bank whose deposits are insured by the Federal Deposit Insurance Corporation.

(b) * * *

(5) A broker or dealer is required to obtain and thereafter maintain the physical possession or control of securities carried for a PAB account, unless the broker or dealer has provided written notice to the account holder that the securities may be used in the ordinary course of its securities business, and has provided an opportunity for the account holder to object.

* * * * *

(d) * * *

(4) Securities included on the broker's or dealer's books or records that allocate to a short position of the broker or dealer or a short position for another person, excluding positions covered by paragraph (m) of this section, for more than 30 calendar days, then the broker or dealer must, not later than the business day following the day on which the determination is made, take prompt steps to obtain physical possession or control of such securities. For the purposes of this paragraph (d)(4), the 30 day time period will not begin to run with respect to a syndicate short position established in connection with an offering of securities until the completion of the underwriter's participation in the distribution as determined pursuant to § 242.100(b) of Regulation M of this chapter (17 CFR 242.100 through 242.105); or

* * * * *

(e) Special reserve bank accounts for the exclusive benefit of customers and PAB accounts. (1) Every broker or dealer must maintain with a bank or banks at all times when deposits are required or hereinafter specified a "Special Reserve Bank Account for the Exclusive Benefit of Customers" (hereinafter referred to as the Customer Reserve Bank Account) and a "Special Reserve Bank Account for Brokers and Dealers" (hereinafter referred to as the PAB Reserve Bank Account), each of which will be separate from the other and from any other bank account of the broker or dealer. Such broker or dealer must at all times maintain in the Customer Reserve Bank Account and the PAB Reserve Bank Account, through deposits made therein, cash and/or qualified securities in amounts computed in accordance with the formula attached as Exhibit A (17 CFR 240.15c3-3a), as applied to customer and PAB accounts respectively.

(2) With respect to each computation required pursuant to paragraph (e)(1) of this section, a broker or dealer must not accept or use any of the amounts under items comprising Total Credits under the formula referred to in paragraph (e)(1) of this section except for the specified purposes indicated under items comprising Total Debits under the formula, and, to the extent Total Credits exceed Total Debits, at least the net amount thereof must be maintained in the Customer Reserve Bank Account and PAB Reserve Bank Account pursuant to paragraph (e)(1) of this section.

(3) Reserve Bank Account computations.

(i) Computations necessary to determine the amount required to be deposited in the Customer Reserve Bank Account and PAB Reserve Bank Account as specified in paragraph (e)(1) of this section must be made weekly, as of the close of the last business day of the week, and the deposit so computed must be made no later than one hour after the opening of banking business on the second following business day; provided, however, a broker or dealer which has aggregate indebtedness not exceeding 800 percent of net capital (as defined in § 240.15c3-1) and which carries aggregate customer funds (as defined in paragraph (a)(10) of this section), as computed at the last required computation pursuant to this section, not exceeding $1,000,000, may in the alternative make the Customer Reserve Bank Account computation monthly, as of the close of the last business day of the month, and, in such event, must deposit not less than 105 percent of the amount so computed no later than one hour after the opening of banking business on the second following business day.

(ii) If a broker or dealer, computing on a monthly basis, has, at the time of any required computation, aggregate indebtedness in excess of 800 percent of net capital, such broker or dealer must thereafter compute weekly as aforesaid until four successive weekly Customer Reserve Bank Account computations are made, none of which were made at a time when its aggregate indebtedness exceeded 800 percent of its net capital.

(iii) A broker or dealer that does not carry the accounts of a "customer" as defined by this section or conduct a proprietary trading business may make the computation to be performed with respect to PAB accounts under paragraph (e)(1) of this section monthly rather than weekly. If a broker or dealer performing the computation with respect to PAB accounts under paragraph (e)(1) of this section on a monthly basis is, at the time of any required computation, required to deposit additional cash or qualified securities in the PAB Reserve Bank Account, the broker or dealer must thereafter perform the computation required with respect to PAB accounts under paragraph (e)(1) of this section weekly until four successive weekly computations are made, none of which is made at a time when the broker or dealer was required to deposit additional cash or qualified securities in the PAB Reserve Bank Account.

(iv) Computations in addition to the computations required in this paragraph (e)(3), may be made as of the close of any business day, and the deposits so computed must be made no later than one hour after the opening of banking business on the second following business day.

(v) The broker or dealer must make and maintain a record of each such computation made pursuant to this paragraph (e)(3) or otherwise and preserve each such record in accordance with § 240.17a-4.

(4) If the computation performed under paragraph (e)(3) of this section with respect to PAB accounts results in a deposit requirement, the requirement may be satisfied to the extent of any excess debit in the computation performed under paragraph (e)(3) of this section with respect to customer accounts of the same date. However, a deposit requirement resulting from the computation performed under paragraph (e)(3) of

this section with respect to customer accounts cannot be satisfied with excess debits from the computation performed under paragraph (e)(3) of this section with respect to PAB accounts.

(5) In determining whether a broker or dealer maintains the minimum deposits required under this section, the broker or dealer must exclude the total amount of any cash deposited with an affiliated bank. The broker or dealer also must exclude cash deposited with a non-affiliated bank to the extent that the amount of the deposit exceeds 15% of the bank's equity capital as reported by the bank in its most recent Call Report or any successor form the bank is required to file by its appropriate Federal banking agency (as defined by section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)).

(f) Notification of banks. A broker or dealer required to maintain a Customer Reserve Bank Account and PAB Reserve Bank Account prescribed by paragraph (e)(1) of this section or who maintains a Special Account referred to in paragraph (k) of this section must obtain and preserve in accordance with § 240.17a-4 a written notification from each bank with which it maintains a Customer Reserve Bank Account, a PAB Reserve Bank Account, or a Special Account that the bank was informed that all cash and/or qualified securities deposited therein are being held by the bank for the exclusive benefit of the customers and account holders of the broker or dealer in accordance with the regulations of the Commission, and are being kept separate from any other accounts maintained by the broker or dealer with the bank, and the broker or dealer must have a written contract with the bank which provides that the cash and/or qualified securities will at no time be used directly or indirectly as security for a loan to the broker or dealer by the bank and will not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank.

(g) Withdrawals from the reserve bank accounts. A broker or dealer may make withdrawals from a Customer Reserve Bank Account and a PAB Reserve Bank Account if and to the extent that at the time of the withdrawal the amount remaining in the Customer Reserve Bank Account and PAB Reserve Bank Account is not less than the amount then required by paragraph (e) of this section. * * *

* * * * *

(j) Treatment of free credit balances. (1) A broker or dealer must not accept or use any free credit balance carried for the account of any customer of the broker or dealer unless such broker or dealer has established adequate procedures pursuant to which each customer for whom a free credit balance is carried will be given or sent, together with or as part of the customer's statement of account, whenever sent but not less frequently than once every three months, a written statement informing the customer of the amount due to the customer by the broker or dealer on the date of the statement, and that the funds are payable on demand of the customer.

(2) A broker or dealer must not convert, invest, or transfer to another account or institution, credit balances held in a customer's account except as provided in paragraphs (j)(2)(i) and (ii) of this section.

(i) A broker or dealer is permitted to invest or transfer to another account or institution, free credit balances in a customer's account only upon a specific order, authorization, or draft from the customer, and only in the manner, and under the terms and conditions, specified in the order, authorization, or draft.

(ii) A broker or dealer is permitted to transfer free credit balances held in a customer's securities account to a product in its Sweep Program or to transfer a customer's interest in one product in a Sweep Program to another product in a Sweep Program, provided:

(A) For an account opened on or after the effective date of this paragraph (j)(2)(ii), the customer gives prior written affirmative consent to having free credit balances in the customer's securities account included in the Sweep Program after being notified:

(1) Of the general terms and conditions of the products available through the Sweep Program; and

(2) That the broker or dealer may change the products available under the Sweep Program.

(B) For any account:

(1) The broker or dealer provides the customer with the disclosures and notices regarding the Sweep Program required by each self-regulatory organization of which the broker or dealer is a member;

(2) The broker or dealer provides notice to the customer, as part of the customer's quarterly statement of account, that the balance in the bank deposit account or shares of the money market mutual fund in which the customer has a beneficial interest can be liquidated on the customer's order and the proceeds returned to the securities account or remitted to the customer; and

(3)(i) The broker or dealer provides the customer with written notice at least 30 calendar days before:

(A) Making changes to the terms and conditions of the Sweep Program;

(B) Making changes to the terms and conditions of a product currently available through the Sweep Program;

(C) Changing, adding or deleting products available through the Sweep Program; or

(D) Changing the customer's investment through the Sweep Program from one product to another.

(ii) The notice must describe the new terms and conditions of the Sweep Program or product or the new product, and the options available to the customer if the customer does not accept the new terms and conditions or product.

* * * * *

(l) Delivery of securities. * * *

(2) Margin securities upon full payment by such customer to the broker or dealer of the customer's indebtedness to the broker or dealer; and, subject to the right of the broker or dealer under Regulation T (12 CFR 220) to retain collateral for its own protection beyond the requirements of Regulation T, excess margin securities not reasonably required to collateralize such customer's indebtedness to the broker or dealer.

* * * * *

6. Section 240.15c3-3a is revised to read as follows:

§ 240.15c3-3a Exhibit A–Formula for determination of customer and PAB account reserve requirements of brokers and dealers under § 240.15c3-3.

	Credits	Debits
1. Free credit balances and other credit balances in customers' security accounts. (See Note A)......................................	$XXX	....
2. Monies borrowed collateralized by securities carried for the accounts of customers (See Note B)...	XXX	....
3. Monies payable against customers' securities loaned (See Note C)................	XXX	....
4. Customers' securities failed to receive (See Note D)...	XXX	....
5. Credit balances in firm accounts which are attributable to principal sales to customers.	XXX	....
6. Market value of stock dividends, stock splits and similar distributions receivable outstanding over 30 calendar days...........	XXX	....
7. Market value of short security count differences over 30 calendar days old..	XXX	....
8. Market value of short securities and credits (not to be offset by longs or by debits) in all suspense accounts over 30 calendar days.	XXX	....
9. Market value of securities which are in transfer in excess of 40 calendar days and have not been confirmed to be in transfer by the transfer agent or the issuer during the 40 days..	XXX	....
10. Debit balances in customers' cash and margin accounts excluding unsecured accounts and accounts doubtful of collection. (See Note E).........................	....	XXX

11. Securities borrowed to effectuate short sales by customers and securities borrowed to make delivery on customers' securities failed to deliver........................	....	XXX
12. Failed to deliver of customers' securities not older than 30 calendar days...............	....	XXX
13. Margin required and on deposit with the Options Clearing Corporation for all option contracts written or purchased in customer accounts. (See Note F)..........................	....	XXX
14. Margin required and on deposit with a clearing agency registered with the Commission under section 17A of the Act (15 U.S.C. 78q-1) or a derivatives clearing organization registered with the Commodity Futures Trading Commission under section 5b of the Commodity Exchange Act (7 U.S.C. 7a-1) related to the following types of positions written, purchased or sold in customer accounts: (1) security futures products and (2) futures contracts (and options thereon) carried in a securities account pursuant to an SRO portfolio margining rule (See Note G)	....	XXX
Total credits....................................	....	....
Total debits.....................................	....	....
15. Excess of total credits (sum of items 1-9) over total debits (sum of items 10-14) required to be on deposit in the "Reserve Bank Account" (§ 240.15c3-3(e)). If the computation is made monthly as permitted by this section, the deposit must be not less than 105% of the excess of total credits over total debits.	....	XXX

Notes Regarding the Customer Reserve Bank Account Computation

Note A. Item 1 must include all outstanding drafts payable to customers which have been applied against free credit balances or other credit balances and must also include checks drawn in excess of bank balances per the records of the broker or dealer.

Note B. Item 2 must include the amount of options-related or security futures product-related Letters of Credit obtained by a member of a registered clearing agency or a derivatives clearing organization which are collateralized by customers' securities, to the extent of the member's margin requirement at the registered clearing agency or derivatives clearing organization. Item 2 must also include the amount of Letters of Credit which are collateralized by customers' securities and related to other futures contracts (and options thereon) carried in a securities account pursuant to an SRO portfolio margining rule.

Note C. Item 3 must include in addition to monies payable against customers' securities loaned the amount by which the market value of securities loaned exceeds the collateral value received from the lending of such securities.

Note D. Item 4 must include in addition to customers' securities failed to receive the amount by which the market value of securities failed to receive and outstanding more than thirty (30) calendar days exceeds their contract value.

Note E. (1) Debit balances in margin accounts must be reduced by the amount by which a specific security (other than an exempted security) which is collateral for margin accounts exceeds in aggregate value 15 percent of the aggregate value of all securities which collateralize all margin accounts receivable; provided, however, the required reduction must not be in excess of the amounts of the debit balance required to be excluded because of this concentration rule. A specified security is deemed to be collateral for a margin account only to the extent it represents in value not more than 140 percent of the customer debit balance in a margin account.

(2) Debit balances in special omnibus accounts, maintained in compliance with the requirements of Section 7(f) of Regulation T (12 CFR 220.7(f)) or similar accounts carried on behalf of another broker or dealer, must be reduced by any deficits in such accounts (or if a credit, such credit must be increased) less any calls for margin, mark to the market, or other required deposits which are outstanding 5 business days or less.

(3) Debit balances in customers' cash and margin accounts included in the formula under Item 10 must be reduced by an amount equal to 1 percent of their aggregate value.

(4) Debit balances in cash and margin accounts of household members and other persons related to principals of a broker or dealer and debit balances in cash and margin accounts of affiliated persons of a broker or dealer must be excluded from the Reserve Formula, unless the

broker or dealer can demonstrate that such debit balances are directly related to credit items in the formula.

(5) Debit balances in margin accounts (other than omnibus accounts) must be reduced by the amount by which any single customer's debit balance exceeds 25% (to the extent such amount is greater than $50,000) of the broker-dealer's tentative net capital (i.e., net capital prior to securities haircuts) unless the broker or dealer can demonstrate that the debit balance is directly related to credit items in the Reserve Formula. Related accounts (e.g., the separate accounts of an individual, accounts under common control or subject to cross guarantees) will be deemed to be a single customer's accounts for purposes of this provision.

If the registered national securities exchange or the registered national securities association having responsibility for examining the broker or dealer ("designated examining authority") is satisfied, after taking into account the circumstances of the concentrated account including the quality, diversity, and marketability of the collateral securing the debit balances or margin accounts subject to this provision, that the concentration of debit balances is appropriate, then such designated examining authority may grant a partial or plenary exception from this provision. The debit balance may be included in the reserve formula computation for five business days from the day the request is made.

(6) Debit balances in joint accounts, custodian accounts, participation in hedge funds or limited partnerships or similar type accounts or arrangements that include both assets of a person or persons who would be excluded from the definition of customer ("noncustomer") and assets of a person or persons who would be included in the definition of customer must be included in the Reserve Formula in the following manner: if the percentage ownership of the non-customer is less than 5 percent then the entire debit balance shall be included in the formula; if such percentage ownership is between 5 percent and 50 percent then the portion of the debit balance attributable to the non-customer must be excluded from the formula unless the broker or dealer can demonstrate that the debit balance is directly related to credit items in the formula; or if such percentage ownership is greater than 50 percent, then the entire debit balance must be excluded from the formula unless the broker or dealer can demonstrate that the debit balance is directly related to credit items in the formula.

Note F. Item 13 must include the amount of margin required and on deposit with the Options Clearing Corporation to the extent such margin is represented by cash, proprietary qualified securities and letters of credit collateralized by customers' securities.

Note G. (a) Item 14 must include the amount of margin required and on deposit with a clearing agency registered with the Commission under section 17A of the Act (15 U.S.C. 78q-1) or a derivatives clearing organization registered with the Commodity Futures Trading Commission under section 5b of the Commodity Exchange Act (7 U.S.C. 7a-1) for customer accounts to the extent that the margin is represented by cash, proprietary qualified securities, and letters of credit collateralized by customers' securities.

(b) Item 14 will apply only if the broker or dealer has the margin related to security futures products, or futures (and options thereon) carried in a securities account pursuant to an approved SRO portfolio margining program on deposit with:

(1) A registered clearing agency or derivatives clearing organization that:

(i) Maintains the highest investment-grade rating from a nationally recognized statistical rating organization; or

(ii) Maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least $2 billion, at least $500 million of which must be in the form of security deposits. For the purposes of this Note G, the term "security deposits" refers to a general fund, other than margin deposits or their equivalent, that consists of cash or securities held by a registered clearing agency or derivative clearing organization; or

(iii) Maintains at least $3 billion in margin deposits; or

(iv) Does not meet the requirements of paragraphs (b)(1)(i) through (b)(1)(iii) of this Note G, if the Commission has determined, upon a written request for exemption by or for the benefit of the broker or dealer, that the broker or dealer may utilize such a registered clearing agency or derivatives clearing organization. The Commission may, in its sole discretion, grant such an exemption subject to such conditions as are appropriate under the circumstances, if the Commission determines that such conditional or unconditional exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors; and

(2) A registered clearing agency or derivatives clearing organization that, if it holds funds or securities deposited as margin for security futures products or futures in a portfolio margin account in a bank, as defined in section 3(a)(6) of the Act (15 U.S.C. 78c(a)(6)), obtains and preserves written notification from the bank at which it holds such funds and securities or at which such funds and securities are held on its behalf. The written notification will state that all funds and/or securities deposited with the bank as margin (including customer security futures products and futures in a portfolio margin account), or held by the bank and pledged to such registered clearing agency or derivatives clearing agency as margin, are being held by the bank for the exclusive benefit of clearing members of the registered clearing agency or derivatives clearing organization (subject to the interest of such registered clearing agency or derivatives clearing organization therein), and are being kept separate from any other accounts maintained by the registered clearing agency or derivatives clearing organization with the bank. The written notification also will provide that such funds and/or securities will at no time be used directly or indirectly as security for a loan to the registered clearing agency or derivatives clearing organization by the bank, and will be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank. This provision, however, will not prohibit a registered clearing agency or derivatives clearing organization from pledging customer funds or securities as collateral to a bank for any purpose that the rules of the Commission or the registered clearing agency or derivatives clearing organization otherwise permit; and

(3) A registered clearing agency or derivatives clearing organization establishes, documents, and maintains:

(i) Safeguards in the handling, transfer, and delivery of cash and securities;

(ii) Fidelity bond coverage for its employees and agents who handle customer funds or securities. In the case of agents of a registered clearing agency or derivatives clearing organization, the agent may provide the fidelity bond coverage; and

(iii) Provisions for periodic examination by independent public accountants; and

(iv) A derivatives clearing organization that, if it is not otherwise registered with the Commission, has provided the Commission with a written undertaking, in a form acceptable to the

Commission, executed by a duly authorized person at the derivatives clearing organization, to the effect that, with respect to the clearance and settlement of the customer security futures products and futures in a portfolio margin account of the broker or dealer, the derivatives clearing organization will permit the Commission to examine the books and records of the derivatives clearing organization for compliance with the requirements set forth in § 240.15c3-3a, Note G (b)(1) through (3).

(c) Item 14 will apply only if a broker or dealer determines, at least annually, that the registered clearing agency or derivatives clearing organization with which the broker or dealer has on deposit margin related to securities future products or futures in a portfolio margin account meets the conditions of this Note G.

Notes Regarding the PAB Reserve Bank Account Computation

Note 1. Broker-dealers should use the formula in Exhibit A for the purposes of computing the PAB reserve requirement, except that references to "accounts," "customer accounts, or "customers" will be treated as references to PAB accounts.

Note 2. Any credit (including a credit applied to reduce a debit) that is included in the computation required by § 240.15c3-3 with respect to customer accounts (the "customer reserve computation") may not be included as a credit in the computation required by § 240.15c3-3 with respect to PAB accounts (the "PAB reserve computation").

Note 3. Note E(1) to § 240.15c3-3a does not apply to the PAB reserve computation.

Note 4. Note E(3) to § 240.15c3-3a which reduces debit balances by 1% does not apply to the PAB reserve computation.

Note 5. Interest receivable, floor brokerage, and commissions receivable of another broker or dealer from the broker or dealer (excluding clearing deposits) that are otherwise allowable assets under § 240.15c3-1 need not be included in the PAB reserve computation, provided the amounts have been clearly identified as payables on the books of the broker or dealer. Commissions receivable and other receivables of another broker or dealer from the broker or dealer that are otherwise non-allowable assets under § 240.15c3-1 and clearing deposits of another broker or dealer may be included as "credit balances" for purposes of the PAB reserve computation, provided the commissions receivable and other receivables are subject to immediate cash payment to the other broker or dealer and the clearing deposit is subject to payment within 30 days.

Note 6. Credits included in the PAB reserve computation that result from the use of securities held for a PAB account ("PAB securities") that are pledged to meet intra-day margin calls in a cross-margin account established between the Options Clearing Corporation and any regulated derivatives clearing organization may be reduced to the extent that the excess margin held by the other clearing corporation in the cross-margin relationship is used the following business day to replace the PAB securities that were previously pledged. In addition, balances resulting from a portfolio margin account that are segregated pursuant to Commodity Futures Trading Commission regulations need not be included in the PAB Reserve Bank Account computation.

Note 7. Deposits received prior to a transaction pending settlement which are $5 million or greater for any single transaction or $10 million in aggregate may be excluded as credits from the PAB reserve computation if such balances are placed and maintained in a separate PAB Reserve Bank Account by 12 p.m. Eastern Time on the following business day. Thereafter, the money representing any such deposits may be withdrawn to complete the related transactions without performing a new PAB reserve computation.

Note 8. A credit balance resulting from a PAB reserve computation may be reduced by the amount that items representing such credits are swept into money market funds or mutual funds of an investment company registered under the Investment Company Act of 1940 on or prior to 10 a.m. Eastern Time on the deposit date provided that the credits swept into any such fund are not subject to any right, charge, security interest, lien, or claim of any kind in favor of the investment company or the broker or dealer. Any credits that have been swept into money market funds or mutual funds must be maintained in the name of a particular broker or for the benefit of another broker.

Note 9. Clearing deposits required to be maintained at registered clearing agencies may be included as debits in the PAB reserve computation to the extent the percentage of the deposit, which is based upon the clearing agency's aggregate deposit requirements (e.g., dollar trading volume), that relates to the proprietary business of other brokers and dealers can be identified.

Note 10. A broker or dealer that clears PAB accounts through an affiliate or third party clearing broker must include these PAB account balances and the omnibus PAB account balance in its PAB reserve computation.

7. Section 240.17a-3 is amended by adding paragraph (a)(23) to read as follows:

§ 240.17a-3 Records to be made by certain exchange members, brokers and dealers.

(a) * * *

(23) A record documenting the credit, market, and liquidity risk management controls established and maintained by the broker or dealer to assist it in analyzing and managing the risks associated with its business activities, Provided, that the records required by this paragraph (a)(23) need only be made if the broker or dealer has more than:

(i) $1,000,000 in aggregate credit items as computed under § 240.15c3-3a; or

(ii) $20,000,000 in capital, which includes debt subordinated in accordance with § 240.15c3-1d.

* * * * *

8. Section 240.17a-4 is amended by:

a. Removing from paragraph (b)(1) the citation "§ 240.17a-3(f)" and its place adding the citation "§ 240.17a-3(g)";

b. Removing from paragraph (b)(9) the citation "§ 240.15c3-3(d)(4)" and in its place adding the citation "§ 240.15c3-3(d)(5)"; and

c. Adding paragraph (e)(9).

The addition reads as follows:

§ 240.17a-4 Records to be preserved by certain exchange members, brokers and dealers.

* * * * *

(e) * * *

(9) All records required pursuant to § 240.17a-3(a)(23) until three years after the termination of the use of the risk management controls documented therein.

* * * * *

9. Section 240.17a-11 is amended by:

a. Revising the first sentence of paragraph (b)(1);

b. Removing from the introductory text of paragraph (c) the text "or (c)(4)" and in its place adding ", (c)(4) or (c)(5)"; and

c. Adding paragraph (c)(5).

The revision and addition read as follows:

§ 240.17a-11 Notification provisions for brokers and dealers

* * * * *

(b)(1) Every broker or dealer whose net capital declines below the minimum amount required pursuant to § 240.15c3-1, or is insolvent as that term is defined in § 240.15c3-1(c)(16), must give notice of such deficiency that same day in accordance with paragraph (g) of this section. * * *

* * * * *

(c) * * *

(5) If a computation made by a broker or dealer pursuant to § 240.15c3-1 shows that the total amount of money payable against all securities loaned or subject to a repurchase agreement or the total contract value of all securities borrowed or subject to a

reverse repurchase agreement is in excess of 2500 percent of its tentative net capital; provided, however, that for purposes of this leverage test transactions involving government securities, as defined in section 3(a)(42) of the Act (15 U.S.C. 78c(a)(42)), must be excluded from the calculation; provided further, however, that a broker or dealer will not be required to send the notice required by this paragraph (c)(5) if it reports monthly its securities lending and borrowing and repurchase and reverse repurchase activity (including the total amount of money payable against securities loaned or subject to a repurchase agreement and the total contract value of securities borrowed or subject to a reverse repurchase agreement) to its designated examining authority in a form acceptable to its designated examining authority.

* * * * *

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

July 30, 2013

Commissioner Paredes
Commissioner Gallagher
Disapproved

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240 and 249

Release No. 34-70073; File No. S7-23-11

RIN 3235-AK56

Broker-Dealer Reports

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission"), under the Securities Exchange Act of 1934 ("Exchange Act"), is amending certain broker-dealer annual reporting, audit, and notification requirements. The amendments include a requirement that broker-dealer audits be conducted in accordance with standards of the Public Company Accounting Oversight Board ("PCAOB") in light of explicit oversight authority provided to the PCAOB by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") to oversee these audits. The amendments further require a broker-dealer that clears transactions or carries customer accounts to agree to allow representatives of the Commission or the broker-dealer's designated examining authority ("DEA") to review the documentation associated with certain reports of the broker-dealer's independent public accountant and to allow the accountant to discuss the findings relating to the reports of the accountant with those representatives when requested in connection with a regulatory examination of the broker-dealer. Finally, the amendments require a broker-dealer to file a new form with its DEA that elicits information about the broker-dealer's practices with respect to the custody of securities and funds of customers and non-customers.

DATES: The deletion of paragraph (e)(5) of Rule 17a-5 (17 CFR 240.17a-5) under the Exchange Act is effective [insert 60 days after publication in the Federal Register].

The amendments to paragraphs (a) and (d)(6) of Rule 17a-5 (17 CFR 240.17a-5) under the Exchange Act and the rule establishing Form Custody (17 CFR 249.639) under the Exchange Act are effective on December 31, 2013.

The amendments to paragraphs (b), (c), (d)(1), (d)(2), (d)(3), (d)(4), (d)(5), (e)(1), (e)(2), (e)(3), (e)(4), (f), (g), (h), (i), (k), (l), (m) and (n) and the deletion of paragraph (j) of Rule 17a-5 (17 CFR 240.17a-5) and the amendments to Rule 17a-11 (17 CFR 240.17a-11) under the Exchange Act are effective on June 1, 2014.

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director, at (202) 551-5525; Thomas K. McGowan, Deputy Associate Director, at (202) 551-5521; Randall W. Roy, Assistant Director, at (202) 551-5522; Mark M. Attar, Branch Chief, at (202) 551-5889; Rose Russo Wells, Special Counsel, at (202) 551-5527; Sheila Dombal Swartz, Special Counsel, at (202) 551-5545; or Kimberly N. Chehardy, Attorney, at (202) 551-5791, Office of Financial Responsibility, Division of Trading and Markets; or Kevin Stout, Senior Associate Chief Accountant, at (202) 551-5930, Office of the Chief Accountant, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-7010.

SUPPLEMENTARY INFORMATION: The Commission is adopting amendments to Rule 17a-5 (17 CFR 240.17a-5) and technical and conforming amendments to Rule 17a-11 (17 CFR 240.17a-11) and is adopting Form Custody (17 CFR 249. 639) under the Exchange Act.

Contents

I. BACKGROUND

A. Overview

In 2009, the Commission began reviewing rules regarding the safekeeping of investor assets in connection with several cases the Commission brought alleging fraudulent conduct by investment advisers and broker-dealers, including, among other things, misappropriation or other misuse of customer securities and funds.[1] As part of the rule review effort, the Commission amended Rule 206(4)-2 under the Investment Advisers Act of 1940 ("Rule 206(4)-2"), which governs the custody of client securities and funds by investment advisers.[2] When adopting this amendment, the Commission stated that it represented "a first step in the effort to enhance custody protections, with consideration of additional enhancements of the rules governing custody of customer assets by broker-dealers to follow."[3]

In June 2011, the Commission proposed rule amendments and a new form designed, among other things, to provide additional safeguards with respect to broker-dealer custody of customer securities and funds.[4] The proposed amendments would have amended certain annual reporting, audit, and notification requirements for broker-dealers.[5] The proposed amendments also would have required a broker-dealer that clears transactions or carries customer accounts (each, a "clearing broker-dealer") to agree to allow representatives of the Commission or the broker-dealer's DEA to review the documentation associated with certain reports of the broker-dealer's independent public accountant and to allow the accountant to discuss with representatives of the Commission or DEA the accountant's findings associated with those reports when requested in connection with an examination of the broker-dealer.[6] Further, the

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1 See, e.g., SEC v. Bernard L. Madoff, et al., Litigation Release No. 20889 (Feb. 9, 2009); SEC v. Stanford International Bank, et al., Litigation Release No. 20901 (Feb. 17, 2009); SEC v. Donald Anthony Walker Young, et al., Litigation Release No. 21006 (Apr. 20, 2009); SEC v. Isaac I. Ovid, et al., Litigation Release No. 20998 (Apr. 14, 2009); SEC v. The Nutmeg Group, LLC, et al., Litigation Release No. 20972 (Mar. 25, 2009); SEC v. WG Trading Investors, L.P., et al., Litigation Release No. 20912 (Feb. 25, 2009).

2 See Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act of 1940 ("Advisers Act") Release No. 2968 (Dec. 30, 2009), 75 FR 1456 (Jan. 11, 2010). See also 17 CFR 275.206(4)-2.

3 See Custody of Funds or Securities of Clients by Investment Advisers, 75 FR at 1456.

4 See Broker-Dealer Reports, Exchange Act Release No. 64676 (June 15, 2011), 76 FR 37572 (June 27, 2011).

5 Id. at 37575–37583.

6 Id. at 37583–37584.

proposed amendments would have required a broker-dealer to file with its DEA on a quarterly basis a new form – Form Custody – that would have elicited information as to whether, and if so how, a broker-dealer maintains custody of securities and funds of customers and others.[7] The Commission also proposed requiring that a broker-dealer file its annual reports with the Securities Investor Protection Corporation ("SIPC").[8]

The proposed amendments were designed to enhance the ability of the Commission to oversee broker-dealer custody practices and, among other things, to: (1) increase the focus of broker-dealers that maintain custody of customer funds and securities ("carrying broker-dealers") and their independent public accountants on compliance, and internal control over compliance, with certain financial and custodial requirements; (2) strengthen and clarify broker-dealer audit and reporting requirements in order to facilitate consistent compliance with these requirements; (3) facilitate the ability of the PCAOB to implement the explicit oversight authority over broker-dealer audits provided to the PCAOB by the Dodd-Frank Act;[9] (4) ensure that SIPC receives the necessary information to assess whether the liquidation fund it maintains is appropriately sized to the risks of a large broker-dealer failure; (5) enable Commission and DEA examiners to conduct risk-based examinations of carrying and clearing broker-dealers by assisting the examiners in selecting areas of focus for their examinations; and (6) provide the Commission and the DEAs with a comprehensive overview of a broker-dealer's custody practices.[10]

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7 Id. at 37584–37592.

8 Id. at 37592–37594.

9 Pub. L. No. 111-203, 124 Stat. 1376, H.R. 4173 (July 21, 2010).

10 The proposed amendments also were designed to avoid duplicative requirements for broker-dealers that are dually-registered as investment advisers in view of the internal control report requirement that was added by the amendment to Rule 206(4)-2. See discussion below in section VII.A. of this release identifying further motivations for the amendments.

The Commission received 27 comment letters on the proposal.[11] The Commission has considered the comments and, as discussed in detail below, is adopting the amendments and the new form with modifications, in part in response to comments received. A number of commenters stated that the Commission should coordinate with the Commodity Futures Trading Commission ("CFTC") to account for broker-dealers that also are registered as futures commission merchants ("FCMs") in order to align the broker-dealer reporting and audit requirements with FCM reporting and audit requirements.[12] The Commission staff is in discussions with the CFTC staff concerning ways to align the reporting and audit requirements for dually-registered broker-dealer/FCMs with the goal of coordinating these requirements, including the requirements that the Commission is adopting today.

11 Comment letter of Naphtali M. Hamlet (June 22, 2011) ("Hamlet Letter"); comment letter of Robert R. Kelley (June 27, 2011) ("Kelley Letter"); comment letter of Chris Barnard (July 20, 2011) ("Barnard Letter"); comment letter of Suzanne Shatto (July 25, 2011) ("Shatto Letter"); comment letter of Suzanne H. Shatto (July 25, 2011) ("Shatto Letter II"); comment letter of Todd Genger (Aug. 2, 2011) ("Genger Letter"); comment letter of Suzanne Shatto (Aug. 14, 2011) ("Shatto Letter III"); comment letter of Deloitte & Touche LLP (Aug. 25, 2011) ("Deloitte Letter"); comment letter of the Securities Industry and Financial Markets Association (Aug. 25, 2011) ("SIFMA Letter"); comment letter of the Center for Audit Quality (Aug. 25, 2011) ("CAQ Letter"); comment letter of KPMG LLP (Aug. 25, 2011) ("KPMG Letter"); comment letter of PricewaterhouseCoopers, LLP (Aug. 25, 2011) ("PWC Letter"); comment letter of Citrin Cooperman & Co., LLP (Aug. 25, 2011) ("Citrin Letter"); comment letter of Grant Thornton LLP (Aug. 26, 2011) ("Grant Thornton Letter"); comment letter of James J. Angel (Aug. 26, 2011) ("Angel Letter"); comment letter of James J. Angel (Aug. 26, 2011) ("Angel Letter II"); comment letter of McGladrey & Pullen, LLP (Aug. 26, 2011) ("McGladrey Letter"); comment letter of the Certified Financial Planner Board of Standards, Inc. (Aug. 26, 2011) ("CFP Letter"); comment letter of Integrated Management Solutions USA LLC (Aug. 26, 2011) ("IMS Letter"); comment letter of the American Institute of Certified Public Accountants (Aug. 26, 2011) ("AICPA Letter"); comment letter of the Committee of Annuity Insurers (Aug. 26, 2011) ("CAI Letter"); comment letter of Ernst & Young LLP (Aug. 26, 2011) ("E&Y Letter"); comment letter of Van Kampen Funds Inc. and Invesco Distributors, Inc. (Aug. 26, 2011) ("Van Kampen/Invesco Letter"); comment letter of Suzanne H. Shatto (Sept. 13, 2011) ("Shatto Letter IV); comment letter N.M. Hamlet (Sept. 14, 2011) ("Hamlet Letter II"); comment letter of the Federal Regulation of Securities Committee, Business Law Section, American Bar Association (Sept. 15, 2011) ("ABA Letter"); and comment letter of the Committee of Annuity Insurers (Apr. 17, 2012) ("CAI II Letter"). The comment letters are available on the Commission's website at http://www.sec.gov/comments/s7-23-11/s72311.shtml. Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC (File No. S7-23-11).

12 See CAQ Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; PWC Letter.

B. Rules Governing Broker-Dealer Financial and Custodial Responsibility

Rule 15c3-1,[13] Rule 15c3-3,[14] and Rule 17a-13,[15] under the Exchange Act and applicable DEA rules that require broker-dealers to periodically send account statements to customers ("Account Statement Rules")[16] (collectively for the purposes of this release, "the financial responsibility rules") are central to today's amendments to the broker-dealer reporting, audit, and notification requirements. In light of the significance of the financial responsibility rules to today's amendments, the following section briefly summarizes the requirements of each rule in order to provide a foundation for the later discussion of the amendments.

1. The Broker-Dealer Net Capital Rule

Rule 15c3-1 requires broker-dealers to maintain a minimum level of net capital (consisting of highly liquid assets) at all times.[17] In computing net capital, a broker-dealer must, among other things, calculate net worth in accordance with U.S. generally accepted accounting principles ("GAAP") and then make certain adjustments to net worth, such as deducting illiquid assets and taking other capital charges and adding qualifying subordinated loans.[18] The amount remaining after these deductions is defined as "tentative net capital."[19] The final step in

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13 17 CFR 240.15c3-1 (a rule prescribing net capital requirements for broker-dealers).

14 17 CFR 240.15c3-3 (a rule prescribing requirements regarding the holding of customer securities and funds by broker-dealers).

15 17 CFR 240.17a-13 (a rule requiring broker-dealers to perform quarterly securities counts).

16 See, e.g., Rule 9.12 of the Chicago Board Options Exchange ("CBOE"); NASD Rule 2340 of the Financial Industry Regulatory Authoirty ("FINRA").

17 See 17 CFR 240.15c3-1. The rule requires that a broker-dealer perform two calculations: (1) a computation of the minimum amount of net capital the broker-dealer must maintain; and (2) a computation of the amount of net capital the broker-dealer is maintaining. See 17 CFR 240.15c3-1(a) and (c)(2). The computation of net capital is based on the definition of the term "net capital" in paragraph (c)(2) of Rule 15c3-1. Id. Generally, a broker-dealer's minimum net capital requirement is the greater of a fixed-dollar amount specified in the rule and an amount determined by applying one of two financial ratios. See 17 CFR 240.15c3-1(a).

18 See 17 CFR 240.15c3-1(c)(2)(i)–(xiii).

19 See 17 CFR 240.15c3-1(c)(15).

computing net capital is to deduct certain percentages ("haircuts") from the market value of the broker-dealer's proprietary positions to account for the market risk inherent in the positions[20] and to create a buffer of liquidity to protect against other risks associated with the broker-dealer's business.[21] The broker-dealer must cease conducting a securities business if the amount of net capital maintained by the firm falls below the minimum required amount.[22]

2. The Broker-Dealer Customer Protection Rule

Rule 15c3-3 imposes two key requirements on a carrying broker-dealer: first, the broker-dealer must maintain physical possession or control over customers' fully paid and excess margin securities;[23] and second, the firm must maintain a reserve of funds or qualified securities[24] in an account at one or more banks that is at least equal in value to the amount of net funds owed to customers.[25] These requirements are designed to protect customers by requiring broker-dealers to segregate customers' securities and funds from the broker-dealer's proprietary

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20 See 17 CFR 240.15c3-1(c)(2)(vi).

21 See, e.g., Uniform Net Capital Rule, Exchange Act Release No. 13635 (June 16, 1977), 42 FR 31778 (June 23, 1977).

22 See 15 U.S.C. 78o(c)(3)(A).

23 See 17 CFR 240.15c3-3(d). Control means the broker-dealer must hold these securities free of lien in one of several locations specified in the rule (e.g., at a bank or clearing agency). See 17 CFR 240.15c3-3(c). The broker-dealer must make a daily determination from its books and records (as of the preceding day) of the quantity of fully paid and excess margin securities not in its possession or control. See 17 CFR 240.15c3-3(d). If the amount in the broker-dealer's possession or control is less than the amount indicated as being held for customers on the broker-dealer's books and records, the broker-dealer generally must initiate steps to retrieve customer securities from non-control locations or otherwise obtain possession of them or place them in control locations. Id. The terms fully paid securities, margin securities, and excess margin securities are defined in Rule 15c3-3. See 17 CFR 240.15c3-3(a)(3), (a)(4), and (a)(5), respectively.

24 The term qualified security is defined in Rule 15c3-3 to mean a security issued by the U.S. or a security in respect of which the principal and interest are guaranteed by the U.S. See 17 CFR 240.15c3-3(a)(6).

25 See 17 CFR 240.15c3-3(e). The amount of the net funds owed to customers ("customer reserve requirement") is computed by adding customer credit items (e.g., cash in securities accounts) and subtracting from that amount customer debit items (e.g., margin loans) pursuant to a formula in Exhibit A to Rule 15c3-3. See 17 CFR 240.15c3-3a. Carrying broker-dealers are required to compute the customer reserve requirement on a weekly basis, except where customer credit balances do not exceed $1 million (in which case the computation can be performed monthly, although the broker-dealer must maintain 105% of the required deposit amount and may not exceed a specified aggregate indebtedness limit). See 17 CFR 240.15c3-3(e)(3).

business activities. If the broker-dealer fails financially, customers' securities and funds should be readily available to be returned to customers. In addition, if the failed broker-dealer is liquidated in a proceeding under the Securities Investor Protection Act of 1970 ("SIPA"), as amended, the customers' securities and funds should be isolated and readily identifiable as "customer property" and, consequently, available to be distributed to customers ahead of other creditors.[26]

Provisions of Rule 15c3-3 exempt a broker-dealer from the requirements of Rule 15c3-3 under certain circumstances.[27] Generally, a broker-dealer is exempt from Rule 15c3-3 if it does not hold customer securities or funds, or, if it does receive customer securities or funds, it promptly delivers the securities or promptly transmits the funds to appropriate persons.[28]

3. The Broker-Dealer Quarterly Securities Count Rule

Rule 17a-13 generally requires a broker-dealer that maintains custody of securities (proprietary, customer, or both), on a quarterly basis, to physically examine and count the securities it holds, account for the securities that are subject to its control or direction but are not in its physical possession (e.g., securities held at a control location), verify the locations of securities under certain circumstances, and compare the results of the count and verification with its records.[29] In accordance with a schedule, the broker-dealer must take an operational capital charge under Rule 15c3-1 for short securities differences (which include securities positions reflected on the broker-dealer's securities record that are not susceptible to either count or

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[26] See 15 U.S.C. 78aaa et seq.

[27] See 17 CFR 240.15c3-3(k).

[28] Id.

[29] See 17 CFR 240.17a-13(b).

confirmation) that are unresolved after discovery.[30] The differences also must be recorded in the broker-dealer's books and records.[31]

4. The Broker-Dealer Account Statement Rules

The Account Statement Rules of DEAs require member broker-dealers to send, at least once every calendar quarter, a statement of account containing a description of any securities positions, money balances, or account activity to each customer whose account had a security position, money balance, or account activity during the period since the last such statement was sent to the customer.[32] The Account Statement Rules provide a key safeguard for customers by requiring that they receive information concerning securities positions and other assets held in their accounts on a regular basis, which they can use to identify discrepancies and monitor the performance of their accounts.

II. FINAL AMENDMENTS TO BROKER-DEALER REPORTING, AUDIT, NOTIFICATION, AND OTHER REQUIREMENTS

A. Overview of New Requirements

The Commission is adopting amendments to the reporting, audit, and notification requirements in Rule 17a-5, and additional amendments to other provisions of the rule, including technical changes. The Commission also is adopting amendments to the notification requirements in Rule 17a-11, and certain other technical amendments to that rule.

Under the amendments to the reporting and audit requirements, broker-dealers must, among other things, file with the Commission annual reports consisting of a financial report and either a compliance report or an exemption report that are prepared by the broker-dealer, as well as certain reports that are prepared by an independent public accountant covering the financial

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30 See 17 CFR 240.15c3-1(c)(2)(v).

31 See 17 CFR 240.17a-3(a)(4)(vi).

32 See, e.g., CBOE Rule 9.12; NASD Rule 2340.

report and the compliance report or the exemption report.[33] The filing of a compliance or exemption report and the related report of the independent public accountant are new requirements. The financial report must contain the same types of financial statements that were required to be filed under Rule 17a-5 prior to these amendments (a statement of financial condition, a statement of income, a statement of cash flows, and certain other financial statements).[34] In addition, the financial report must contain, as applicable, the supporting schedules that were required to be filed under Rule 17a-5 prior to these amendments (a computation of net capital under Rule 15c3-1, a computation of the reserve requirements under Rule 15c3-3, and information relating to the possession or control requirements under Rule 15c3-3).[35]

A broker-dealer that did not claim that it was exempt from Rule 15c3-3 throughout the most recent fiscal year must file the compliance report, and a broker-dealer that did claim it was exempt from Rule 15c3-3 throughout the most recent fiscal year (generally, a "non-carrying broker-dealer") must file the exemption report.[36] Broker-dealers must make certain statements and provide certain information relating to the financial responsibility rules in these reports.[37]

In addition to preparing and filing the financial report and the compliance report or exemption report, a broker-dealer must engage a PCAOB-registered independent public accountant to prepare a report based on an examination of the broker-dealer's financial report in

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33 See paragraph (d) of Rule 17a-5.

34 See paragraph (d)(2)(i) of Rule 17a-5. The requirements for the financial report are discussed below in more detail in section II.B.2. of this release.

35 See paragraph (d)(2)(ii) of Rule 17a-5.

36 See paragraphs (d)(1)(i)(B)(1) and (2) of Rule 17a-5.

37 See paragraphs (d)(3) and (4) of Rule 17a-5. The requirements for the compliance report and the exemption report are discussed below in more detail in section II.B.3. and section II.B.4. of this release, respectively.

accordance with PCAOB standards.[38] A carrying broker-dealer also must engage the PCAOB-registered independent public accountant to prepare a report based on an examination of certain statements in the broker-dealer's compliance report.[39] A non-carrying broker-dealer must engage the PCAOB-registered independent public accountant to prepare a report based on a review of certain statements in the broker-dealer's exemption report.[40] In each case, the examination or review must be conducted in accordance with PCAOB standards. The broker-dealer must file these reports with the Commission along with the financial report and the compliance report or exemption report prepared by the broker-dealer.[41]

The annual reports also must be filed with SIPC if the broker-dealer is a member of SIPC.[42] In addition, broker-dealers must generally file with SIPC a supplemental report on the status of the membership of the broker-dealer in SIPC.[43] The supplemental report must include a report of the independent public accountant that covers the SIPC annual general assessment reconciliation or exclusion from membership forms based on certain procedures specified in the rule. In the future, SIPC may determine the format of this report by rule, subject to Commission approval.[44]

Finally, the PCAOB-registered independent public accountant must immediately notify the broker-dealer if the accountant determines during the course of preparing the accountant's

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38 See paragraphs (f)(1) and (g)(1) of Rule 17a-5.

39 See paragraphs (f)(1) and (g)(2)(i) of Rule 17a-5.

40 See paragraphs (f)(1) and (g)(2)(ii) of Rule 17a-5.

41 See paragraph (d)(1)(i)(C) of Rule 17a-5. The requirements for the engagement of the independent public accountant are discussed below in more detail in section II.D.3. of this release.

42 See paragraph (d)(6) of Rule 17a-5. This requirement is discussed below in more detail in section II.B.6. of this release.

43 See paragraph (e)(4) of Rule 17a-5. This requirement is discussed below in more detail in section II.C.4. of this release.

44 Id. Currently, Rule 17a-5 prescribes the format of the report. See 17 CFR 240.17a-5.

reports that the broker-dealer is not in compliance with the financial responsibility rules or if the accountant determines that any material weakness exists in the broker-dealer's internal control over compliance with the financial responsibility rules.[45] The broker-dealer, in turn, must file a notification with the Commission and its DEA under Rule 15c3-1, Rule 15c3-3, or Rule 17a-11 if the independent public accountant's notice concerns an instance of non-compliance that would trigger notification under those rules.[46] Under the amendments to Rule 17a-11, a broker-dealer also must file a notification with the Commission and its DEA if the broker-dealer discovers or is notified by the independent public accountant of the existence of any material weakness (as defined in the amendments) in the broker-dealer's internal control over compliance with the financial responsibility rules.[47]

Each of these amendments is discussed in more detail in the following sections of this release.

B. Annual Reports to Be Filed – Paragraph (d) of Rule 17a-5

Prior to today's amendments, paragraph (d) of Rule 17a-5 generally required a broker-dealer to annually file the financial statements and supporting schedules discussed below in section II.B.2. of this release and a report prepared by the broker-dealer's independent public accountant covering the financial statements and supporting schedules.[48] The Commission proposed amendments that would, among other things, restructure paragraph (d) and – as part of

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45 See paragraph (h) of Rule 17a-5. As discussed below, material weakness is defined for purposes of the compliance report and, therefore, the notification of a material weakness only can occur in the context of the audit of a broker-dealer that files a compliance report.

46 Id. Notifications under Rule 17a-11 also must be filed with the CFTC if the broker-dealer is registered as a an FCM with the CFTC. See 17 CFR 240.17a-11(g).

47 See paragraph (e) of Rule 17a-11. These notification provisions are discussed below in more detail in section II.F. of this release.

48 See 17 CFR 240.17a-5(d)(1)(i). Certain types of broker-dealers were exempt from the requirement to file the reports or to file reports that had been audited by an independent public accountant. See 17 CFR 240.17a-5(d)(1)(ii)–(iii).

the proposed revisions to the attestation engagement provisions – add the requirement that a broker-dealer file either a compliance report or an exemption report, as applicable, and a report prepared by the broker-dealer's independent public accountant based on an examination of the compliance report or a review of the exemption report.[49] As discussed in sections II.B.1. through II.B.6. of this release, the Commission is adopting the proposed amendments to paragraph (d) with modifications.[50]

1. Requirement to File Reports – Paragraph (d)(1) of Rule 17a-5

i. Proposed Amendments

The Commission proposed to amend paragraph (d)(1) of Rule 17a-5[51] to require that a broker-dealer file a financial report containing financial statements and supporting schedules and either a compliance report or an exemption report, as applicable.[52] The proposal provided that a broker-dealer must file a compliance report "unless the [broker-dealer] is exempt from the provisions of [Rule 15c3-3]" in which case the broker-dealer would be required to file an exemption report.[53] The proposed amendments also would have required a broker-dealer generally to file reports prepared by an independent public accountant covering the financial report and compliance report or exemption report, as applicable, unless the broker-dealer was

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49 See Broker-Dealer Reports, 76 FR at 37575–37581.

50 Before today's amendments, paragraph (d) of Rule 17a-5 was titled "Annual filing of audited financial statements." In the proposing release, the Commission proposed to change the title to "Annual reports" to reflect that, under the proposed amendments to paragraph (d), broker-dealers would be required to prepare and file two reports with the Commission – a financial report and a compliance report or an exemption report. See Broker-Dealer Reports, 76 FR at 37575. The Commission received no comments on this proposal and is adopting the new title as proposed. See paragraph (d) of Rule 17a-5. In addition, the Commission is making a technical amendment to paragraph (d) of Rule 17a-5 to replace the term "fiscal or calendar year" with the term "fiscal year." The Commission is adopting this technical amendment because the term "fiscal year" includes instances in which December 31st, i.e., the calendar year end, is the broker-dealer's fiscal year end.

51 See 17 CFR 240.17a-5(d)(1).

52 See Broker-Dealer Reports, 76 FR at 37575.

53 Id.

exempt from the requirement to file the reports or from the requirement to engage an independent public accountant with respect to the reports.[54] To accommodate these changes, the Commission also proposed to reorganize the provisions of paragraph (d)(1) of Rule 17a-5, and to make other technical amendments.[55]

The proposed amendments with respect to the compliance report and exemption report set forth different requirements for carrying broker-dealers as compared with broker-dealers that do not hold customer securities and funds.[56] In order to provide clarity with respect to this distinction, the proposed amendments referenced Rule 15c3-3, which applies to carrying broker-dealers and contains provisions under which a broker-dealer is exempt from the requirements in the rule. The goal was to establish a clear way of determining whether a broker-dealer would need to file a compliance report or an exemption report. However, not all broker-dealers that are subject to Rule 15c3-3 regularly hold customer securities or funds. This prompted the Commission to inquire in the proposing release as to whether there are broker-dealers that would not qualify to file the proposed exemption report because they are not exempt from Rule 15c3-3, but that should be allowed to file a more limited report than the proposed compliance report based on the limited scope of their business.[57]

ii. Comments Received

The Commission received several comments on its proposed amendments to paragraph (d)(1) of Rule 17a-5.[58] Some commenters asked whether the provision that would require the

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54 Id.

55 Id. at 37575–37578, 37603–37604.

56 Id. at 37575–37578, 37580–37581 (discussing the compliance report and exemption report, respectively).

57 Id. at 37581.

58 See, e.g., CAI Letter; CAI II Letter; CAQ Letter; Citrin Letter; Deloitte Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter.

broker-dealer to file an exemption report instead of a compliance report related to a period end date or to a period of time.[59] Further, as discussed in more detail in sections II.B.4. and II.D.3. of this release, commenters raised questions and concerns about how instances of exceptions to meeting the exemption provisions of paragraph (k) of Rule 15c3-3 would be treated under the proposed reporting requirements.[60] One commenter also stated that "limited purpose" carrying broker-dealers should not be required to file a compliance report, and broker-dealers with certain business model characteristics should not be required to file the compliance report.[61] Similarly, another commenter stated that broker-dealers engaging exclusively in proprietary trading or investment banking may not technically be exempt from Rule 15c3-3 but nonetheless should not have to file the compliance report as they do not have "customers."[62] Finally, one commenter stated that the Commission should clarify who must sign the compliance reports and exemption reports and the liability that attaches in the event of a misstatement or omission in the reports.[63]

iii. The Final Rule

After considering these comments, the Commission is adopting the proposed amendments with certain modifications.[64] Under the final rule, all broker-dealers generally must

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59 See CAQ Letter; Deloitte Letter; Grant Thornton Letter; KPMG Letter.

60 See CAI Letter; SIFMA Letter.

61 See CAI Letter; CAI II Letter.

62 See McGladrey Letter.

63 See CAI Letter.

64 See paragraph (d)(1) of Rule 17a-5. Paragraph (d)(1)(iii) of Rule 17a-5 (now re-designated as paragraph (d)(1)(iv)) contains an exemption from filing an annual report if the broker-dealer is a member of a national securities exchange and has transacted business in securities solely with or for other members of a national securities exchange, and has not carried any margin account, credit balance or security for any person who is defined as a "customer" in paragraph (c)(4) of Rule 17a-5. See paragraph (d)(1)(iv) of Rule 17a-5. The Commission also proposed to move the exemptions from having to file financial statements under paragraph (d) of Rule 17a-5 from paragraphs (d)(1)(ii) and (d)(1)(iii) of Rule 17a-5 to paragraphs (d)(1)(iii) and (d)(1)(iv), respectively. The Commission received no comments on these amendments and is adopting them as proposed. See paragraphs (d)(1)(iii) and (d)(1)(iv) of Rule 17a-5. For clarity, the amendments to paragraph (d)(1)(i) of Rule 17a-5 include a reference to the exemptions from the requirement for a broker-dealer to file the annual reports so that the paragraph now states "[e]xcept as provided in paragraphs

prepare and file a financial report and either the compliance report or the exemption report.[65] A broker-dealer that did not claim an exemption from Rule 15c3-3 at any time during the most recent fiscal year or claimed an exemption for only part of the fiscal year must prepare and file the compliance report.[66] A broker-dealer must prepare and file the exemption report if the firm did claim that it was exempt from Rule 15c3-3 throughout the most recent fiscal year.[67] Broker-dealers also must file reports prepared by a PCAOB-registered independent public accountant covering the financial report and the compliance report or exemption report, as applicable.[68]

The final rule is modified from the proposal in three key ways. First, the final rule provides that the broker-dealer must file the exemption report if it did "claim that it was exempt"

(d)(1)(iii) and (d)(1)(iv) of this section, every broker or dealer registered under section 15 of the Act must file annually . . . ." See paragraph (d)(1)(i) of Rule 17a-5. As proposed, the final rule provided that the reports must be filed annually "on a calendar or fiscal year basis." The final rule deletes the phrase "on a calendar or fiscal year basis" as the rule provides elsewhere that the annual reports must be filed on a fiscal year basis. Id. In addition, the Commission proposed to move the requirement that reports under paragraph (d) of Rule 17a-5 be as of the same fixed or determinable date each year, unless a change is approved in writing by the broker-dealer's DEA, from paragraph (d)(1)(i) of Rule 17a-5 to paragraph (d)(1)(ii). The Commission received no comments on this proposed amendment and is adopting it substantially as proposed. See paragraph (d)(1)(ii) of Rule 17a-5. The final rule also includes a technical modification from the proposal to require that the reports required to be filed under paragraph (d) must be as of the same "fiscal year end each year," rather than as of the same "fixed or determinable date each year." See paragraph (d)(1)(ii) of Rule 17a-5. This change, by having the rule refer to the broker-dealer's "fiscal year," eliminates outdated language and conforms the language in paragraph (d) of Rule 17a-5 to language in paragraph (n) of Rule 17a-5. See 17 CFR 240.17a-5(n). The final rule also adds a clarifying cross-reference to the provision in Rule 17a-5 pursuant to which a broker-dealer requests a change of its fiscal year end. See paragraph (d)(1)(i) of Rule 17a-5. Furthermore, the final rule requires that a copy of the written approval by the broker-dealer's DEA of a change in the broker-dealer's fiscal year be sent to the Commission's principal office in Washington, DC, in addition to the regional office of the Commission for the region in which the broker-dealer has its principal place of business. Id. This change is consistent with paragraph (n) of Rule 17a-5, which requires that when a broker-dealer changes its fiscal year, it must file a notice with the Commission's principal office in Washington, DC as well as the regional office of the Commission for the region in which the broker-dealer has its principal place of business. See 17 CFR 240.17a-5(n).

65 See paragraph (d)(1)(i) of Rule 17a-5. The financial report, compliance report, and exemption report are discussed below in more detail in sections II.B.2., II.B.3., and II.B.4., respectively, of this release.

66 See paragraph (d)(1)(i)(B)(1) of Rule 17a-5.

67 See paragraph (d)(1)(i)(B)(2) of Rule 17a-5.

68 See paragraph (d)(1)(i)(C) of Rule 17a-5. The proposed requirements and final rule with respect to the attestation engagement for the independent public accountant are discussed below in section II.D. of this release.

from Rule 15c3-3[69] throughout the most recent fiscal year.[70] This modification from the proposal – which provided that a broker-dealer "shall" file the exemption report if the broker-dealer "is exempt from the provisions of [Rule 15c3-3]" – is designed to provide greater clarity as to whether a broker-dealer must file the exemption report (as opposed to the compliance report), particularly when the broker-dealer had exceptions to meeting the exemption provisions in paragraph (k) of Rule 15c3-3 during the fiscal year.[71] Specifically, if the broker-dealer claimed an exemption from Rule 15c3-3 in its Financial and Operational Combined Uniform Single Reports ("FOCUS Reports") throughout the fiscal year,[72] it must file the exemption report even it had exceptions to the exemption provisions.[73] Consequently, the applicability of the exemption report under the final rule is based on an objective and easily ascertainable factor: whether the broker-dealer claimed an exemption from Rule 15c3-3 throughout the most recent fiscal year.[74]

As noted above, several commenters argued that broker-dealers that engage in limited custodial activities and, therefore, are not exempt from Rule 15c3-3, should not be required to

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69 See paragraph (d)(1)(i)(B)(2) of Rule 17a-5. A broker-dealer claiming an exemption from Rule 15c3-3 is required to indicate the basis for the exemption on the periodic reports it files with securities regulators. See, e.g., Item 24 of Part IIa of the Financial and Operational Combined Uniform Single Report. See 17 CFR 249.617.

70 As discussed below in more detail in section II.B.4. of this release, the provisions of paragraph (k) of Rule 15c3-3 prescribe "exemptions" from the requirements of Rule 15c3-3. See 17 CFR 240.15c3-3(k)(1), (k)(2)(i), (k)(2)(ii), and (k)(3).

71 See CAI Letter; SIFMA Letter.

72 The FOCUS Reports are: Form X-17A-5 Schedule I; Form X-17A-5 Part II; Form X-17A-5 Part IIa; Form X-17A-5 Part IIb; and Form X-17A-5 Part III.

73 As discussed in detail below in section II.B.4. of this release, a broker-dealer that has exceptions to meeting the exemption provisions in paragraph (k) of Rule 15c3-3 must identify them in the exemption report.

74 See discussion in section II.B.4. of this release. There may be circumstances in which a broker-dealer has not held customer securities or funds during the fiscal year, but does not fit into one of the exemptive provisions listed under Item 24 of Part IIa. Even though there is not a box to check on the FOCUS Report, these broker-dealers should file an exemption report and related accountant's report.

file a compliance report.[75] Specifically, one of these commenters suggested that a "new" category of "limited purpose" broker-dealer with certain business model characteristics should be addressed in the rule and that this "new" category of broker-dealer should not be required to file the compliance report.[76] The Commission has considered these comments but has determined not to provide for a broader exception from the requirement to file a compliance report for broker-dealers with limited custodial activities. The objectives of the compliance report and related examination of the compliance report are intended, among other things, to "increase the focus of independent public accountants on the custody practices of broker-dealers" and to "help identify broker-dealers that have weak controls for safeguarding investor assets."[77] Therefore, broker-dealers that hold customer assets – even if their custodial activities are limited – generally should be subject to the requirement to file the compliance report and related accountant's report.[78]

The level of effort required by carrying broker-dealers to prepare a compliance report will depend on the nature and extent of their activities. For example, the controls of a carrying broker-dealer that engages in limited custodial activities could be less complex than the controls of a carrying broker-dealer that engages in more extensive custodial activities.[79] Therefore, this

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75 See, e.g., CAI Letter; CAI II Letter; McGladrey Letter.

76 See CAI II Letter.

77 See Broker-Dealer Reports, 76 FR at 37599.

78 Broker-dealers with extremely limited custodial activities (e.g., holding customer checks made out to a third party for limited periods of time) could seek exemptive relief under section 36 of the Exchange Act (15 U.S.C. 77mm) from the requirement to file the compliance report and report of the independent public accountant covering the compliance report.

79 As discussed below in section II.D. of this release, the PCAOB has proposed attestation standards for an independent public accountant's examination of the compliance report and the review of the exemption report. The proposed examination standard provides procedural requirements for independent public accountants that are "designed to be scalable based on the broker's or dealer's size and complexity." See Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB

requirement is intended to be scalable so that a carrying broker-dealer with limited custodial activities generally should have to expend less effort to support its statements in the compliance report, particularly with respect to the statements relating to Rules 15c3-3 and 17a-13.

The second key modification is that the final rule provides that the requirement to file the exemption report applies if the broker-dealer did claim that it was exempt from Rule 15c3-3 "throughout the most recent fiscal year."[80] Thus, a broker-dealer that did not claim an exemption from Rule 15c3-3 at any time during the most recent fiscal year or claimed an exemption for only part of the fiscal year must file the compliance report.[81]

The third key modification is that the final rule specifies the individual who must execute the compliance reports and exemption reports.[82] As noted above, one commenter stated that the Commission should make clear who should sign the compliance reports and exemption reports and what liability attaches in the event of a misstatement or omission.[83] The commenter suggested a reasonableness standard, and stated that the Commission should make clear that the reports do not create a new private right of action.[84] In response to this comment, the final rule provides that the compliance report and the exemption report must be executed by the person

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Standards, PCAOB Release No. 2011-004, PCAOB Rulemaking Docket Matter No. 035 (July 12, 2011) at 8 ("PCAOB Proposing Release").

80 See paragraphs (d)(1)(i)(B)(1)–(2) of Rule 17a-5.

81 There will be cases where a broker-dealer changes its business model to convert from a carrying broker-dealer to a non-carrying broker-dealer during the fiscal year. In this case, the broker-dealer could seek exemptive relief under section 36 of the Exchange Act (15 U.S.C. 78mm) from the requirement to file the compliance report and to instead file the exemption report. In analyzing such a request, the period of time the broker-dealer operated as a carrying broker-dealer would be a relevant consideration.

82 See paragraphs (d)(1)(i)(B)(1)–(2) of Rule 17a-5.

83 See CAI Letter. The filings discussed above constitute a "report" for purposes of 15 U.S.C. 78ff(a) and other applicable provisions of the Exchange Act. As a consequence, it would be unlawful for a broker-dealer 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 filings.

84 Id.

who makes the oath or affirmation under paragraph (e)(2) of Rule 17a-5.[85] As discussed below in more detail in section II.C.2. of this release, paragraph (e)(2) of Rule 17a-5 requires an oath or affirmation to be attached to the financial report and provides that the oath or affirmation must be made by certain types of persons depending on the corporate form of the broker-dealer (e.g., a duly authorized officer if the broker-dealer is a corporation).[86] The requirement to file these new reports with the Commission is not intended to establish a new private cause of action.

2. The Financial Report – Paragraph (d)(2) of Rule 17a-5

Before today's amendments, paragraph (d)(2) of Rule 17a-5 required that the annual audited report of a broker-dealer contain certain financial statements in a format consistent with Form X-17A-5 Part II or Form X-17A-5 Part IIa, as applicable, including a statement of financial condition, an income statement, a statement of cash flows, a statement of changes in owners' equity, and a statement of changes in liabilities subordinated to claims of general creditors.[87] Paragraph (d)(3) of Rule 17a-5 required that the annual audited report contain supporting schedules, including a computation of net capital under Rule 15c3-1, a computation for determining reserve requirements under Rule 15c3-3, and information relating to the possession and control requirements of Rule 15c3-3.[88] Paragraph (d)(4) of Rule 17a-5 required a reconciliation between the net capital and reserve computations in the audited report and those in

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85 See paragraphs (d)(1)(i)(B)(1)-(2) of Rule 17a-5.

86 See paragraph (e)(2) of Rule 17a-5.

87 See 17 CFR 240.17a-5(d)(2). As noted above, Form X-17A-5 Part II and Form X-17A-5 Part IIa are among the FOCUS Reports that broker-dealers complete and file with the Commission or their DEA on a periodic basis. See 17 CFR 240.17a-5(a) and 17 CFR 249.617. These two forms require broker-dealers to file monthly or quarterly financial information with the Commission or their DEA, including information about the broker-dealer's: (1) assets and liabilities; ownership equity; net capital computation under Rule 15c3-1; minimum net capital requirement under Rule 15c3-1; income (loss); computation of the customer reserve requirement under Rule 15c3-3 in the case of Form X-17A-5 Part II; the possession and control requirements under Rule 15c3-3 in the case of Form X-17A-5 Part II; and changes in ownership equity.

88 See 17 CFR 240.17a-5(d)(3).

the most recent Form X-17A-5 Part II or Form X-17A-5 Part IIa, if there were material differences between the annual audited report and the form.[89]

The Commission proposed combining the provisions in paragraphs (d)(2) through (d)(4) of Rule 17a-5 in revised paragraph (d)(2) without substantive modification to those provisions.[90] In addition, the Commission proposed that revised paragraph (d)(2) be titled "Financial report" to reflect that the information required in this report would be financial in nature and to differentiate it from the proposed compliance reports and exemption reports. The Commission did not receive comments concerning the amendments to paragraph (d)(2) of Rule 17a-5 and is adopting them substantially as proposed.[91]

3. The Compliance Report – Paragraph (d)(3) of Rule 17a-5

i. The Proposed Amendments

As proposed, the requirements for the contents of the compliance report were prescribed in paragraph (d)(3) of Rule 17a-5.[92] Under the proposal, a carrying broker-dealer would need to include in the compliance report a specific statement, certain assertions, and descriptions.[93] The independent public accountant would examine the assertions in the compliance report in

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89 <u>See</u> 17 CFR 240.17a-5(d)(4).

90 <u>See</u> <u>Broker-Dealer Reports,</u> 76 FR at 37575.

91 <u>See</u> paragraph (d)(2) of Rule 17a-5. The Commission has made plain English changes to the language of the paragraph (<u>e.g.</u>, replacing the term "shall" with "must"). The Commission also, consistent with current practice, has clarified that the financial statements must be prepared in accordance with U.S. GAAP to distinguish from other accounting frameworks. <u>See</u> paragraph (d)(2) of Rule 17a-5. In addition, the Commission has replaced the words "notes to the consolidated statement of financial condition" with "notes to the financial statements." This change in terminology is designed to conform the language in Rule 17a-5 to current accounting practice. Under GAAP, notes to a complete set of financial statements must cover all the financial statements, and not just one of the statements, such as the consolidated statement of financial condition.

92 <u>See</u> <u>Broker-Dealer Reports,</u> 76 FR at 37575–37578.

93 <u>Id.</u>

preparing the report of the accountant.[94]

Specifically, as proposed, the carrying broker-dealer would be required to include in the compliance report a statement as to whether the firm has established and maintained a system of internal control to provide the broker-dealer with reasonable assurance that any instances of material non-compliance with the financial responsibility rules will be prevented or detected on a timely basis.[95] In addition, the compliance report would need to include the following three assertions: (1) whether the broker-dealer was in compliance in all material respects with the financial responsibility rules as of its fiscal year end; (2) whether the information used to assert compliance with the financial responsibility rules was derived from the books and records of the broker-dealer; and (3) whether internal control over compliance with the financial responsibility rules was effective during the most recent fiscal year such that there were no instances of material weakness.[96] Finally, the carrying broker-dealer would need to include in the compliance report a description of each identified instance of material non-compliance and each identified material weakness in internal control over compliance with the financial responsibility rules.[97] The independent public accountant would examine the assertions in preparing the report of the accountant.[98] The independent public accountant would not examine the statement regarding the establishment of the system of internal control.

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94 Id. The independent public accountant would not have been required to examine the proposed "statement" and descriptions in the compliance report.

95 See Broker-Dealer Reports, 76 FR at 37575–37576.

96 Id.

97 Id.

98 Id. GAAS and PCAOB standards for attestation engagements provide that accountants ordinarily should obtain written assertions in an examination or review engagement. See, e.g., PCAOB Interim Attestation Standard, AT Section 101 at ¶ .09. Accordingly, the Commission proposed that the independent public accountant's report cover only the three assertions in the compliance report.

Under the proposal, the broker-dealer would not be able to assert compliance with the financial responsibility rules as of its most recent fiscal year end if it identified one or more instances of material non-compliance.[99] Similarly, the broker-dealer would not be able to assert that its internal control over compliance with the financial responsibility rules during the fiscal year was effective if one or more material weaknesses existed with respect to internal control over compliance.[100]

An instance of material non-compliance was proposed to be defined as a failure by the broker-dealer to comply with any of the requirements of the financial responsibility rules in all material respects.[101] When determining whether an instance of non-compliance is material, the Commission stated that the broker-dealer should consider all relevant factors including but not limited to: (1) the nature of the compliance requirements, which may or may not be quantifiable in monetary terms; (2) the nature and frequency of non-compliance identified; and (3) qualitative considerations.[102] The Commission also stated that some deficiencies would necessarily be instances of material non-compliance, including failing to maintain the required minimum amount of net capital under Rule 15c3-1 or failing to maintain the minimum deposit requirement in a special reserve bank account for the exclusive benefit of customers under Rule 15c3-3.[103]

The term material weakness was proposed to be defined as a deficiency, or a combination of deficiencies, in internal control over compliance with the financial responsibility rules, such that there is a reasonable possibility that material non-compliance with the financial

99 See Broker-Dealer Reports, 76 FR at 37576–37577.

100 Id. at 37577.

101 Id.

102 Id.

103 Id.

responsibility rules will not be prevented or detected on a timely basis.[104] The proposed definition of material weakness was modeled on the definition of material weakness in a Commission rule – Rule 1-02(a)(4) of Regulation S-X[105] – and in auditing literature governing financial reporting.[106] In the proposing release, the Commission stated that a deficiency in internal control over compliance would exist when the design or operation of a control does not allow the broker-dealer, in the normal course of performing its assigned functions, to prevent or detect non-compliance with the financial responsibility rules on a timely basis.[107] The Commission also stated that, for purposes of the proposed definition of the term material weakness, there is a reasonable possibility of an event occurring if it is probable or reasonably possible.[108] The Commission further stated that an event is probable if the future event or events are likely to occur and that an event is reasonably possible if the chance of the future event or events occurring is more than remote, but less than likely.[109]

ii. Comments Received

The Commission received a number of comments on the proposed compliance report. Generally, the comments focused on the intended scope of the compliance report and the

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104 Id.

105 See 17 CFR 210.1-02(a)(4); 17 CFR 240.12b-2.

106 See PCAOB Auditing Standard, AS No. 5 app. A at ¶ A7; American Institute of Certified Public Accountants ("AICPA"), AU Section 325 at ¶ .06.

107 See Broker-Dealer Reports, 76 FR at 37577.

108 Id. See also 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, Securities Act of 1933 Release No. 8810 (June 20, 2007), 72 FR 35324, 35332 n.47 and corresponding text (June 27, 2007).

109 Broker-Dealer Reports, 76 FR at 37577. The Commission has stated in other contexts that there is a reasonable possibility of an event occurring if it is "probable" or "reasonably possible." See Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting, Exchange Act Release No. 55928 (June 20, 2007), 72 FR 35310 (June 27, 2007). See also 17 CFR 240.12b-2; 17 CFR 210.1-02. Commission guidance provides that an event is "probable" if the future event or events are likely to occur, and that an event is "reasonably possible" if the chance of the future event or events occurring is more than remote, but less than likely. 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, 72 FR at 35332 n.47 and corresponding text.

assertions to be included. Specifically, many commenters raised concerns about what would constitute "material non-compliance."[110] Several of these commenters urged the Commission to provide guidance with additional specific examples or quantitative and qualitative factors to be considered when determining whether non-compliance was material.[111] One commenter proposed alternate definitions for material non-compliance and material weakness and provided examples of non-compliance that should not be regarded as material.[112]

Commenters also addressed the time period covered by the assertion relating to effectiveness of internal control. In particular, some commenters stated that the proposed assertion that internal control was effective should be as of a point in time, as opposed to "during the fiscal year."[113] One commenter stated that broker-dealers that must file the internal control report required under Rule 206(4)-2 should be able to elect to make the assertion pertain to the entire fiscal year in order to satisfy reporting requirements under the IA Custody Rule.[114] Others stated that broker-dealers should have the opportunity to remediate any material weaknesses in internal control that were identified during the period and, if corrective action was taken, not be required to include them in the compliance report.[115]

Regarding the proposed assertion that the broker-dealer was in compliance with the financial responsibility rules, one commenter stated that broker-dealers may need to interpret

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110 See ABA Letter; CAI Letter; CAQ Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter; PWC Letter; SIFMA Letter; Van Kampen/Invesco Letter.

111 See ABA Letter; CAQ Letter; E&Y Letter; KPMG Letter; McGladrey Letter; PWC Letter.

112 See SIFMA Letter.

113 See Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter.

114 See E&Y Letter. This commenter also stated that a point-in-time assessment would be consistent with the requirement for issuers subject to internal control reporting under section 404 of the Sarbanes-Oxley Act. Further, for carrying broker-dealers that are not subject to Rule 206(4)-2, this commenter stated that the incremental benefits of having the assertion pertain to the entire year rather than the year end assessment does not justify the cost. Id.

115 See CAQ Letter; Deloitte Letter; McGladrey Letter.

certain requirements and in other cases broker-dealers may be relying on informal interpretations obtained through dialogue with the Commission or its DEA.[116] This commenter recommended that in those circumstances the Commission require broker-dealers to formally document such interpretations and obtain evidence of agreements reached with the Commission or the DEA.

Some commenters stated that the Commission should provide additional guidance about the control objectives that would need to be met to achieve effective internal control over compliance with the financial responsibility rules.[117] Several commenters urged the Commission to clarify the interaction between material weaknesses in internal control over financial reporting and material weaknesses in internal control over compliance with the financial responsibility rules.[118] One commenter stated that the compliance report was over-inclusive and burdensome, and suggested that the final rule focus instead on "issues most vital to the financial condition of the broker-dealer and its compliance and internal control over compliance."[119]

Some commenters had questions and comments about the proposed assertion that information used to assert compliance with the financial responsibility rules was derived from the books and records of the broker-dealer. Three commenters asked whether "books and records" means records maintained under Rule 17a-3.[120]

iii. The Final Rule

The Commission is adopting the proposed amendments to Rule 17a-5 requiring a carrying broker-dealer to prepare and file a compliance report, with modifications, some of

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116 See E&Y Letter.

117 See Angel Letter; Deloitte Letter.

118 See Deloitte Letter; KPMG Letter; PWC Letter.

119 See CAI Letter.

120 See CAQ Letter; Deloitte Letter; E&Y Letter.

which are in response to comments.[121] Generally, as adopted, the broker-dealer's compliance report will include five specific statements, and two descriptions, if applicable.

Specifically, paragraph (d)(3) of Rule 17a-5 requires that the compliance report contain statements as to whether: (1) the broker-dealer has established and maintained Internal Control Over Compliance (which, as discussed below, is a defined term in the final rule); (2) the Internal Control Over Compliance of the broker-dealer was effective during the most recent fiscal year; (3) the Internal Control Over Compliance of the broker-dealer was effective as of the end of the most recent fiscal year; (4) the broker-dealer was in compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3 as of the end of the most recent fiscal year; and (5) the information the broker-dealer used to state whether it was in compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3 was derived from the books and records of the broker-dealer. Further, if applicable, the compliance report must contain a description of: (1) each identified material weakness in the Internal Control Over Compliance during the most recent fiscal year, including those that were identified as of the end of the fiscal year; and (2) any instance of non-compliance with Rule 15c3-1 or paragraph (e) of Rule 15c3-3 as of the end of the most recent fiscal year.

The final rule does not use the term assertion – the assertions contained in the proposal are now referred to as statements.[122] The consistent use of the term statements is designed to simplify the structure of the rule rather than to substantively change the nature of the matters stated in the compliance report or which of the statements are to be examined by the independent public accountant.

In the final rule, the first statement in the compliance report is whether the broker-dealer

121 See paragraph (d)(3) of Rule 17a-5.

122 See paragraphs (d)(3)(i)(A)(1)–(5) of Rule 17a-5.

has established and maintained Internal Control Over Compliance.[123] The rule defines Internal Control Over Compliance to mean internal controls that have the objective of providing the broker-dealer with reasonable assurance that non-compliance with the financial responsibility rules will be prevented or detected on a timely basis.[124] In order to clarify the application of the rule, the proposal has been modified so that part of the statement contained in the proposed compliance report, as to the broker-dealer's system of internal control, has been incorporated in the definition of Internal Control Over Compliance in the final rule.[125] Under the final rule, a broker-dealer cannot state that it has established and maintained Internal Control Over Compliance if the internal controls do not provide the broker-dealer with reasonable assurance that non-compliance with the financial responsibility rules will be prevented or detected on a timely basis.

The final rule also provides that a broker-dealer is not permitted to conclude that its Internal Control Over Compliance was effective if there were one or more material weaknesses in its Internal Control Over Compliance.[126] A material weakness is defined as a deficiency, or a combination of deficiencies, in the broker-dealer's Internal Control Over Compliance such that there is a reasonable possibility[127] that non-compliance with Rule 15c3-1 or paragraph (e) of

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123 See paragraph (d)(3)(i)(A)(1) of Rule 17a-5.

124 See paragraph (d)(3)(ii) of Rule 17a-5.

125 Id.

126 See paragraph (d)(3)(iii) of Rule 17a-5. See also 17 CFR 229.308(a)(3) (providing that "[m]anagement is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting.").

127 As noted above, the Commission has stated in other contexts that there is a reasonable possibility of an event occurring if it is "probable" or "reasonably possible." See Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting, 72 FR 35310. See also 17 CFR 240.12b-2; 17 CFR 210.1-02. Commission guidance provides that an event is "probable" if the future event or events are likely to occur, and that an event is "reasonably possible" if the chance of the future event or events occurring is more than remote, but less than likely. 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, 72 FR at 35332 n.47 and corresponding text.

Rule 15c3-3 will not be prevented or detected on a timely basis, or that non-compliance to a material extent with Rule 15c3-3, except for paragraph (e), Rule 17a-13 or any Account Statement Rule will not be prevented or detected on a timely basis.[128] A deficiency in Internal Control Over Compliance exists when the design or operation of a control does not allow the management or employees of the broker-dealer to prevent or detect on a timely basis non-compliance with the financial responsibility rules in the normal course of performing their assigned functions.

The final amendments reflect several other key changes from the proposal. For example, one commenter stated that the compliance report was overinclusive and burdensome, and therefore suggested that the final rule focus on "issues most vital to the financial condition of the broker-dealer and its compliance and internal control over compliance."[129] The final rule requires a statement as to whether the broker-dealer was in compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3 as of the end of the most recent fiscal year and, if applicable, a description of any instances of non-compliance with these rules as of the fiscal year end. This is a modification from the proposed assertion that the broker-dealer is in compliance with the financial responsibility rules in all <u>material</u> respects and proposed description of any material non-compliance with the financial responsibility rules. Thus, the final rule reflects two changes from the proposal: (1) elimination of the concepts of "material non-compliance" and "compliance in all material respects" for the purposes of reporting in the compliance report; and (2) a narrowing of these statements and requirements from compliance with all of the financial

128 <u>See</u> paragraph (d)(3)(iii) of Rule 17a-5. <u>See also</u> 17 CFR 240.12b-2; 17 CFR 210.1-02(a)(4) (providing that a "[m]aterial weakness means a deficiency, or a combination of deficiencies, in internal controls over financial reporting … such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis.").

129 <u>See</u> <u>CAI Letter</u>.

responsibility rules to compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3. In this way, the final rule more narrowly focuses on the core requirements of the financial responsibility rules, as suggested by the commenter.

The "material non-compliance" and "compliance in all material respects" concepts were designed to limit the types of instances of non-compliance that would prevent a carrying broker-dealer from stating that it was in compliance with the financial responsibility rules. In order to retain a limiting principle, the final rule focuses on provisions that trigger notification requirements when they are not complied with, namely, Rule 15c3-1 and the customer reserve requirement in paragraph (e) of Rule 15c3-3.[130] Any instance of non-compliance with these requirements as of the fiscal year end must be addressed in the compliance report. As stated in the proposing release, failing to maintain the required minimum amount of net capital under Rule 15c3-1 or failing to maintain the minimum deposit requirement in a special reserve bank account under paragraph (e) of Rule 15c3-3 would have been instances of material non-compliance under the proposed rule.[131] Accordingly, under the proposal, a broker-dealer would have been required to describe all instances of non-compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3. Under the proposal, a broker-dealer also would have been required to describe instances of material non-compliance with Rule 17a-13 and the Account Statement Rules. The final rule is narrower in that a broker-dealer is only required to describe instances of non-compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3.

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130 See 17 CFR 240.15c3-1(a)(6)(iv)(B), (a)(6)(v), (a)(7)(ii), (a)(7)(iii), (c)(2)(x)(B)(1), (c)(2)(x)(F)(3) (notification requirements with respect to Rule 15c3-1); 17 CFR 240.17a-11(b)-(c) (notification requirements with respect to Rule 15c3-1); 17 CFR 240.15c3-3(i) (notification requirement in the event of a failure to make a required deposit to the reserve account).

131 See Broker-Dealer Reports, 76 FR at 37577.

Consistent with these changes, the final rule requires a statement as to whether the carrying broker-dealer has established and maintained Internal Control Over Compliance, which is defined as internal controls that have the objective of providing the broker-dealer with reasonable assurance that non-compliance with the financial responsibility rules will be prevented or detected on a timely basis.[132] The definition of Internal Control Over Compliance modifies the proposed statement that the carrying broker-dealer has established and maintained a system of internal control to provide the firm with reasonable assurance that any instances of material non-compliance with the financial responsibility rules will be prevented or detected on a timely basis.[133] Thus, the definition eliminates the concept of material non-compliance. Similarly, the proposed assertion as to whether the information used to assert compliance with the financial responsibility rules was derived from the books and records of the carrying broker-dealer has been modified to a statement as to whether the information used to state whether the carrying broker-dealer was in compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3 was derived from the broker-dealer's books and records.[134]

The definition of material weakness similarly has been modified from the proposal. Under the final rule, a material weakness would include deficiencies in internal control relating to "non-compliance" with Rule 15c3-1 or paragraph (e) of Rule 15c3-3, and "non-compliance to a material extent" with Rule 15c3-3, except for paragraph (e), Rule 17a-13, and the Account Statement Rules.[135] This modification of the definition of material weakness is based on the practical difficulties in creating a system of control that will eliminate a reasonable possibility of

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132 See paragraphs (d)(3)(i)(A)(1) and (d)(3)(ii) of Rule 17a-5. As indicated above, the independent public accountant is not required to examine this statement. See paragraph (g)(2)(i) of Rule 17a-5.

133 See paragraphs (d)(3)(i)(A)(1) and (d)(3)(ii) of Rule 17a-5.

134 See paragraph (d)(3)(i)(A)(5) of Rule 17a-5.

135 See paragraph (d)(3)(iii) of Rule 17a-5.

the occurrence of any instances of non-compliance with certain requirements of the financial responsibility rules. For example, the inadvertent failure to send one account statement out of thousands of such statements would not constitute non-compliance to a material extent with the Account Statement Rules though it would be an instance of non-compliance.

Further, and consistent with current auditing standards, the definition of "deficiency in internal control" in the final rule has been modified to include the phrase "the management or employees of the broker or dealer" in place of the phrase "the broker or dealer."[136]

The final rule – substantially as proposed – requires the carrying broker-dealer to state whether its Internal Control Over Compliance was effective during the most recent fiscal year.[137] Some commenters suggested that a broker-dealer that has remediated a material weakness be permitted to provide an assertion about whether a material weakness still exists at the end of the year, instead of having to state whether internal control was effective during the most recent fiscal year.[138] In light of the importance of a broker-dealer being in continual compliance with the financial responsibility rules, the Commission believes it is appropriate for the broker-dealer's statement to address effectiveness of its Internal Control Over Compliance throughout the fiscal year. Consequently, the final rule requires the statement to cover the entire fiscal year as opposed to the date that is the end of the fiscal year as suggested by commenters.

However, in response to comments suggesting that the broker-dealer be permitted to report the remediation or whether a material weakness still exists at the end of the year,[139] the

136 Id. See also PCAOB Auditing Standard, AS No. 5 app. A, at ¶ A3 (providing that "[a] deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.").

137 See paragraph (d)(3)(i)(A)(2) of Rule 17a-5.

138 See CAQ Letter; E&Y Letter; KPMG Letter; PWC Letter.

139 See CAQ Letter; Deloitte Letter; E&Y Letter; McGladrey Letter.

final rule also requires the carrying broker-dealer to state whether its Internal Control Over Compliance was effective as of the end of the most recent fiscal year.[140] Thus, if there was a material weakness in the Internal Control Over Compliance of the broker-dealer during the year that has been addressed such that the broker-dealer no longer considers there to be a material weakness at fiscal year end, the compliance report would reflect both the identification of the material weakness and that its Internal Control Over Compliance was effective as of the end of the most recent fiscal year, thereby indicating that the material weakness had been addressed as of the fiscal year end.

Consistent with these changes, the final rule provides that the carrying broker-dealer cannot conclude that its Internal Control Over Compliance was effective during the most recent fiscal year if there were one or more material weaknesses in Internal Control Over Compliance of the broker-dealer during the fiscal year.[141] The final rule adds a similar provision relating to the effectiveness of a broker-dealer's Internal Control Over Compliance at the end of the most recent fiscal year[142] to respond to comments[143] and to align with the additional statement discussed above as to whether the broker-dealer's Internal Control Over Compliance was effective as of the end of the fiscal year.[144]

The final rule also retains the proposed requirement that the carrying broker-dealer provide a description of each identified material weakness in the broker-dealer's Internal Control Over Compliance, but, in conformity with other modifications to the proposal, the final rule

140 See paragraph (d)(3)(i)(A)(3) of Rule 17a-5.

141 See paragraph (d)(3)(iii) of Rule 17a-5. See also 17 CFR 229.308(a)(3) (providing that "[m]anagement is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting.").

142 See paragraph (d)(3)(iii) of Rule 17a-5.

143 See CAQ Letter; Deloitte Letter; E&Y Letter; McGladrey Letter.

144 See paragraph (d)(3)(i)(A)(3) of Rule 17a-5.

requires that the material weaknesses include those identified during the most recent fiscal year as well as those that were identified as of the end of the fiscal year.[145] This change should not add a significant burden because broker-dealers should know whether any material weaknesses identified before year end have been remediated.

As noted above, one commenter recommended that the Commission require broker-dealers to document oral guidance obtained through dialogue with Commission or DEA staff.[146] While such a requirement was not proposed and is not being adopted in the final rule, it may be appropriate and prudent for a broker-dealer to maintain documentation in its books and records of the matters discussed with the Commission or DEA staff, the broker-dealer's own views and conclusion on those matters, and any guidance received by the broker-dealer.

Also as noted above, two commenters asked the Commission to provide additional guidance about the control objectives that should be met to achieve effective internal control over compliance with the financial responsibility rules.[147] As stated in the proposing release, the control objectives identified in the Commission's guidance on Rule 206(4)-2 are more general than the specific operational requirements in the financial responsibility rules.[148] In particular, broker-dealers are subject to operational requirements with respect to handling and accounting for customer assets.[149] Given the specificity of the financial responsibility rules, the Commission does not believe that additional guidance about the control objectives is necessary.

As noted above, several commenters sought assurances that the independent public accountant's examination of the compliance report would not cover the effectiveness of internal

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145 See paragraph (d)(3)(i)(B) of Rule 17a-5.

146 See E&Y Letter.

147 See Angel Letter; Deloitte Letter.

148 See Broker-Dealer Reports, 76 FR at 37580.

149 Id.

control over financial reporting.[150] The final rule does not require that the broker-dealer include a statement regarding the effectiveness of its internal control over financial reporting, nor does it require that the independent public accountant attest to the effectiveness of internal control over financial reporting. The requirement in the final rule is for the broker-dealer to state whether its Internal Control Over Compliance was effective during the most recent fiscal year and at the end of the fiscal year and for the accountant to express an opinion based on an examination of those statements.

A broker-dealer's Internal Control Over Compliance is intended to focus, for example, on a broker-dealer's oversight of custody arrangements and protection of customer assets. In contrast, internal control over financial reporting is focused on the reliability of financial reporting and the preparation of financial statements in accordance with GAAP. As stated in the proposing release, the Commission did not propose that effectiveness of internal control over financial reporting be included as one of the assertions made by the broker-dealer in the compliance report. The Commission intends that the compliance report should focus on oversight of net capital, custody arrangements, and protection of customer assets, and therefore, should be focused on compliance with the financial responsibility rules.

Further, the examination of the compliance report would pertain solely to certain statements in the compliance report and not to the broker-dealer's process for arriving at the statements. The report of the independent public accountant, based on the examination of the compliance report, requires the accountant to perform its own independent examination of the related internal controls. Consequently, it is not necessary for the independent public accountant to provide an opinion with regard to the process that the broker-dealer used to arrive at its

150 See Deloitte Letter; KPMG Letter; PWC Letter.

conclusions.

As noted above, commenters sought clarification of the meaning of "books and records" as used in the compliance report statement. The reference in paragraph (d)(3)(i)(A)(5) of Rule 17a-5 to books and records refers to the books and records a broker-dealer is required to make and maintain under Commission rules (e.g., Rule 17a-3 and Rule 17a-4).[151]

4. The Exemption Report – Paragraph (d)(4) of Rule 17a-5

i. Proposed Amendments

The Commission proposed that the exemption report must contain an assertion by the broker-dealer that it is exempt from Rule 15c3-3 because it meets conditions set forth in paragraph (k) of Rule 15c3-3 and "should identify the specific conditions."[152] As discussed below in section II.D.3. of this release, under the proposal, the independent public accountant, as part of the engagement, would have been required to prepare a report based on a review of the exemption report in accordance with PCAOB standards.[153]

ii. Comments Received

The Commission received several comments regarding the exemption report.[154] Some commenters stated that the Commission should clarify whether the assertion would cover the entire fiscal year or be as of a fixed date.[155] One commenter stated that the assertion should be as of a fixed date.[156] With respect to the independent public accountant's review of the exemption

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[151] See 17 CFR 240.17a-3; 17 CFR 240.17a-4.

[152] See Broker-Dealer Reports, 76 FR at 37580–37581.

[153] Id. at 37578–37579. PCAOB standards for attestation engagements provide that accountants ordinarily should obtain written assertions in an examination or review engagement.

[154] See CAQ Letter; Deloitte Letter; Grant Thornton Letter; KPMG Letter. Some of the comments relating to the exemption report and the response to the comments are discussed above in section II.B.1. of this release.

[155] See CAQ Letter; Deloitte Letter; Grant Thornton Letter; KPMG Letter.

[156] See KPMG Letter.

report, one commenter provided the example of a bank or clerical error that results in a broker-dealer that operates under an exemption to Rule 15c3-3 finding itself in possession of customer assets overnight once during the fiscal year.[157] This commenter stated that such a situation should not "warrant the 'material modification' of a broker-dealer's Exemption Report."[158] Similarly, another commenter noted that "to consider a single instance of a broker-dealer failing to promptly forward a customer's securities as an instance that would necessitate a material modification creates an unworkable standard."[159]

One commenter stated that the exemption report relates only to Rule 15c3-3 and asked how the Commission intended to assess, for a firm that claims an exemption from Rule 15c3-3, compliance with Rule 15c3-1 and the adequacy of the firm's internal control over compliance with that rule.[160] Another commenter asked whether the exemption report should be replaced with a box to check on the FOCUS Report, as the amount of paperwork involved for small firms "seems rather excessive."[161]

iii. The Final Rule

The Commission is adopting, with modifications discussed below, the requirements regarding the exemption report.[162] The modifications are designed to address commenters' concerns that the proposed exemption report assertion would create an unworkable standard given the possibility that a broker-dealer might have instances of exceptions to meeting the

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157 See SIFMA Letter.

158 Id.

159 See CAI Letter.

160 See McGladrey Letter.

161 See Angel Letter.

162 See paragraph (d)(4) of Rule 17a-5.

exemption provisions in paragraph (k) of Rule 15c3-3 and that the proposed requirements with respect to the exemption report did not explicitly provide how exceptions should be treated. In response to these concerns, the final rule provides that exemption reports must contain the following statements made to the best knowledge and belief of the broker-dealer: (1) a statement that identifies the provisions in paragraph (k) of Rule 15c3-3 under which the broker-dealer claimed an exemption from Rule 15c3-3; (2) a statement the broker-dealer met the identified exemption provisions in paragraph (k) of Rule 15c3-3 throughout the most recent fiscal year without exception or that it met the identified exemption provisions in paragraph (k) of Rule 15c3-3 throughout the most recent fiscal year except as described in the exemption report; and (3) if applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified provisions in paragraph (k) of Rule 15c3-3 and that briefly describes the nature of each exception and the approximate date(s) on which the exception existed.[163]

In response to comments seeking clarity as to whether the assertion in the exemption report should cover a fixed date or the fiscal year,[164] the final rule explicitly provides that the statement and certain information in the exemption report must cover the most recent fiscal year.[165] This corresponds to the provisions of paragraph (d)(1)(i)(B) of Rule 17a-5 governing when a broker-dealer must file the exemption report instead of the compliance report. In particular, a broker-dealer that claimed an exemption from Rule 15c3-3 throughout the most recent fiscal year must file the exemption report.[166]

In addition, as proposed, the exemption report was required to contain an assertion that

163 Id.

164 See CAQ Letter; Deloitte Letter; Grant Thornton Letter; KPMG Letter.

165 See paragraph (d)(4)(ii) of Rule 17a-5.

166 See paragraph (d)(1)(i)(B) of Rule 17a-5.

the broker-dealer "is exempt from the provisions" of Rule 15c3-3 "because it meets conditions set forth in" paragraph (k) of Rule 15c3-3 and "should identify the specific conditions."[167] Thus, the exemption report would have required the broker-dealer to state definitively that "it is exempt" from Rule 15c3-3 because it "meets the conditions set forth in" in paragraph (k).[168] As noted above, commenters raised questions and concerns about how certain exceptions would be handled under the proposed exemption report requirements. The final rule addresses these comments in a number of ways.

First, it provides that the statements in the exemption report must be made to the "best knowledge and belief of the broker or dealer."[169] This modification is designed to address situations where the broker-dealer is unaware of an instance or instances in which it had an exception to meeting the exemption provisions in paragraph (k) of Rule 15c3-3 during the most recent fiscal year. As discussed below, the broker-dealer must state in the report that it met the exemption provisions throughout the year without exceptions or with exceptions that must be identified.[170]

Second, the final rule provides that the broker-dealer first must identify in the exemption report the "provisions" in paragraph (k) of Rule 15c3-3 under which it "claimed" an exemption from Rule 15c3-3.[171] As discussed above in section II.B.1. of this release, the final rule has been

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167 See Broker-Dealer Reports, 76 FR at 37604.

168 Id.

169 See paragraph (d)(4) of Rule 17a-5.

170 As discussed above in section II.B.3. of this release, a carrying broker-dealer must state in the compliance report whether it was in compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3 as of the end of the most recent fiscal year. See paragraph (d)(3)(i)(A)(4) of Rule 17a-5. In response to comments and in light of the nature of the statements required in the exemption report, the Commission added the best knowledge and belief standard to the exemption report requirement.

171 See paragraph (d)(4)(i) of Rule 17a-5. As proposed, paragraph (d)(4) of Rule 17a-5 provided that the exemption report "shall contain a statement by the broker or dealer that it is exempt from the provisions of [Rule 15c3-3] because it meets the conditions set forth in [paragraph (k) of Rule 15c3-3] and should identify the specific conditions." See Broker-Dealer Reports, 76 FR 37604 (emphasis added). The

modified to provide that a broker-dealer must file the exemption report if it did "claim that it was exempt" from Rule 15c3-3 throughout the most recent fiscal year.[172] This change is designed to remove any ambiguity as to when a broker-dealer must file the exemption report as opposed to the compliance report, particularly in situations where the broker-dealer had exceptions to meeting the exemption provisions in paragraph (k) of Rule 15c3-3. Consistent with this change, the final rule requires the broker-dealer to identify in the exemption report the provisions in paragraph (k) under which it "claimed the exemption."[173]

Further, as proposed, the broker-dealer would have been required to identify the exemption "conditions" in paragraph (k) of Rule 15c3-3.[174] The use of the word "provisions" in the final rule is designed to eliminate a potential ambiguity as to whether the exemption provisions in paragraphs (k)(2) and (3) of Rule 15c3-3 applied to the exemption report. In particular, paragraph (k) of Rule 15c3-3 prescribes "exemptions" from the requirements of Rule 15c3-3.[175] Paragraph (k)(1) provides that the requirements of Rule 15c3-3 do not apply to a broker-dealer that meets all of the "conditions" set forth in the paragraph.[176] Paragraph (k)(2) identifies two sets of conditions (without using the word "conditions") either of which exempts a

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Commission intended that the broker-dealer be required to identify the provisions of paragraph (k) of Rule 15c3-3 under which the broker-dealer was claiming the exemption. To make clear that this requirement and the other requirements of the exemption report are mandatory, the final rule uses the word "must" in relation to each element of the exemption report. See paragraph (d)(4) of Rule 17a-5.

172 See paragraph (d)(1)(i)(B)(2) of Rule 17a-5. A broker-dealer claiming an exemption from Rule 15c3-3 is required to indicate the basis for the exemption on the periodic reports it files with securities regulators. See, e.g., Item 24 of Part IIa of the FOCUS Reports. See 17 CFR 249.617.

173 See paragraph (d)(4)(i) of Rule 17a-5.

174 See paragraph (d)(4)(ii) of Rule 17a-5. The proposed rule provided that the broker-dealer must assert that it is exempt from the provisions of Rule 15c3-3 because it meets "conditions" set forth in paragraph (k) and should identify the specific "conditions." See Broker-Dealer Reports, 76 FR at 37580–37581.

175 See 17 CFR 240.15c3-3(k)(1), (k)(2)(i), (k)(2)(ii), and (k)(3).

176 See 17 CFR 240.15c3-3(k)(1)(i)–(iv).

broker-dealer from the requirements of Rule 15c3-3.[177] Paragraph (k)(3) provides that the Commission may exempt a broker-dealer from the provisions of Rule 15c3-3, either unconditionally or on specified terms and conditions, if the Commission finds that the broker-dealer has established safeguards for the protection of funds and securities of customers comparable with those provided for by Rule 15c3-3 and that it is not necessary in the public interest or for the protection of investors to subject the particular broker-dealer to the provisions of Rule 15c3-3.[178] The Commission intended that a broker-dealer file an exemption report if it is exempt from Rule 15c3-3 under the provisions in either paragraph (k)(1), (k)(2)(i), (k)(2)(ii), or (k)(3) of Rule 15c3-3. To make this clear, the final rule refers to the "provisions" of paragraph (k) of Rule 15c3-3.[179] Consequently, a broker-dealer filing the exemption report must identify the provisions in paragraph (k) that it relied on to claim an exemption from Rule 15c3-3.[180]

The third modification designed to address commenters' questions and concerns about how to handle exceptions to meeting the exemption provisions in paragraph (k) of Rule 15c3-3 relates to the proposed assertion that the broker-dealer "is exempt from the provisions" of Rule 15c3-3 "because it meets conditions set forth in" paragraph (k). The final rule provides that the exemption report must contain a statement that the broker-dealer met the identified exemption

177 See 17 CFR 240.15c3-3(k)(2)(i)–(ii).

178 See 17 CFR 240.15c3-3(k)(3).

179 This modification is consistent with Item 24 of Part IIa of the FOCUS Report, which is titled "EXEMPTIVE PROVISION UNDER RULE 15c3-3" and requires a broker-dealer that claims to be exempt from the requirements of Rule 15c3-3 to identify the provision in Rule 15c3-3 – paragraph (k)(1), paragraph (k)(2)(i), paragraph (k)(2)(ii), or paragraph (k)(3) – under which it is claiming to be exempt. See 17 CFR 249.617.

180 This change also is intended to make clear that the broker-dealer can identify the provisions of paragraph (k) of Rule 15c3-3 that the broker-dealer is relying on to claim the exemption by simply identifying in the exemption report the subparagraph in paragraph (k) (i.e., (k)(1), (k)(2)(i), (k)(2)(ii), or (k)(3)) that contains the particular conditions the broker-dealer is relying on to claim the exemption rather than repeating the conditions themselves in the exemption report. For example, it would be sufficient for a broker-dealer relying on the exemption provisions in paragraph (k)(2)(ii) of Rule 15c3-3 to identify the provisions in the exemption report under which in claimed an exemption by referring to "paragraph (k)(2)(ii) of Rule 15c3-3" or "17 CFR 240.15c3-3(k)(2)(ii)."

provisions in paragraph (k) of Rule 15c3-3 throughout the most recent fiscal year without exception or that it met the identified exemption provisions in paragraph (k) of Rule 15c3-3 throughout the most recent fiscal year except as described in the exemption report.[181] This modification from requiring the broker-dealer to state an absolute (i.e., that it is exempt from Rule 15c3-3) allows the broker-dealer to account for instances in which it had exceptions to meeting the exemption provisions in paragraph (k) of Rule 15c3-3 directly in the exemption report (rather than having to file the compliance report). Specifically, if to the broker-dealer's best knowledge and belief, it had no exceptions during the most recent fiscal year to the identified exemption provisions in paragraph (k) of Rule 15c3-3, it must state in the exemption report that it met the identified exemption provisions in paragraph (k) without exception. Alternatively, a broker-dealer that had exceptions must state that it met the identified exemption provisions except as described in the exemption report.

If the broker-dealer states that it had exceptions (e.g., exceptions identified during the year, such as through routine monitoring of its compliance processes as part of the execution of its internal controls, internal or external audits, or regulatory examinations), the final rule requires the firm to identify, to its best knowledge and belief, each exception and briefly describe the nature of the exception and the approximate date(s) on which the exception existed.[182] The Commission expects that non-carrying broker-dealers generally track exceptions as part of monitoring compliance with the exemption provisions in paragraph (k) of Rule 15c3-3.[183] Further, a non-carrying broker-dealer's adherence to the exemption provisions in paragraph (k)

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181 See paragraph (d)(4)(ii) of Rule 17a-5.

182 See paragraph (d)(4)(iii) of Rule 15c3-3.

183 See, e.g., Net Capital Rule, Exchange Act Release No. 31511 (Nov. 24, 1992), 57 FR 56973 (Dec. 2, 1992), at 56981 n.25 (stating that non-carrying broker-dealers must develop procedures to ensure that they do not receive customer securities or checks made payable to themselves).

of Rule 15c3-3 generally is a focus of Commission examiners when they conduct financial responsibility examinations on this class of firm. For example, examiners will review whether a non-carrying broker-dealer promptly forwards checks in accordance with provisions in paragraph (k) of Rule 15c3-3. The Commission also notes that the 2011 AICPA Broker Dealer Audit Guide states: "In auditing the financial statements of a broker-dealer claiming exemption from SEC Rule 15c3-3, the auditor should determine whether and to what extent the broker-dealer complied with the specific exemption during the audit period as well as the quality of the broker-dealer's controls and procedures to ensure ongoing compliance."[184] In addition, under the PCAOB's proposed standards, the independent public accountant should inquire of individuals at the broker-dealer who have relevant knowledge of controls relevant to the broker-dealer's compliance with the exemption provisions and who are responsible for monitoring compliance with the exemption provisions whether they are aware of any deficiencies in controls over compliance or instances of non-compliance with the exemption conditions.[185] Moreover, in the independent public accountant's report, "[i]f the broker's or dealer's statement is not fairly stated, in all material respects, because of an instance or certain instances of non-compliance with the exemption conditions, the auditor must modify the review report to describe those instances of non-compliance and state that the broker or dealer is not in compliance with the specified exemption conditions."[186]

Under the final rule, a non-carrying broker-dealer must identify in the exemption report and describe each exception during the most recent fiscal year in meeting the identified exemption provisions in paragraph (k) of Rule 15c3-3. The description must include the

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184 See AICPA Broker-Dealer Audit Guide at ¶ 3.35.

185 See PCAOB Proposing Release app. 2 at ¶ 10.

186 Id. at ¶ 20.

approximate date(s) on which the exception existed. Without such reporting, the Commission and the broker-dealer's DEA would have no information to assess the nature, extent, and significance of the exceptions.

As noted above, one commenter asked whether the exemption report should be replaced with a box to check on the FOCUS Report, as the amount of paperwork involved for small firms "seems rather excessive."[187] The Commission does not believe this is an appropriate alternative. First, as indicated above, a broker-dealer claiming an exemption from Rule 15c3-3 already is required to indicate the basis for the exemption on its FOCUS Report.[188] Second, the exemption report requires the broker-dealer to make certain statements that the independent public accountant must review. Thus, the exemption report will provide a standardized statement across all broker-dealers claiming an exemption from Rule 15c3-3 for the independent public accountant to review. Third, the exemption report will provide the Commission and the broker-dealer's DEA with more information than currently is reported by non-carrying broker-dealers in the FOCUS Report. Specifically, it requires the broker-dealer to, among other things, state either that it met the identified exemption provisions in paragraph (k) throughout the most recent fiscal year without exception or that it met the identified exemption provisions throughout the most recent fiscal year except as described in the report. This will provide the Commission and the broker-dealer's DEA with information as to whether a broker-dealer is meeting the exemption provisions of paragraph (k) of Rule 15c3-3 (not simply that the broker-dealer is claiming the exemption as is reported in the FOCUS Report). Fourth, requiring that the exemption report be filed with the Commission should increase broker-dealers' focus on the statements being made, facilitating consistent compliance with the exemption provisions in Rule 15c3-3, and therefore,

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187 See Angel Letter.

188 See Item 24 of Part IIa of the FOCUS Report.

providing better protection of customer assets. Fifth, the requirement to prepare and file the exemption report should not result in excessive paperwork, as stated by one commenter.[189]

As noted above, one commenter pointed out that the exemption report relates solely to Rule 15c3-3 and asked how the adequacy of a non-carrying broker-dealer's internal controls over compliance with Rule 15c3-1 would be assessed.[190] Under the final amendments, a broker-dealer's financial report will continue to include a supporting schedule containing a net capital computation under Rule 15c3-1, which will be covered by the independent public accountant's examination of the financial report. Moreover, the PCAOB has proposed standards for auditing supplemental information accompanying audited financial statements.[191]

5. Time for Filing Annual Reports – Paragraph (d)(5) of Rule 17a-5

Prior to today's amendments, paragraph (d)(5) of Rule 17a-5 required that the annual audit report be filed not more than 60 days after the date of the financial statements.[192] The Commission proposed amending paragraph (d)(5) to replace the term annual audit report with annual reports.[193] This change was designed to reflect the fact that, under the proposal, broker-dealers must file a financial report, a compliance report or exemption report, and reports prepared by an independent public accountant covering these reports. While the Commission did not receive comments on this proposed change, one commenter stated that the existing

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189 See Angel Letter. The commenter did not explain why the exemption report would result in excessive paperwork. Id. See also discussion below in section VI.D.1.iii. of this release for the estimated paperwork hour burden associated with this requirement.

190 See McGladery Letter. The material inadequacy report – which applied to carrying and non-carrying broker-dealers – covered Rule 15c3-1. See 17 CFR 240.17a-5(g).

191 See Proposed Auditing Standard, Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards, PCAOB Release No. 2011-05, PCAOB Rulemaking Docket Matter No. 036 (July 12, 2011) ("PCAOB Proposed Auditing Standard for Supplemental Information").

192 See 17 CFR 240.17a-5(d)(5).

193 See Broker-Dealer Reports, 76 FR at 37604.

requirement in Rule 17a-5 that the annual audit report be filed 60 days after the date of the financial statements should be lengthened to 90 days.[194] In support of this recommendation, the commenter cited CFTC Rule 1.10, which allows an FCM up to 90 days to file annual audit reports.[195]

The Commission is adopting, with modifications, the proposed amendment to paragraph (d)(5) of Rule 17a-5.[196] The modifications add the term "calendar" to make explicit that the time for filing the annual reports is 60 calendar days after the fiscal year end (as opposed to business days). The modifications replace the words "date of the financial statements" with the words "end of the fiscal year of the broker or dealer" to provide consistency in the language of Rule 17a-5.[197] The final rule does not change the time limit for filing the annual reports to 90 days after the end of the fiscal year. The 60-day time frame is a long standing requirement and it provides the Commission and other regulators with relatively current information to, among other things, monitor the financial condition of broker-dealers. Further, broker-dealers may seek an extension of time to file the annual reports from their DEAs.[198]

6. Filing of Annual Reports with SIPC – Paragraph (d)(6) of Rule 17a-5

Prior to today's amendments, paragraph (d)(6) of Rule 17a-5 provided that the "annual audit report" must be filed at the regional office of the Commission for the region in which the broker-dealer has its principal place of business, the Commission's principal office in

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194 See IMS Letter.

195 See 17 CFR 1.10(b)(ii). Rule 1.10 also provides that if the FCM is registered with the Commission as a broker-dealer, the FCM must file the report not later than the time permitted for filing an annual audit report under Rule 17a-5.

196 See paragraph (d)(5) of Rule 17a-5.

197 Id. See also paragraph (n) of Rule 17a-5.

198 See paragraph (m) of Rule 17a-5.

Washington, DC, and the principal office of the DEA of the broker-dealer.[199] Copies were required to be provided to all self-regulatory organizations ("SROs") of which the broker-dealer is a member.

i. The Proposed Amendments

The Commission proposed two amendments to this provision. First, the Commission proposed that an SRO that is not a broker-dealer's DEA could by rule waive the requirement that broker-dealers file annual reports with it because many SROs do not believe that it is necessary to receive copies of broker-dealer annual reports if they are not the broker-dealer's DEA.[200] The Commission received no comments on this proposal and is adopting it as proposed.[201]

Second, the Commission proposed amending this provision to require a broker-dealer to file its annual reports with SIPC.[202] SIPC, a nonprofit, nongovernmental membership corporation established by SIPA, is responsible for providing financial protection to customers of failed broker-dealers. SIPA also provided for the establishment of a fund ("SIPC Fund") to pay for SIPC's operations and activities. SIPC uses the fund to make advances to satisfy customer claims for securities and cash that cannot be readily returned to the customer. SIPA limits the amount of the advance to $500,000 per customer, of which $250,000 can be used to satisfy the cash portion of a customer's claim. The SIPC Fund also covers the administrative expenses of liquidation proceedings for failed broker-dealers when the general estate of the failed firm is insufficient; these include costs incurred by a trustee, trustee's counsel, and other advisors. SIPC finances the SIPC Fund through annual assessments, set by SIPC, on all member firms, plus

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199 See 17 CFR 240.17a-5(d)(6).

200 See Broker-Dealer Reports, 76 FR at 37592.

201 See paragraph (d)(6) of Rule 17a-5.

202 See Broker-Dealer Reports, 76 FR at 37592.

interest generated from its permitted investments. Generally, all broker-dealers registered with the Commission under section 15(b) of the Exchange Act[203] are required to be members of SIPC.[204] Before today's amendments, broker-dealers were required to file only limited information with SIPC. Specifically: (1) information elicited on Form SIPC-6, the "General Assessment Payment Form;" (2) information elicited on Form SIPC-7, the "Annual General Assessment Reconciliation;" and (3) for periods in which the SIPC assessment is not a minimum assessment, a comparison by the independent public accountant of the amounts reflected in the annual report the broker-dealer filed with the Commission with amounts reported on Form SIPC-7.

The Commission explained in the proposing release that the proposed requirement for broker-dealers to file their annual reports with SIPC could allow SIPC to better monitor industry trends and enhance its knowledge of particular firms.[205] The Commission also explained that the requirement that broker-dealers file copies of their annual reports with SIPC was designed to address cases where the SIPC Fund has been used to pay the administrative expenses of the liquidation of a failed broker-dealer and SIPC sought to recover the money advanced when the estate had insufficient assets.[206] In some of these cases, SIPC has sought to recover money damages from the broker-dealer's auditing firm based on an alleged failure to comply with auditing standards. At least one court, however, has held under New York law that SIPC could

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203 See 15 U.S.C. 78o(b).

204 See 15 U.S.C. 78ccc(a)(2). However, broker-dealers engaged exclusively in the distribution of mutual fund shares, the sale of variable annuities, the insurance business, the furnishing of investment advice to investment companies or insurance company separate accounts, or whose principal business is conducted outside the U.S. are not required to be members of SIPC. See 15 U.S.C. 78ccc(a)(2)(A)(i)–(iii).

205 See Broker-Dealer Reports, 76 FR at 37592.

206 Id. See also SIPC, 2010 Annual Report, at 18, available at http://www.sipc.org/pdf/2010%20Annual%20Report.pdf.

not maintain such a claim because it was not a recipient of the annual audit filing and could not have relied on it.[207]

ii. Comments Received

The Commission received seven comments on the proposal that broker-dealers be required to file their annual reports with SIPC.[208] Six commenters generally opposed the requirement.[209] One commenter indicated that it is appropriate for broker-dealers to file their annual reports with SIPC if SIPC uses the reports to reconcile the annual reports with the Form SIPC-7 or otherwise places reliance on them.[210] Three of the commenters stated that the Commission failed to adequately articulate the policy considerations driving the proposed change and also failed to discuss the possible costs of increased litigation risk to accountants.[211] Some of the commenters argued that this change would contradict limitations on SIPC's authority to bring claims against accountants under SIPA and the securities laws imposed by the U.S. Supreme Court.[212]

After the proposal, a task force established by SIPC to undertake a comprehensive review of SIPA and SIPC's operations and policies and to propose reforms to modernize SIPA and SIPC recommended to the SIPC Board that SIPC members be required to file audit reports with SIPC concurrently with their filing with the SEC, a position consistent with the proposal. In a report

207 See SIPC v. BDO Seidman, LLP, 746 N.E.2d 1042 (N.Y. 2001).

208 See CAQ Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter; PWC Letter.

209 See CAQ Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; PWC Letter.

210 See McGladrey Letter. Form SIPC-7 is discussed in more detail below in section II.C.4. of this release.

211 See CAQ Letter; Deloitte Letter; KPMG Letter.

212 See CAQ Letter; Deloitte Letter; E&Y Letter; KPMG Letter; PWC Letter.

presented to the SIPC Board of Directors in February 2012,[213] the task force stated that including SIPC as a designated recipient of the audit report "would further the goal of investor protection by providing another layer of review of the report by an organization directly affected by its contents."[214] In addition, the task force stated that "including SIPC as a recipient would help to address the persistent concern that any signs of 'financial weakness, as by non-compliance with net capital requirements or otherwise, [be] watched very carefully and followed up' in order to augment the financial responsibility requirements SIPA was intended to enhance, and to provide greater investor protection."[215]

iii. The Final Rule

The Commission is adopting the amendment requiring broker-dealers to file their annual reports with SIPC substantially as proposed.[216] SIPC plays an important role in the securities markets and the SIPC Fund can help reduce losses to investors from the failure of their broker-dealer. SIPC has a legitimate interest in receiving the annual reports of its broker-dealer members to assist it with its maintenance of the SIPC Fund and to monitor trends in the broker-dealer industry. SIPC presently obtains revenue information from broker-dealers, through Form SIPC-7, to determine how best to structure broker-dealer assessments to maintain the SIPC Fund at an appropriate level. However, the information collected in the form is limited and may not

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213 See Report and Recommendations of the SIPC Modernization Task Force (Feb. 2012), available at http://www.sipc.org/pdf/Final%Report%202012.pdf. The Task Force was comprised of volunteers, and included investor advocates, regulatory specialists, and academic experts, including the trustee for the liquidation of Lehman Brothers Inc. and MF Global Inc.

214 See Report and Recommendations of the SIPC Modernization Task Force, at 19.

215 Id. (quoting the SEC, Study of Unsafe and Unsound Practices of Broker-Dealers, H.R. Doc. No. 92-231, at 152 (1971)).

216 See paragraph (d)(6) of Rule 17a-5. The Commission clarified that the broker-dealer must file the annual reports with SIPC only "if the broker or dealer is a member of SIPC." The Commission believes that SIPC has an interest in receiving annual reports only from broker-dealers that are SIPC members, because only these broker-dealers may pose a risk to the SIPC Fund.

assist SIPC in assessing whether the SIPC Fund is appropriately sized to the risks of a large broker-dealer failure. The annual audited reports contain much more detailed information about the assets, liabilities, income, net capital, and Rule 15c3-3 customer reserve requirements of broker-dealers, and also include, for carrying broker-dealers, a compliance report containing information about the broker-dealer's compliance with, and controls over compliance with, the broker-dealer financial responsibility rules. The annual reports also generally include the independent public accountant's reports covering the financial report and compliance report or exemption report, as applicable, prepared by the broker-dealer. This information will assist SIPC in monitoring the financial strength of broker-dealers and, therefore, in assessing the adequacy of the SIPC Fund.[217]

In addition, by receiving the annual reports, SIPC may be able to overcome a legal hurdle to pursuing claims against a broker-dealer's accountant where the accountant's failure to adhere to professional standards in auditing a broker-dealer caused a loss to the SIPC Fund. Although this amendment is intended to remove one potential legal hurdle to SIPC actions against accountants, the other elements of any relevant cause of action would be unaffected. The Commission does not intend by this amendment to take a position on the circumstances under which SIPC may have a viable cause of action against an independent public accountant.[218]

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217 See McGladrey Letter.

218 Several commenters argue that requiring the annual report to be filed with SIPC would contradict limitations the Supreme Court has imposed on SIPC's authority to bring claims against accountants. The decisions cited by these commenters, however, do not speak to the precise issue the amended rule is intended, among other things, to address – the New York Court of Appeals' decision held that SIPC could not state a cause of action for either fraudulent or negligent misrepresentation against an auditing firm because it was not a recipient of the annual audit report. See SIPC v. BDO Seidman, LLP, 746 N.E.2d 1042 (N.Y. 2001); aff'd, 245 F.3d 174 (2d Cir. 2001). Rather, in Holmes v. Securities Investor Protection Corporation, the Supreme Court found that the statutory provision relied on by SIPC, 15 U.S.C. 78eee(d), did not, either alone or with the Racketeer Influenced and Corrupt Organizations Act, confer standing. 503 U.S. 258, 275 (1992). And, in Touche Ross & Co. v. Redington, the Supreme Court determined that customers of securities brokerage firms do not have an implied cause of action for damages under section 17(a) of the Exchange Act against accountants who audit the financial reports filed by such firms; thus,

Several commenters stated that the Commission did not address the potential costs and benefits of requiring broker-dealers to file copies of their annual reports with SIPC, including potential accounting litigation costs.[219] As discussed below in section VII. of this release, the Commission recognizes that there may be increased litigation costs (or reserves for potential litigation costs) as a result of the amendment and that to the extent that there are such costs, some of them may be passed on to broker-dealers in the form of increased audit fees. But, while this amendment may facilitate the ability of SIPC to bring actions against accountants for malpractice or material misrepresentation under state law by removing one potential legal hurdle to such actions, it will not necessarily result in a significant increase in such actions. Generally, SIPC initiates a small number of proceedings each year, and most of these proceedings have not involved a claim against a broker-dealer's accountant. Specifically, SIPC was established in 1971. In the period from 1971-2011, SIPC initiated 324 proceedings under SIPA to liquidate a failed broker-dealer.[220] This results in an average of approximately 8 SIPA proceedings per year, though 109 of the 324 proceedings were initiated in the period from 1971-1974, which was the immediate aftermath of the financial crisis of 1968-1970.[221] According to SIPC staff, SIPC has brought 9 lawsuits against accountants since 1971, which is one lawsuit for every 36 SIPA proceedings.[222] Accordingly, the likelihood of a lawsuit against an accountant is small and the

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SIPC could not assert this implied cause of action on behalf of these customers. 442 U.S. 560, 567 (1979). As already noted, the Commission does not intend by this amendment to take a position on the circumstances under which SIPC may have a viable cause of action against an independent public accountant.

219 See, e.g., CAQ Letter; Deloitte Letter; KPMG Letter.

220 See SIPC, Annual Report 2011, at 6.

221 Id. See also Commission, Study of Unsafe and Unsound Practices of Brokers and Dealers: Report and Recommendations of the Securities and Exchange Commission (December 1971) (discussing the financial crisis of 1968–1970). Since its inception through 2001, SIPC initiated 299 proceedings under SIPA.

222 See Redington v. Touche Ross & Co., 592 F.2d 617 (2d Cir. 1978); In re Bell & Beckwith, 77 B.R. 606 (Bkrtcy. N.D. Ohio, 1987); Mishkin v. Peat, Marwick, Mitchell & Co., 658 F.Supp. 271 (S.D.N.Y. 1987); SIPC v. BDO Seidman, LLP, 49 F.Supp.2d 644 (S.D.N.Y. 1999); In re Donahue Securities Inc., 2004 WL

Commission anticipates that the overall costs related to litigation as a result of the filing requirement should not be significant. The Commission believes that any such costs are justified by the benefits of enhanced customer protection and the associated ability of SIPC to better assess the financial condition of broker-dealers and the adequacy of the SIPC Fund.

C. The Nature and Form of the Annual Reports

1. Exemptions from Audit Requirement – Paragraph (e)(1) of Rule 17a-5

Prior to today's amendments, paragraph (e)(1)(i) of Rule 17a-5 provided, among other things, that the audit of the broker-dealer's financial statements needed to be performed by an accountant that is independent as defined in paragraph (f) of Rule 17a-5.[223] Paragraph (e)(1)(i) also contained provisions under which certain broker-dealers were not required to engage an accountant to audit their financial statements.[224]

The Commission proposed amending paragraph (e)(1)(i) of Rule 17a-5 to remove the words "An audit shall be conducted by a public accountant who shall be in fact independent as defined in paragraph (f)(3) of this section herein, and he shall give an opinion covering the statements filed pursuant to paragraph (d)." This amendment would consolidate the requirements with respect to the qualifications of the accountant in paragraph (f) of Rule 17a-5, and paragraph (e)(1)(i) of Rule 17a-5 would address only exemptions from the requirement to engage an independent public accountant to audit the annual reports prepared by the broker-

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3152763 (Bkrtcy S.D. Ohio, 2004); In re SIPC v. R.D. Kushnir & Co, 274 B.R. 768 (Bkrtcy. N.D. Ill., 2002); In re Sunpoint Securities, Inc., 377 B.R. 513 (Bkrtcy. E.D. Tex., 2007); Compliant at 5–6, Gilbert v. Ohab, Bkrtcy. M.D. Fl. (May 2010) (No. 6:08-ap-00145-KSJ); Complaint at 2, Shively v. Mortland, Bkrtcy. D. Co. (Feb. 2004) (No. 03-BK-1102-HRT).

223 See 17 CFR 240.17a-5(e)(1)(i).

224 Id.

dealer.[225] The Commission received no comments on this proposal, and is adopting it with modifications.[226] The modifications: (1) modernize certain terms in the rule in a manner consistent with the Commission's "plain English" initiative; and (2) cite to the reports required under "Rule 17a-5(d)(1)(i)(C)" to provide a more precise cross reference than the former citation to reports required under "Rule 17a-5(d)."[227]

2. Affirmation – Paragraph (e)(2) of Rule 17a-5

Prior to today's amendments, paragraph (e)(2) of Rule 17a-5 provided that an oath or affirmation must be attached to the annual audit report that, to the best knowledge and belief of the person making the oath or affirmation, the financial statements and schedules are true and correct and, among other things, that the oath or affirmation must be made by the proprietor if a sole proprietorship, by a general partner, if a partnership, or by a duly authorized officer, if a corporation.[228] The Commission proposed amending the first sentence of paragraph (e)(2) of Rule 17a-5 by adding the word "financial" before the word "report."[229] The Commission is adopting this amendment as proposed.

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225 See Broker-Dealer Reports, 76 FR at 37593–37594. The proposed and final amendments to paragraph (f) of Rule 17a-5 are discussed below in section II.E. of this release.

226 See paragraph (e)(1)(i) of Rule 17a-5.

227 Id. Prior to today's amendments, paragraph (e)(1)(ii) of Rule 17a-5 provided that "[a] broker or dealer who files a report which is not covered by an accountant's opinion shall include in the oath or affirmation required by paragraph (e)(2) of this section a statement of the facts and circumstances relied upon as a basis for exemption from the requirement that financial statements and schedules filed pursuant to paragraph (d) of this section be covered by the opinion of an accountant." See 17 CFR 240.17a-5(e)(1)(ii). The Commission did not propose amendments to this subparagraph. However, to be consistent with today's amendments, the Commission is making technical amendments to paragraph (e)(1)(ii) of Rule 17a-5 so that it now provides that "[a] broker or dealer that files annual reports under paragraph (d) of this section that are not covered by reports prepared by an independent public accountant must include in the oath or affirmation required by paragraph (e)(2) of this section a statement of the facts and circumstances relied upon as a basis for exemption from the requirement that the annual reports filed under paragraph (d) of this section be covered by reports prepared by an independent public accountant." See paragraph (e)(1)(ii) of Rule 17a-5.

228 See 17 CFR 240.17a-5(e)(2).

229 See Broker-Dealer Reports, 76 FR at 37603.

One commenter stated that currently paragraph (e)(2) of Rule 17a-5 does not specifically cover limited liability companies, and its reference to partnerships assumes that a general partner is a natural person.[230] The commenter argued that it should be updated to conform to generally accepted business laws.

In response to this comment, the Commission is adopting amendments to paragraph (e)(2) of Rule 17a-5 that modify the proposed amendments.[231] In particular, the Commission is adding that if the broker-dealer is a limited liability company or limited liability partnership, the oath or affirmation must be made by the chief executive officer, chief financial officer, manager, managing member, or any of those members vested with management authority for the limited liability company or limited liability partnership.[232]

3. Confidentiality of Annual Reports – Paragraph (e)(3) of Rule 17a-5

Prior to today's amendments, paragraph (e)(3) of Rule 17a-5 provided that the financial statements filed under paragraph (d) are public, except that if the Statement of Financial Condition is bound separately from the balance of the annual audited financial statements filed under paragraph (d)(1), the balance of the annual audited financial statements will be deemed confidential.[233] As noted in the proposing release, the wording of this provision has led to confusion.[234] In particular, Commission staff has received inquiries on how broker-dealers can indicate that they are requesting confidential treatment for the portion of the financial statements intended to be kept confidential to the extent permitted by law and, on occasion, financial

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230 See IMS Letter.

231 See paragraph (e)(2) of Rule 17a-5.

232 See IMS Letter.

233 See 17 CFR 240.17a-5(e)(3).

234 See Broker-Dealer Reports, 76 FR at 37592–37593.

statements broker-dealers intended to be confidential are inadvertently made public.[235] This could happen, for example, if a broker-dealer fails to bind the balance sheet separately from the other portion of the financial statements when it files the financial statements with the Commission.[236]

Consequently, the Commission proposed amending paragraph (e)(3) of Rule 17a-5 to provide that the annual reports filed pursuant to paragraph (d) are public, except that if the Statement of Financial Condition is bound separately from the annual report filed pursuant to "paragraph (d)(2) of Rule 17a-5," and each page of the balance of the annual report is stamped "confidential," the balance of the annual report shall be deemed confidential.[237] The proposed rule text inadvertently referenced only the financial report. It was intended that the financial report, compliance report, exemption report, and related accountant reports would be treated the same under paragraph (e)(3) of Rule 17a-5. Consequently, the Commission is modifying the proposed amendment. Specifically, paragraph (e)(3) of Rule 17a-5, as adopted, provides that if the Statement of Financial Condition is bound separately from the balance of the "annual reports filed under paragraph (d) of this section," and each page of the balance of the annual reports is stamped "confidential," then the balance of the annual reports will be deemed confidential to the extent permitted by law.[238] Consequently, if the compliance reports and exemption reports and the related reports of the independent public accountant are submitted in accordance with the

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235 The public portions of broker-dealer annual audited reports are available on the Commission's website. These reports may be accessed via the Search for Company Filings link under Filings & Forms on the Commission's home page.

236 The Commission staff has previously posted guidance on the Commission website on how to request confidential treatment for the financial statements other than the statement of financial condition. See http://www.sec.gov/divisions/marketreg/bdnotices.htm.

237 See Broker-Dealer Reports, 76 FR at 37592–37593.

238 See paragraph (e)(3) of Rule 17a-5.

procedures specified in paragraph (e)(3) of Rule 17a-5, these reports will be deemed confidential to the extent permitted by law.[239]

Prior to today's amendments, paragraph (e)(3) of Rule 17a-5 also provided that the broker-dealer's reports, including the confidential portions, will be available, for example, for official use by any official or employee of the U.S. and an official or employee of any national securities exchange and registered national securities association of which the broker-dealer is a member and "by any other person to whom the Commission authorizes disclosure of such information as being in the public interest."[240] The Commission proposed amending this list of permitted recipients to include the PCAOB.[241] The Commission did not receive comments on this proposal and is adopting it essentially as proposed with a minor wording edit for clarity.[242]

4. Supplemental Report on SIPC Membership – Paragraph (e)(4) of Rule 17a-5

As discussed above in section II.B.6. of this release, SIPC maintains the SIPC Fund to be used in liquidations of broker-dealers under SIPA. The SIPC Fund is established and maintained through assessments on broker-dealers that are required to be members of SIPC.[243] In order to

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239 See 5 U.S.C. 552 et seq. (Freedom of Information Act – "FOIA"). FOIA provides at least two potentially pertinent exemptions under which the Commission has authority to withhold certain information. FOIA Exemption 4 provides an exemption for "trade secrets and commercial or financial information obtained from a person and privileged or confidential." 5 U.S.C. 552(b)(4). FOIA Exemption 8 provides an exemption for matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." 5 U.S.C. 552(b)(8). However, as discussed below, under paragraph (c)(2)(iv) of Rule 17a-5, if there are material weaknesses, the accountant's report on the compliance report must be made available for customers' inspection and, consequently, it would not be deemed confidential. In addition, paragraph (c)(2)(i) of Rule 17a-5 (which is not being amended today) requires a broker-dealer to furnish to its customers annually a balance sheet with appropriate notes prepared in accordance with GAAP and which must be audited if the broker-dealer is required to file audited financial statements with the Commission. See 17 CFR 240.17a-5(c)(2)(i).

240 See 17 CFR 240.17a-5(e)(3).

241 See Broker-Dealer Reports, 76 FR at 37592–37593.

242 See paragraph (e)(3) of Rule 17a-5.

243 Broker-dealers engaged exclusively in the distribution of mutual fund shares, the sale of variable annuities, the insurance business, the furnishing of investment advice to investment companies or insurance company

assist in the collection of assessments from member broker-dealers, SIPC has promulgated two forms that broker-dealers must file with SIPC, as applicable: Form SIPC-3 and Form SIPC-7. Form SIPC-3 is required when a broker-dealer is claiming an exemption from SIPC membership (i.e., when the broker-dealer does not have to pay an assessment). In this case, the broker-dealer must file Form SIPC-3 each year certifying that the broker-dealer remained qualified for the exemption during the prior year. Form SIPC-7 elicits information from a broker-dealer that is a SIPC member about the broker-dealer's sources of revenue attributable to its securities business. Every broker-dealer that is a member of SIPC must file this form annually.

Prior to today's amendments, paragraph (e)(4) of Rule 17a-5 provided that a broker-dealer must file with its annual report a supplemental report on the status of the membership of the broker-dealer in SIPC, which was required to be "covered by an opinion of the independent public accountant" if the annual report of the broker-dealer was required to be audited.[244] Among other things, the supplemental report needed to cover the SIPC annual general assessment reconciliation or exclusion from membership forms (i.e., Form SIPC-7 or Form SIPC-3).[245] Paragraph (e)(4)(iii) of Rule 17a-5 used the terms "review" and "opinion" in describing the accountant's report that must cover the supplement report.[246] In addition, it required that the review by the accountant include certain minimum procedures.[247]

Under this provision, the supplemental report did not need to be filed if the SIPC Fund

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separate accounts, or whose principal business is conducted outside the U.S. are not required to be members of SIPC. See 15 U.S.C. 78ccc(a)(2)(A)(i)–(iii).

244 See 17 CFR 240.17a-5(e)(4).

245 Id.

246 See 17 CFR 240.17a-5(e)(4)(iii).

247 See 17 CFR 240.17a-5(e)(4)(iii)(A)–(F).

assessments were the minimum assessment provided for under SIPA.[248] Between 1996 and 2009, the annual assessment for SIPC members remained at the $150 minimum assessment level provided for under SIPA.[249] In 2009, SIPC raised the assessment above the minimum, which triggered the requirement in paragraph (e)(4) of Rule 17a–5 to file a supplemental report with the Commission, the broker-dealer's DEA, and SIPC.[250]

The Commission stated in the proposing release that, because Forms SIPC-3 and SIPC-7 are used solely by SIPC for purposes of levying its assessments, the supplemental report required pursuant to paragraph (e)(4) of Rule 17a-5 relating to these forms would be more appropriately filed exclusively with SIPC and that SIPC (rather than the Commission) should prescribe by rule the form of the supplemental report.[251] The Commission stated that it would continue to have a role in establishing the requirements for a supplemental report because the Commission must approve SIPC rules.[252]

For these reasons, the Commission proposed to amend paragraph (e)(4) of Rule 17a-5 to require that broker-dealers file with SIPC a report on the SIPC annual general assessment reconciliation or exclusion from membership forms that contains such information and is in such format as determined by SIPC by rule and approved by the Commission.[253] However, because there would be an interim period before a rule determined by SIPC became effective, the Commission proposed amendments to paragraph (e)(4) under which broker-dealers would continue to file a supplemental report with the Commission, the broker-dealer's DEA, and SIPC

248 See 17 CFR 240.17a-5(e)(4); 15 U.S.C. 78ddd(d)(1)(c).

249 See SIPC, SIPC to Reinstitute Assessments of Member Firms' Operating Revenues (Mar. 2, 2009) (news release).

250 Id.

251 See Broker-Dealer Reports, 76 FR at 37582.

252 Id.

253 Id.

until SIPC adopts a rule pursuant to paragraph (e)(4)(i) of Rule 17a-5 and the rule is approved by the Commission.[254] Consequently, a broker-dealer would be required to file the SIPC supplemental reports with SIPC using the existing formats for the reports until the earlier of the Commission approving a rule adopted by SIPC or two years. If after two years, a rule promulgated by SIPC has not been approved by the Commission, broker-dealers would no longer be required to file these reports.

Further, to facilitate this change, the Commission proposed to update the rule text to conform it to existing professional standards and industry practices.[255] Specifically, the Commission proposed amending paragraph (e)(4) of Rule 17a-5 to eliminate the ambiguity that stems from the differing auditing terms used in that rule by removing all references to "review" and "opinion."[256] In their place, the Commission proposed that the supplemental report include an independent public accountant's report based on the performance of the procedures listed in paragraph (e)(4)(iii) of Rule 17a-5, which the Commission did not propose to change.[257]

The Commission received two comments relating to the proposed amendments to paragraph (e)(4) of Rule 17a-5, both of which supported the proposed change.[258] One commenter indicated that the proposed amendment would decrease the burden on broker-dealers associated with filing the supplemental report with the Commission and the broker-dealer's

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254 Id.

255 Id.

256 Id.

257 See Broker-Dealer Reports, 76 FR at 37582. The Commission proposed one modification to the procedures listed in former paragraph (e)(4)(iii); namely, amending the procedure described in paragraph (e)(4)(iii)(F), which is now renumbered (e)(4)(ii)(6), to change the reference from "Form SIPC-7" to "Form SIPC-3" because the reference to Form SIPC-7 is inaccurate. Id.

258 See CAI Letter; McGladrey Letter.

DEA.[259] In addition, the other commenter indicated that until the supplemental reports are filed exclusively with SIPC, they should be subject to confidential treatment.[260]

The Commission is adopting the amendments to paragraph (e)(4) of Rule 17a-5 as proposed.[261] With respect to the comment about the Commission keeping the supplemental report confidential, a broker-dealer can request confidential treatment for the report.[262] If such a request is made, the Commission anticipates that it will accord the supplemental report confidential treatment to the extent permitted by law.[263]

D. Engagement of the Accountant

As part of today's amendments to the broker-dealer annual reporting requirements in Rule 17a-5, the Commission is amending certain requirements relating to a broker-dealer's engagement of an independent public accountant. Specifically, the Commission is requiring that a broker-dealer engage an independent public accountant to prepare reports based on an examination of the broker-dealer's financial report and either an examination of certain statements in the broker-dealer's compliance report or a review of certain statements in the broker-dealer's exemption report. The examinations and reviews must be made in accordance with the standards of the PCAOB, consistent with the explicit authority granted to the PCAOB

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259 See CAI Letter.

260 See McGladrey Letter.

261 See paragraph (e)(4) of Rule 17a-5.

262 See 17 CFR 200.83. Information about how to request confidential treatment of information submitted to the Commission is available at http://www.sec.gov/foia/howfo2.htm#privacy.

263 See, e.g., Exchange Act section 24, 15 U.S.C. 78x (governing the public availability of information obtained by the Commission) and 5 U.S.C. 552 et seq. (Freedom of Information Act – "FOIA"). FOIA provides at least two pertinent exemptions under which the Commission has authority to withhold certain information. FOIA Exemption 4 provides an exemption for "trade secrets and commercial or financial information obtained from a person and privileged or confidential." 5 U.S.C. 552(b)(4). FOIA Exemption 8 provides an exemption for matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." 5 U.S.C. 552(b)(8).

by the Dodd-Frank Act to establish (subject to Commission approval) auditing and attestation standards with respect to broker-dealer audits.[264] Among other things, the amendments replace provisions that required the filing of a "material inadequacy" report and are intended to update terminology in the rule to make the rule's requirements clear and to provide for a more consistent approach to engaging broker-dealer independent public accountants.

This section addresses statutory requirements for broker-dealer annual reports and the Commission's authority with regard to these reports, describes the engagement of accountant requirements in Rule 17a-5 prior to today's amendments, summarizes the Commission's proposed amendments and comments received, and discusses the final rule amendments.

1. Statutory Requirements and Commission Authority

Section 17(e)(1)(A) of the Exchange Act requires a broker-dealer to file annually with the Commission a "certified" balance sheet and income statement as well as "such other financial statements (which shall, as the Commission specifies, be certified) 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."[265] Section 17(e)(2) of the Exchange Act provides the Commission with authority, by rule, to prescribe the form and content of the financial statements and the accounting principles and standards used in their preparation as it deems necessary or appropriate in the public interest or for the protection of investors.[266] In addition, section 17(a) of the Exchange Act more generally requires registered broker-dealers to make and disseminate such reports as the Commission, by rule, may prescribe as necessary or

264 See Pub. L. No. 111-203 § 982.

265 See 15 U.S.C. 78q(e)(1)(A).

266 See 15 U.S.C. 78q(e)(2).

appropriate in the public interest, for the protection of investors.[267] The Commission adopted Rule 17a-5, in part, under these provisions.[268]

Prior to the enactment of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act"),[269] section 17(e)(1)(A) required that the annual financial statements a broker-dealer must file with the Commission be certified by "an independent public accountant." The Sarbanes-Oxley Act established the PCAOB[270] and amended section 17(e)(1)(A) by replacing the words "certified by an independent public accountant" with the words "certified by a registered public accounting firm."[271] Title I of the Sarbanes-Oxley Act prescribed specific PCAOB registration, standards-setting, inspection, investigation, disciplinary, foreign application, oversight, and funding programs in connection with audits of issuers.[272] However, as originally enacted, the Sarbanes-Oxley Act did not expressly prescribe similar programs in connection with audits of broker-dealers that are not issuers.

The Dodd-Frank Act, enacted in July 2010, amended the Sarbanes-Oxley Act to provide the PCAOB with explicit authority to, among other things, establish (subject to Commission approval) auditing and related attestation, quality control, ethics, and independence standards for registered public accounting firms with respect to their preparation of audit reports to be included in broker-dealer filings with the Commission, and the authority to conduct and require an

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267 See 15 U.S.C. 78q(a).

268 See Broker-Dealer Reports, Exchange Act Release No. 11935 (Dec. 17, 1975), 40 FR 59706 (Dec. 30, 1975).

269 Pub. L. No. 107-204, 116 Stat. 745 (2002).

270 Pub. L. No. 107-204 §101.

271 See Pub. L. No. 107-204 § 205(c)(2). The term Registered Public Accounting Firm is defined in section 2(a)(12) as "a public accounting firm registered with the [PCAOB] in accordance with this Act." See Pub. L. No. 107-204 § 2(a)(12).

272 Section 2(a)(7) of the Sarbanes-Oxley Act defines the term issuer as "an issuer as defined in section 3 of the [Exchange Act], the securities of which are registered under section 12 of [the Exchange Act], or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933..., and that it has not withdrawn" (U.S.C. citations omitted). See Pub. L. No. 107-204 § 2(a)(7).

inspection program of registered public accounting firms that audit broker-dealers.[273] The Dodd-Frank Act addressed inspection authority by adding section 104(a)(2)(A) to the Sarbanes-Oxley Act, which provides that the PCAOB "may, by rule, conduct and require a program of inspection...of registered public accounting firms that provide one or more audit reports for a broker or dealer" and that the PCAOB, in establishing a program for inspection, "may allow for differentiation among classes of brokers or dealers, as appropriate."[274]

The Dodd-Frank Act also added section 104(a)(2)(D) to the Sarbanes-Oxley Act, which provides that a public accounting firm is not required to register with the PCAOB if the public accounting firm is exempt from an inspection program established by the PCAOB.[275] The Dodd-Frank Act made a conforming amendment to section 17(e)(1)(A) of the Exchange Act to replace the words "certified by a registered public accounting firm" with the words "certified by an independent public accounting firm, or by a registered public accounting firm if the firm is required to be registered under the Sarbanes-Oxley Act of 2002."[276]

Before today's amendments, paragraph (g)(1) of Rule 17a-5 required that audits of broker-dealer reports filed with the Commission under Rule 17a-5 be made in accordance with generally accepted auditing standards ("GAAS"), which are established by the Auditing Standards Board of the American Institute of Certified Public Accountants ("AICPA"). In light of the authority granted to the PCAOB by the Dodd-Frank Act to establish standards governing audit reports to be included in broker-dealer filings with the Commission, the Commission issued

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273 See Pub. L. No. 111-203 § 982.

274 See Pub. L. No. 111-203 § 982(e)(1).

275 Id.

276 See Pub. L. No. 111-203 § 982(e)(2). As discussed below, today's amendments to the qualifications of the independent public accountant provisions require, consistent with amended section 17(e)(1)(A), that the accountant be qualified, independent, and registered with the PCAOB "if required by the Sarbanes-Oxley Act of 2002." See paragraph (f)(1) of Rule 17a-5.

transitional interpretive guidance to clarify that references in Commission rules, 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 U.S., in addition to any applicable rules of the Commission.[277] The guidance also stated that the Commission intended to revisit the interpretation in connection with a rulemaking project to update the audit and related attestation requirements under the federal securities laws for broker-dealers.[278] As discussed below, the Commission is now adopting amendments to Rule 17a-5 to require that audits and attestations of broker-dealer reports filed under Rule 17a-5 be made in accordance with standards of the PCAOB – the rule as amended does not contain references to GAAS.

Since the Commission proposed these amendments, the PCAOB has taken a number of actions to implement the explicit authority over broker-dealer audits provided to it by the Dodd-Frank Act. For example, on August 18, 2011, the Commission approved two PCAOB rule changes: a temporary PCAOB rule that established an interim program of inspection of audits of broker-dealers,[279] and a PCAOB rule change providing that funds to cover the PCAOB's annual budget be allocated among issuers, brokers, and dealers.[280] In addition, as discussed below, subsequent to the Commission's proposal to amend Rule 17a-5, the PCAOB proposed attestation

277 See Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers, Exchange Act Release No. 62991 (Sept. 24, 2010), 75 FR 60616, 60617 (Oct. 1, 2010).

278 Id.

279 See Public Company Accounting Oversight Board; Order Approving Proposed Temporary Rule for an Interim Program of Inspection Related to Audits of Brokers and Dealers, Exchange Act Release No. 65163 (Aug. 18, 2011), 76 FR 52996 (Aug. 24, 2011).

280 See Public Company Accounting Oversight Board; Order Approving Proposed Board Funding Rules for Allocation of the Board's Accounting Support Fee Among Issuers, Brokers, and Dealers, and Other Amendments to the Board's Funding Rules, Exchange Act Release No. 65162 (Aug. 18, 2011), 76 FR 52997 (Aug. 24, 2011).

standards to establish requirements for examining broker-dealer compliance reports and reviewing broker-dealer exemption reports "to align its attestation standards more closely with the auditor's responsibilities under [the proposed amendments to Rule 17a-5]."[281] The PCAOB concurrently proposed an auditing standard for supplemental information accompanying audited financial statements that would supersede the current standard.[282] The auditing standard would apply to supporting schedules broker-dealers must file under Rule 17a-5, including schedules regarding the computation of net capital and the customer reserve requirement and information related to the broker-dealer's possession or control of customer assets.[283] The PCAOB also proposed amendments "to tailor certain of its rules to the audits and [independent public accountants] of broker-dealers."[284]

2. Engagement of Accountant Requirements Prior to Today's Amendments

Rule 17a-5 requires that a broker-dealer prepare and file certain financial statements and supporting schedules in addition to the balance sheet and income statement required under section 17(e)(1)(A) of the Exchange Act.[285] Before today's amendments, the financial statements and supporting schedules were generally required to be audited in accordance with GAAS by an independent public accountant registered with the PCAOB.[286]

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281 See PCAOB Proposing Release at 5.

282 See PCAOB Proposed Auditing Standard for Supplemental Information.

283 Id. at 3.

284 See Proposed Amendments to Conform the Board's Rules and Forms to the Dodd-Frank Act and Make Certain Updates and Clarifications, PCAOB Release No. 2012-002, PCAOB Rulemaking Docket Matter No. 039 (Feb. 28, 2012).

285 See 17 CFR 240.17a-5(d).

286 See 17 CFR 240.17a-5(g). An engagement to perform an audit (or examination) of financial statements is designed to provide reasonable assurance about whether the financial statements are free of material misstatement. See, e.g., PCAOB Interim Auditing Standard, AU Section 110 at ¶ .02. The term audit is defined in section 110(1) of the Sarbanes-Oxley Act, as amended by the Dodd-Frank Act, to mean "an examination of the financial statements, reports, documents, procedures, controls, or notices of an issuer,

In addition to filing a report of the independent public accountant covering the financial statements and supporting schedules, paragraph (j) of Rule 17a-5 required the broker-dealer to file with the annual audit a supplemental report prepared by the accountant ("material inadequacy report") that either: (1) indicated that the accountant did not find any material inadequacies; or (2) described any material inadequacies in internal control the accountant found during the course of the audit of the financial statements and supporting schedules and any corrective action taken or proposed by the broker-dealer.[287]

For purposes of preparing the material inadequacy report, paragraph (g)(1) of Rule 17a-5 required that the audit include a "review" of the broker-dealer's accounting system, internal accounting control, and procedures for safeguarding securities.[288] Further, the accountant was required to review the practices and procedures of the broker-dealer in: (1) making the periodic computations of aggregate indebtedness and net capital under paragraph (a)(11) of Exchange Act

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broker, or dealer by an independent public accountant in accordance with the rules of the [PCAOB] or the Commission, for the purpose of expressing an opinion on the financial statements or providing an audit report."

287 See 17 CFR 240.17a-5(j). Prior to today's amendments, paragraph (g)(3) of Rule 17a-5 describes a material inadequacy in a broker-dealer's accounting system, internal accounting controls, procedures for safeguarding securities, and practices and procedures to include any condition which has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to: (1) inhibit a broker-dealer from promptly completing securities transactions or promptly discharging its responsibilities to customers, other broker-dealers or creditors; (2) result in material financial loss; (3) result in material misstatements of the broker-dealer's financial statements; or (4) result in violations of the Commission's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in (1) through (3) above. See 17 CFR 240.17a-5(g)(3). In addition to the material inadequacy report, a broker-dealer was required to file during certain periods a supplemental report covered by an opinion of the independent public accountant on the status of the broker-dealer's membership in SIPC. See 17 CFR 240.17a-5(e)(4). The Commission is amending this requirement as discussed above in section II.C.4. of this release. Further, a broker-dealer that computes net capital under the alternative model-based standard in Appendix E to Rule 15c3-1 (17 CFR 240.15c3-1e) is required to file a supplemental report of an independent public accountant indicating the results of the accountant's review of the internal risk management control system established and documented by the broker-dealer in accordance with Rule 15c3-4 (17 CFR 240.15c3-4). See 17 CFR 240.17a-5(k). The Commission is not amending this requirement today.

288 See 17 CFR 240.17a-5(g)(1).

Rule 17a-3 and the reserve required by paragraph (e) of Rule 15c3-3;[289] (2) making the quarterly securities examinations, counts, verifications, and comparisons and the recordation of differences required by Rule 17a-13;[290] (3) complying with the requirement for prompt payment for securities under Regulation T of the Board of Governors of the Federal Reserve System ("Regulation T");[291] and (4) obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3.[292] The scope of the independent public accountant's procedures was required to be sufficient to provide "reasonable assurance" that any material inadequacies existing at the date of the examination in the broker-dealer's accounting system, internal accounting control, and procedures for safeguarding securities as well as in the practices and procedures described in items (1) through (4) above would be disclosed.[293]

The AICPA Broker-Dealer Audit Guide provided that the material inadequacy report should address what the independent public accountant concluded in its "study" of the adequacy of the broker-dealer's practices and procedures in complying with the financial responsibility rules in relation to the definition of material inadequacy as stated in paragraph (g)(3) of Rule 17a-5.[294] The issuance of a study is relatively unique to broker-dealer audits, however, and while

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289 See 17 CFR 240.17a-5(g)(1)(i).

290 See 17 CFR 240.17a-5(g)(1)(ii).

291 See 17 CFR 240.17a-5(g)(1)(iii). See also 12 CFR 220 et seq. (Regulation T).

292 See 17 CFR 240.17a-5(g)(1)(iv).

293 See 17 CFR 240.17a-5(g)(1).

294 The material inadequacy report is addressed in the AICPA's Audit & Accounting Guide: Brokers and Dealers in Securities (Sept. 1, 2011 ed.) ("AICPA Broker-Dealer Audit Guide"), which provides that the report should: (1) address what auditors concluded in their study of the adequacy of the broker-dealer's practices and procedures in complying with the Commission's financial responsibility rules in relation to the definition of a material inadequacy in Rule 17a-5; and (2) disclose material weaknesses in internal control over financial reporting (including procedures for safeguarding securities) that are revealed through auditing procedures designed and conducted for the purpose of expressing an opinion on the financial statements. See AICPA Broker-Dealer Audit Guide at ¶ 3.77. The AICPA Broker-Dealer Audit Guide further provides that if conditions believed to be material weaknesses are found to exist or have existed

auditing standards at one time referred to the performance of a study, current auditing standards no longer contain such references.

Additional engagement of accountant requirements prior to today's amendments were set forth in paragraphs (g) and (i) of Rule 17a-5. Paragraph (g)(2) of Rule 17a-5 provided that, if the broker-dealer was exempt from Rule 15c3-3, the independent public accountant must ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to the independent public accountant's attention to indicate that the exemption had not been complied with during the period since the last examination.[295]

Paragraph (i) of Rule 17a-5, before today's amendments, was titled, "Accountant's reports – general provisions."[296] Paragraph (i)(1) of Rule 17a-5 provided that the accountant's report must be dated, signed manually, indicate the city and state where issued, and identify the financial statements and schedules covered by the report.[297] Paragraph (i)(2) of Rule 17a-5 provided that the accountant's report must state whether the audit was made in accordance with generally accepted auditing standards; state whether the accountant reviewed the procedures followed for safeguarding securities; and designate any auditing procedures deemed necessary by the accountant under the circumstances of the particular case which have been omitted, and the reason for their omission.[298] Further, the rule provided that "[n]othing in this section shall be construed to imply authority for the omission of any procedure which independent accountants

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during the year, the report should disclose the nature of the weaknesses and the corrective action taken or proposed to be taken by the broker-dealer. See AICPA Broker-Dealer Audit Guide at ¶ 3.80. The AICPA Broker-Dealer Audit Guide also provides sample reports "on internal control required by SEC Rule 17a-5(g)(1)." See AICPA Broker-Dealer Audit Guide apps. C, D, and F.

295 See 17 CFR 240.17a-5(g)(2).

296 See 17 CFR 240.17a-5(i).

297 See 17 CFR 240.17a-5(i)(1).

298 See 17 CFR 240.17a-5(i)(2).

would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required under [Rule 17a-5]."[299]

Prior to today's amendments, paragraph (i)(3) of Rule 17a-5 provided that the accountant's report must state clearly the opinion of the accountant: (i) with respect to the financial statements and schedules covered by the report and the accounting principles and practices; and (ii) as to the consistency of the application of the accounting principles, or as to any changes in such principles that have a material effect on the financial statements.[300] Paragraph (i)(4) provided that any matters to which the accountant took exception must be clearly identified, the exception specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.[301] Paragraph (i)(5) of Rule 17a-5 provided that the terms audit (or examination), accountant's report, and certified have the meanings given in Rule 1-02 of Regulation S-X (17 CFR 210.1-02).[302]

3. Amended Engagement of Accountant Requirements

i. Proposed Amendments

The Commission proposed to substantially amend paragraph (g) and remove paragraph (j) of Rule 17a-5, in part, to update the engagement of the accountant requirements to address outdated or inconsistent terminology in the rule.[303] The proposed amendments to paragraph (g) and removal of paragraph (j) of Rule 17a-5 would have eliminated the requirement for the

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299 Id.

300 See 17 CFR 240.17a-5(i)(3).

301 See 17 CFR 240.17a-5(i)(4).

302 See 17 CFR 240.17a-5(i)(5).

303 See Broker-Dealer Reports, 76 FR at 37578–37579. In addition, the Commission proposed changing the title of paragraph (g) from Audit objectives to Engagement of the independent public accountant. Id. at 37606.

accountant to prepare and the broker-dealer to file a material inadequacy report.[304] In its place, the independent public accountant would have been required to prepare, and the broker-dealer would have been required to file, in addition to a report covering the financial report, a report covering either the broker-dealer's compliance report or exemption report, as applicable.[305] Specifically, the Commission proposed to amend paragraph (g) of Rule 17a-5 to be titled "Engagement of independent public accountant" and to require a broker-dealer required to file annual reports under paragraph (d) of Rule 17a-5 to engage an independent public accountant, unless the broker-dealer is subject to the exclusions in paragraphs (d)(1) and (e)(1)(i) of Rule 17a-5. The independent public accountant, as part of the engagement, would have been required to undertake to: (1) prepare a report based on an examination of the broker-dealer's financial report in accordance with standards of the PCAOB; and (2) prepare a report based on an "examination" of the assertions of the broker-dealer in the compliance report in accordance with standards of the PCAOB[306] or to prepare a report based on a "review" of the broker-dealer's exemption report in accordance with standards of the PCAOB.[307] This provision would have

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304 Id. at 37578–37579.

305 Id.

306 An attest engagement designed to provide a high level of assurance is referred to as an "examination." See, e.g., PCAOB Interim Attestation Standard, AT Section 101 at ¶ .54. For this type of engagement, the accountant's conclusion will be expressed in the form of an opinion. For example, the accountant's conclusion based on an examination of an assertion could state that in the accountant's opinion, [the assertion] is fairly stated in all material respects. See, e.g., PCAOB Interim Attestation Standard, AT Section 101 at ¶ .84. The proposed rule provided that the examination and related report would apply to the broker-dealer's "assertions" in the compliance report (and therefore would not apply to other items in the proposed compliance report; namely, a statement as to whether the broker-dealer has established a system of internal control and a description of instances of material non-compliance, and material weaknesses over compliance with, the financial responsibility rules).

307 An attest engagement designed to provide a moderate level of assurance is referred to as a "review." See, e.g., PCAOB Interim Attestation Standard, AT Section 101 at ¶¶ .55, .89. For this type of engagement, the accountant's conclusion will be expressed, not in the form of an opinion, but in the form of "negative assurance." See, e.g., PCAOB Interim Attestation Standard, AT Section 101 at ¶ .68. For example, the accountant's conclusion based on a review of an assertion could state that no information came to the accountant's attention that indicates that the assertion is not fairly stated in all material respects. See, e.g., PCAOB Interim Attestation Standard, AT Section 101 at ¶ .88.

retained the requirement that the financial statements and supporting schedules be audited by the independent public accountant, so that the accountant would have continued to be required to obtain "reasonable assurance" about whether they were free of material misstatement, but would have changed the audit standards from GAAS to standards of the PCAOB.[308]

The Commission proposed making conforming amendments to paragraph (i) of Rule 17a-5, substituting the words "examinations" and "reviews" for the word "audits," substituting the words "standards of the PCAOB" for "generally accepted auditing standards," substituting "annual reports" for "financial statements," and changing the title to "Reports prepared by the independent public accountant." The Commission also proposed deleting paragraph (i)(5) of Rule 17a-5, which provided that the terms "audit," "examination," "accountant's report," and "certified" have the meanings given in Rule 1-02 of Regulation S-X. As proposed, paragraph (i)(1) of Rule 17a-5 would have provided that the independent public accountant's reports must: be dated; be signed manually; indicate the city and state where issued; and identify without detailed enumeration the items covered by the reports. Paragraph (i)(2) of Rule 17a-5 would have provided that the accountant's report must state whether the examination or review was made in accordance with standards of the PCAOB and must designate any examination, and, if applicable, review procedures deemed necessary by the independent public accountant under the circumstances of the particular case that have been omitted, and the reason for their omission. Further, the rule would have provided that "[n]othing in this section shall be construed to imply authority for the omission of any procedure that independent public accountants would ordinarily employ in the course of an examination or review made for the purpose of expressing the

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308 See Broker-Dealer Reports, 76 FR at 37606. As stated above, an engagement to perform an audit of financial statements is designed to provide "reasonable assurance" about whether the financial statements are free of material misstatement. See, e.g., PCAOB Interim Attestation Standard, AT Section 101 at ¶ .54.

opinions or statement required under [Rule 17a-5]." Paragraph (i)(3) of Rule 17a-5 would have provided that the independent public accountant's reports must state clearly the opinion of the independent public accountant: (i) with respect to the financial report and the accounting principles and practices reflected therein and the compliance report; and (ii) with respect to the financial report, as to the consistency of the application of the accounting principles, or as to any changes in such principles that have a material effect on the financial statements. Paragraph (i)(4) of Rule 17a-5 would have provided that any matters to which the independent public accountant takes exception must be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on any related items contained in the annual reports.

As stated above, after the Commission proposed the amendments to Rule 17a-5, the PCAOB issued proposed standards that "would establish requirements for examining the assertions in a broker's or dealer's compliance report and reviewing a broker's or dealer's assertion in the exemption report." [309] The PCAOB stated that the proposed standards were "tailored to the requirements" in Rule 17a-5 as proposed to be amended by the Commission.[310]

ii. Comments

The Commission received several comments regarding the proposed revisions to the independent accountant engagement requirements in Rule 17a-5.[311] One commenter stated that GAAS should be used for audits of non-carrying broker-dealers; or, in the alternative, that the Commission should delay the effective date for the requirement that the audit be conducted in accordance with PCAOB standards for smaller broker-dealers until one year after the approval of

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309 See PCAOB Proposing Release at 5.

310 Id.

311 See, e.g., ABA Letter; AICPA Letter; Citrin Letter; E&Y Letter; Van Kampen/Invesco Letter.

the amendments.[312] A second commenter stated that PCAOB standards should apply only for broker-dealers "permanently subject to PCAOB inspection" and that the Commission should not require that audits of broker-dealers be performed in accordance with PCAOB standards for non-issuer broker-dealers until the PCAOB determines which non-issuer broker-dealers will be subject to its permanent inspection program.[313]

One commenter noted that the proposing release states that broker-dealers will be required to file a report by the accountant that "addresses" the assertions in the compliance report,[314] and stated that the Commission should provide more guidance on what an accountant must address, as "nowhere in the Release or in the proposed rules is there guidance as to what 'addresses' means or entails."[315] This commenter further stated that the Commission "presumably" will rely on PCAOB rules, and suggested that final rules regarding the accountant's obligations with respect to its examination of the compliance report should be deferred until after a comment period of at least 60 days after the PCAOB rules are finalized or the Commission amends its proposal to include specifics as to what "address" means and what type of review is required by the accountant.[316] The commenter also stated that the requirement should not be effective unless the AICPA Broker-Dealer Audit Guide is revised and updated.[317] One commenter asked what was expected of the auditor with respect to the books and records

312 See Citrin Letter. The Commission also received many comments seeking additional time to transition to the final rules. Those comments are discussed below in section V. of this release.

313 See AICPA Letter.

314 See Broker-Dealer Reports, 76 FR at 37575.

315 See ABA Letter.

316 Id.

317 Id. As stated below, AICPA guidance will no longer be applicable once standards of the PCAOB apply to broker-dealer annual reports.

assertion and stated that a separate opinion on this assertion may entail more detailed procedures as to the source of the information.[318]

Another commenter stated that a review engagement should not be employed for the exemption report because inquiry and observation would not provide sufficient evidence regarding a broker-dealer's assertion that it is exempt from the requirements of Rule 15c3-3 and stated that, under the PCAOB's interim attestation standards, an auditor should not accept an engagement to perform a "review" level of service related to an entity's compliance with specified requirements or an assertion with regard to that compliance.[319] As an alternative, this commenter suggested an "agreed-upon procedures" approach addressing the results of procedures specified by the Commission or the performance of an examination engagement if suitable criteria were developed.[320] Another commenter stated that the benefit of receiving an audit report covering the exemption report would not justify the cost.[321] Similarly, a commenter stated that the exemption report should be replaced with a box to check on the FOCUS Report as the auditor attestation provided no added benefit.[322]

Several commenters urged the Commission to clarify the interaction between material weaknesses in internal control over financial reporting and material weaknesses in internal control over compliance with the financial responsibility rules.[323] One commenter stated that due to the reliance placed on the financial books and records to calculate net capital, it will not be feasible to attest to the effectiveness of internal control over the financial responsibility rules

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318 See Grant Thornton Letter.

319 See E&Y Letter.

320 Id.

321 See Citrin Letter.

322 See Angel Letter.

323 See Deloitte Letter; KPMG Letter; PWC Letter.

without also attesting to internal control over financial reporting.[324] The commenter stated that, accordingly, it is necessary to include internal control over financial reporting within the scope of the rule. The commenter stated its understanding that accountants expect to include internal control over financial reporting in their attestation scope over the financial responsibility rules, and that the process will include documenting all existing processes and engaging internal audit to validate the effectiveness of the procedures implemented through procedural walkthroughs and control testing to validate management's assertions.[325] This commenter also stated its belief that independent public accountants will need "to include an attestation of the additional in scope processes within the scope of their audit work in order to comply with PCAOB requirements."[326]

As noted above in section II.B.4.ii. of this release, with respect to the independent public accountant's review of the exemption reports, one commenter stated that, for example, a bank or clerical error that results in a broker-dealer that operates under an exemption to Rule 15c3-3 finding itself in possession of customer assets overnight once during the fiscal year should not "warrant the 'material modification' of a broker-dealer's Exemption Report."[327] Another commenter noted that "to consider a single instance of a broker-dealer failing to promptly forward a customer's securities as an instance that would necessitate a material modification creates an unworkable standard."[328]

iii. The Final Rule

The Commission is adopting amendments to the engagement of the accountant requirements in Rule 17a-5 substantially as proposed, except for revisions, as discussed in detail

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[324] See Van Kampen/Invesco Letter.

[325] Id.

[326] Id.

[327] See SIFMA letter.

[328] See CAI Letter.

below, to clarify the rule's requirements and to make technical changes. Paragraph (g) of Rule 17a-5 as adopted provides that the independent public accountant engaged by the broker-dealer to provide reports on the financial report and either the compliance report or exemption report must, as part of the engagement undertake to: (1) prepare a report based on an examination of the broker-dealer's financial report in accordance with standards of the PCAOB; and (2) prepare a report based on an examination of certain enumerated statements of the broker-dealer in the compliance report[329] in accordance with standards of the PCAOB or prepare a report based on a review of the statements in the broker-dealer's exemption report in accordance with standards of the PCAOB. Additionally, as proposed, the amendments delete paragraph (j) of Rule 17a-5, which, as explained above, required that the broker-dealer file with the annual audit report a material inadequacy report, as well as provisions in paragraph (g) of Rule 17a-5 requiring that the audit be conducted in accordance with GAAS and addressing the accountant's review for material inadequacies.

Various commenters suggested that GAAS instead of PCAOB standards should apply for engagements of accountants with respect to certain broker-dealer reports, such as reports of non-carrying broker-dealers.[330] The Commission believes that requiring GAAS for audits of broker-dealers that are exempt from Rule 15c3-3 would not be consistent with the provisions of the Dodd-Frank Act that provide the PCAOB with explicit authority to establish standards with

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329 As discussed above in section II.B.3. of this release, the final rule does not use the term assertion – the assertions contained in the proposal are now referred to as statements. These changes are not intended to be substantive. Paragraph (g) of Rule 17a-5 specifies that the accountant prepare a report based on an examination of certain statements enumerated in the rule. Similar to the proposal, the statements subject to the examination do not include a statement as to whether the broker-dealer has established a system of internal control or a description of instances of non-compliance with certain financial responsibility rules.

330 See AICPA Letter; Citrin Letter.

regard to audits of broker-dealer reports filed with the Commission.[331] These provisions enable the PCAOB to exercise its standard-setting authority over audits of broker-dealers registered with the Commission. The change from GAAS to PCAOB auditing standards will facilitate the Commission's regulatory oversight authority because the Commission has direct oversight authority over the PCAOB, including the ability to approve or disapprove the PCAOB's rules and standards. The Commission also has greater confidence in the quality of audits conducted by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.[332] Further, as the PCAOB develops and implements an inspection program of broker-dealer audits as contemplated by the Dodd-Frank Act, that program will include inspection of, among other things, "registered public accounting firms' current compliance with laws, rules, and standards in performing audits of brokers and dealers."[333] The requirement that all broker-dealer independent public accountants comply with the standards established by the PCAOB should facilitate the development and implementation of its permanent inspection program, as contemplated by the Dodd-Frank Act.

As noted above, the PCAOB has proposed an auditing standard for supplemental information accompanying audited financial statements, including the supporting schedules broker-dealers must file as part of the financial report.[334] The PCAOB stated that a primary factor that led it to reexamine its requirements regarding supplemental information was the

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331 See Pub. L. No. 111-203 § 982. For example, section 982(a) of the Dodd-Frank Act added section 110 to the Sarbanes-Oxley Act, which contains definitions of terms such as audit, audit report, and professional standards. These definitions apply to audits, audit reports, and professional standards with respect to audits of broker-dealers as well as audits of issuers. In addition, section 982(b) of the Dodd-Frank Act amended section 101 of the Sarbanes-Oxley Act to substitute the words "issuers, brokers, and dealers" for the word "issuers."

332 See Custody of Funds or Securities of Clients by Investment Advisers, 75 FR at 1460.

333 See Temporary Rule for an Interim Program of Inspection Related to Audits of Brokers and Dealers, PCAOB Release No. 2011-001, PCAOB Rulemaking Docket Matter No. 32, 1 (June 14, 2011).

334 See PCAOB Proposed Auditing Standard for Supplemental Information.

Commission's proposal to amend the reporting requirements of Rule 17a-5.[335] In addition, as noted above, the PCAOB has proposed specific attestation standards for examining compliance reports and reviewing exemption reports. The PCAOB's proposing release noted that the proposed standards "are tailored to the requirements in SEC Proposed Rule 17a-5."[336] The proposed standards, if adopted, would establish a single and broker-dealer-specific approach to examining compliance reports and reviewing exemption reports. This should provide greater clarity as to procedures an independent public accountant should use in examining a compliance report and reviewing an exemption report.

With respect to comments suggesting that PCAOB standards should apply only to auditors of broker-dealers "permanently subject to PCAOB inspection,"[337] the PCAOB has not exempted the audits by independent public accountants of any class of broker-dealer from the PCAOB's permanent inspection program.[338] In fact, the PCAOB has established an interim inspection program for all broker-dealer audits by independent public accountants that will "allow the Board to begin inspections of relevant audits and auditors and provide a source of information to help guide decisions about the scope and elements of a permanent program."[339] The PCAOB stated that it did not intend "to postpone all use of its new inspection authority until after those judgments were made."[340]

At this time, there is no reason to expect that any type of broker-dealer audit will be

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335 Id. at 2–3.

336 See PCAOB Proposing Release at 5.

337 See AICPA Letter.

338 See Public Company Accounting Oversight Board: Order Approving Proposed Temporary Rule for an Interim Program of Inspection Related to Audits of Brokers and Dealers, Exchange Act Release No. 65163 (Aug. 18, 2011), 76 FR at 52996 (Aug. 24, 2011).

339 Id. at 52997.

340 Id.

exempt from the PCAOB's permanent inspection program, and any PCAOB determination to exempt broker-dealer audits from the PCAOB's permanent inspection program must be approved by the Commission. Therefore, notwithstanding any such exemption, paragraph (g) of Rule 17a-5 is amended to require that broker-dealer independent public accountants prepare reports covering the financial report and compliance report or exemption report in accordance with standards of the PCAOB.

On August 20, 2012, the PCAOB published its first report on the progress of the interim inspection program.[341] The report contains observations from inspections of portions of 23 broker-dealer audits conducted by ten independent public accounting firms that were all conducted in accordance with GAAS.[342] The inspections did not exclude any broker-dealer audits from being eligible for selection.[343] PCAOB staff identified deficiencies in all of the audits inspected.[344] For example, as to all of the 14 audits of broker-dealers that claimed an exemption from Rule 15c3-3, the staff stated that the accountant "did not perform sufficient procedures to ascertain that the broker or dealer complied with the conditions of the exemption,"[345] and in 21 of the 23 audits, that the accountant "failed to perform sufficient audit procedures to obtain reasonable assurance that any material inadequacies found to exist since the date of the last examination...would have been disclosed in the accountant's supplemental report."[346] The deficiencies noted in the PCAOB's report on the progress of the interim inspection program provide further support for the amendments that the Commission is adopting

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341 See PCAOB, Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers, PCAOB Release No. 2012-005 (August 20, 2012) ("PCAOB Inspection Report").

342 Id. at ii.

343 Id. at 8.

344 Id. at ii.

345 Id. at iii.

346 Id.

today to establish the foundation for the PCAOB's development of standards that are tailored to Rule 17a-5, and to strengthen and facilitate consistent compliance with broker-dealer audit and reporting requirements.

Several commenters suggested that the Commission delay the applicability of these requirements because, among other things, PCAOB standards regarding broker-dealer audits, including standards that apply to compliance reports and exemption reports, will not be final when these rule amendments are adopted.[347] In response, as discussed below in section V. of this release, the Commission is delaying the effective dates of most of the rule amendments. In accordance with the effective dates, broker-dealers must file compliance reports or exemption reports, as applicable, and broker-dealers must file reports of independent public accountants covering compliance reports or exemption reports in accordance with Rule 17a-5 as amended, for fiscal years ending on or after June 1, 2014. In the interim, broker-dealers must continue to file material inadequacy reports in accordance with the provisions of Rule 17a-5 as they existed before today's amendments. Broker-dealer independent public accountants must prepare reports based on an examination of broker-dealer financial reports in accordance with PCAOB standards for fiscal years ending on or after June 1, 2014. In the interim, audits of broker-dealer financial statements filed with the Commission under Rule 17a-5 should continue to be understood to mean auditing standards generally accepted in the U.S., plus any applicable rules of the Commission.[348] The June 1, 2014 effective date should provide sufficient time for the PCAOB to finalize, subject to Commission approval, the standards for broker-dealer audits and for

347 See, e.g., CAQ Letter; Deloitte Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter.

348 See Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers, Exchange Act Release No. 62991 (Sept. 24, 2010), 75 FR 60616, 60617 (Oct. 1, 2010).

broker-dealers and their independent public accountants to prepare to comply with the new requirements and standards.

As noted above, one commenter stated the Commission should provide more guidance on what an independent public accountant must address, and that the requirement for PCAOB standards should not be effective unless the AICPA Broker-Dealer Audit Guide is revised and updated.[349] Another commenter sought clarification on what was expected of the auditor with respect to the books and records assertion.[350] In response to these comments, the Commission notes that the PCAOB's proposed standards with respect to the examination of the compliance report by the independent public accountant address, among other things: (1) the objective of the examination; (2) the relationship between the examination engagement and the audit of the financial report; (3) considerations for broker-dealers with multiple divisions or branches; (4) identifying risks of material non-compliance; (5) testing controls over compliance; (6) performing compliance tests; (7) testing information used to assert compliance; (8) evaluating the results of the examination procedures; (9) subsequent events; (10) obtaining a representation letter; (11) communication requirements; (12) reporting on the examination engagement; (13) the examination report date; and (14) examination report modifications.[351] The PCAOB's proposed standards with respect to the review of the exemption report by the independent public accountant address, among other things: (1) the objective of the review; (2) the relationship between the review engagement and the audit of the financial report; (3) the review procedures; (4) evaluating the results of the examination procedures; (5) obtaining a representation letter; (6) communication requirements; (7) reporting on the review engagement; (8) the review report

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349 See ABA Letter.

350 See Grant Thorton Letter.

351 See PCAOB Proposing Release app. 1.

date; and (9) review report modifications.[352] The Commission expects that the final standards of the PCAOB, which are subject to Commission approval, will provide sufficient guidance to independent public accountants performing examinations of compliance reports and reviews of exemption reports.

In response to the comment that the requirements with respect to the compliance reports and exemption reports should not be effective unless the AICPA Broker-Dealer Audit Guide is revised and updated, as stated above, once adopted, only the standards of the PCAOB apply to broker-dealer annual reports. The PCAOB has proposed standards with respect to the examination of the compliance report and the review of the exemption report and it is expected that final standards will be in place before the audit requirements with respect to the compliance report and the exemption report are effective. Consequently, there is no need to wait for the AICPA Broker-Dealer Audit Guide to be updated.

As noted above, several commenters requested clarity about the interaction between material weaknesses in internal control over financial reporting and material weaknesses in internal control over compliance with the financial responsibility rules.[353] Additionally, one commenter stated that due to the reliance placed on the financial books and records of the broker-dealer, it will not be feasible for the independent public accountant to attest to the effectiveness of internal control over the financial responsibility rules without also attesting to internal control over financial reporting.[354] As discussed above in section II.B.3.iii. of this release, although a broker-dealer is required to state in the compliance report that the information it used to state whether it was in compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3

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352 See PCAOB Proposing Release app. 2.

353 See Deloitte Letter; KPMG Letter; PWC Letter.

354 See Van Kampen/Invesco Letter.

was derived from its books and records, the final rule does not require that the broker-dealer include a statement regarding the effectiveness of its internal control over the accuracy of its books and records, nor does it require that the independent public accountant attest to the effectiveness of internal control over the accuracy of the broker-dealer's books and records. Additionally, under the final rule, the independent public accountant is not required to opine on the effectiveness of the broker-dealer's internal control over financial reporting. However, the independent public accountant's existing obligation to gain an understanding and perform appropriate procedures relative to the broker-dealer's internal control over financial reporting, as a necessary part of the independent public accountant's financial report audit, remains unchanged.[355] Further, as discussed above in section II.B.3.iii. of this release, the examination of the compliance report would pertain solely to certain statements in the compliance report and not to the broker-dealer's process for arriving at the statements. The report of the independent public accountant, based on the examination of the compliance report, requires the accountant to perform its own independent examination of the related controls and procedures. Consequently, it is not necessary for the independent public accountant to provide an opinion with regard to the process that the broker-dealer used to arrive at its conclusions.

As noted above, one commenter stated that a review engagement should not be employed for the exemption report, because an accountant's inquiry and observation would not provide sufficient evidence regarding a broker-dealer's assertion that it is exempt from Rule 15c3-3, and under the PCAOB's attestation standards, an auditor should not accept an engagement to perform a "review" engagement related to an entity's compliance with specified requirements.[356] As an

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[355] See PCAOB Auditing Standard, AS No. 12 (for audits of fiscal years beginning on or after December 15, 2010).

[356] See E&Y Letter.

alternative, this commenter suggested an "agreed-upon procedures" approach or an examination engagement.[357]

The PCAOB's attestation standards currently provide that an accountant should not accept an engagement to perform a review of an entity's compliance with specified requirements or about the effectiveness of an entity's internal control over compliance, and that an agreed upon procedures engagement be considered as an alternative.[358] Irrespective of the PCAOB's current standards, Rule 17a-5, as amended, provides that the broker-dealer engage an independent public accountant to perform a review of the exemption report. Moreover, in July 2011, as part of its proposed standards for attestation engagements related to broker-dealer compliance reports or exemption reports, the PCAOB proposed replacing the provision cited by the commenter with the following: "When a practitioner is engaged to perform a review engagement on assertions made by a broker or dealer in an exemption report that is prepared pursuant to SEC Proposed Rule 17a-5, the practitioner must conduct the review engagement pursuant to Proposed Attestation Standard, Review Engagements Regarding Exemption Reports of Brokers and Dealers."[359] In addition, as discussed above, the PCAOB has proposed specific standards for an accountant to perform a review of the exemption report.[360] The PCAOB's final standards, which must be approved by the Commission, are intended by the PCAOB to clarify the procedures an independent public accountant will need to perform in a review of an

357 Id.

358 See PCAOB Interim Attestation Standard, AT Section 601 at ¶ 7.

359 See PCAOB Proposing Release app. 3 at A3–4. The PCAOB's attestation standards currently provide that an accountant should not accept an engagement to perform a review of an entity's compliance with specified requirements or about the effectiveness of an entity's internal control over compliance or an assertion regarding those items. See PCAOB Interim Attestation Standard, AT Section 601 at ¶ 7.

360 See PCAOB Proposing Release app. 2.

exemption report.[361]

In response to the comment that a review engagement should not be employed for the exemption report because inquiry and observation would not provide sufficient evidence,[362] the independent public accountant would be able to obtain the moderate level of assurance contemplated by the required review through a combination of procedures that the accountant would perform in connection with the financial audit currently required under Rule 17a-5 and certain inquiries and other procedures specifically targeting the exemption report. Also, the PCAOB's proposal includes specific requirements for a review engagement regarding exemption reports of brokers and dealers. In addition to inquiry and observation, the PCAOB's proposal states that "in performing the review engagement, the auditor should...[e]valuate whether the evidence obtained and the results of the procedures performed in the audit of the financial statements and supplemental information corroborate or contradict the broker's or dealer's assertion regarding compliance with the exemption conditions."[363] Additionally, the auditor should "[p]erform other procedures as necessary in the circumstances to obtain moderate assurance."[364] The PCAOB's final standards will provide clarity on the procedures to be performed by the independent public accountant to obtain a moderate level of assurance to form a conclusion with respect to the review of the exemption report.[365]

The commenter's suggestion to use an "agreed-upon procedures" engagement for the exemption report was considered. The final rule, however, requires a review engagement as proposed. Under an "agreed-upon procedures" engagement, the independent public accountant

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361 Id.

362 See E&Y Letter.

363 See PCAOB Proposing Release app. 2.

364 Id.

365 Id.

is engaged by a client to issue a report of findings based on specific procedures performed on subject matter that the specified parties believe are appropriate.[366] Additionally, in an "agreed-upon procedures" engagement, the independent public accountant does not perform an examination or a review, and does not provide an opinion or negative assurance. Thus, no conclusion would be rendered as to the broker-dealer's statement that it met certain exemption provisions in Rule 15c3-3.

In addition to the commenter advocating an "agreed-upon procedures" standard,[367] a second commenter stated that the cost "would not justify the need" for an audit report covering the exemption report[368] and a third commenter stated that the exemption report should be replaced with a box to check on the FOCUS Report as the auditor attestation provided no added benefit.[369] In response to all these comments, the Commission notes that previously Rule 17a-5 required that if a broker-dealer is exempt from Rule 15c3-3, the independent public accountant is required to ascertain whether the conditions of the exemption were being complied with and that no facts came to the accountant's attention to indicate that the exemption had not been complied with.[370] Consequently, the rule previously required the independent public accountant to reach a conclusion with respect to a broker-dealer's claimed exemption from Rule 15c3-3. The Commission believes that the rule should continue to require a conclusion from the independent public accountant on the broker-dealer's claimed exemption from Rule 15c3-3 because of the importance of safeguarding customer securities and cash. Consequently, the Commission does not believe that it would be appropriate to use a lower standard (i.e., the agreed-upon procedures

366 See PCAOB Interim Attestation Standard, AT Section 201 at ¶ .03.

367 See E&Y Letter.

368 See Citrin Letter.

369 See Angel Letter.

370 See 17 CFR 240.17a-5(g)(2).

standard) or to have no requirement for the independent public accountant to perform any work with respect to the exemption report. Moreover, because the independent public accountant was previously required to render a conclusion with respect to the broker-dealer's claimed exemption from Rule 15c3-3, the exemption report review should not result in significant incremental cost over the existing requirement.

As noted above, two commenters raised concerns that minor exceptions to meeting the exemption provisions of paragraph (k) of Rule 15c3-3 could result in the independent public accountant becoming aware of material modifications that should be made to the statement in the exemption report.[371] Under PCAOB standards for attestation engagements, the independent public accountant's review report on a statement in an exemption report would be required to include a statement about whether the accountant is aware of any material modifications that should be made to the statement in the exemption report in order for it to be fairly stated in all material respects.[372] As discussed above in section II.B.4.iii. of this release, the exemption report requirements have been modified from the proposal so that a broker-dealer must either state that it met the identified exemption provisions in paragraph (k) throughout the most recent fiscal year without exception or that it met the identified exemption provisions throughout the most recent fiscal year except as described in the report. Consequently, a broker-dealer that had exceptions will state that fact in the exemption report and describe the exceptions. Under PCAOB standards, if the statement is fairly stated in all material respects, including descriptions of any

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371 See CAI Letter; SIFMA letter.

372 See PCAOB Interim Attestation Standard, AT Section 101 at ¶ .90. See also PCAOB Proposing Release app. 2 at ¶ 11 ("The auditor should evaluate the identified instances of non-compliance with the exemption conditions to determine whether the instances of non-compliance, individually or in combination, cause the broker's or dealer's assertion not to be fairly stated, in all material respects. If the broker's or dealer's assertion is not fairly stated, in all material respects, the auditor should: (a) modify the review report … and (b) evaluate the effect of the matter on the audit of the financial statements and supplemental information.").

exceptions, the broker-dealer's independent public accountant would not need to state that the accountant is aware of any material modifications that should be made to the statement.[373]

The Commission did not receive comments regarding the proposed amendments to paragraph (i) of Rule 17a-5. However, the final rule has been revised from the proposal for clarity and consistency with the other amendments to Rule 17a-5. The title of the rule has been modified from the proposal to add a citation for clarity. As adopted, the title is, "Reports of the independent public accountant required under paragraph (d)(1)(i)(C) of [Rule 17a-5]." As adopted, paragraph (i)(1) of Rule 17a-5 provides, as proposed, that the independent public accountant's reports must: be dated; be signed manually; indicate the city and state where issued; and identify without detailed enumeration the items covered by the reports.

Paragraph (i)(2) of Rule 17a-5, as adopted, is also consistent with the proposal except that the word "Identify" is substituted for the word "Designate" for clarity and the phrase "opinions or conclusions" is substituted for the phrase "opinions or statement" because as explained above, consistent with auditing standards, a review engagement will not result in an opinion, but in the accountant's conclusion in the form of "negative assurance" – for example, a conclusion that no information came to the accountant's attention that indicates that a statement is not fairly stated in all material respects.[374] The rule therefore provides that the independent public accountant's reports must: (i) state whether the examinations or review, as applicable, were made in accordance with standards of the PCAOB; (ii) identify any examination and, if applicable, review procedures deemed necessary by the independent public accountant under the

373 See PCAOB Interim Attestation Standard, AT Section 101 at ¶ .67 (stating that in expressing its conclusion, an independent public accounting "should consider an omission or a misstatement to be material if the omission or misstatement – individually or when aggregated with others – is such that a reasonable person would be influenced by the omission or misstatement.").

374 Id. at ¶¶ .68, .88.

circumstances of the particular case that have been omitted and the reason for their omission. The rule also provides that: "[n]othing in this section may be construed to imply authority for the omission of any procedure that independent public accountants would ordinarily employ in the course of an examination or review made for the purpose of expressing the opinions or conclusions required under [Rule 17a-5]."

Paragraph (i)(3) of Rule 17a-5, as adopted, is re-organized for clarity. Specific reference has been added to those statements in the compliance report that the accountant must examine, consistent with other amendments to Rule 17a-5 (e.g., the amendments to paragraph (g)(2)(i) of Rule 17a-5 regarding the engagement of the accountant to prepare a report based on the examination of specified statements in the compliance report). In addition, a subparagraph is added to include a reference to the exemption report.[375] The rule provides that the independent public accountant's reports must state clearly: (i) the opinion of the independent public accountant with respect to the financial report required under paragraph (d)(1)(i)(A) of Rule 17a-5 and the accounting principles and practices reflected in that report; (ii) the opinion of the independent public accountant with respect to the financial report required under paragraph (d)(1)(i)(A) of Rule 17a-5, as to the consistency of the application of the accounting principles, or as to any changes in those principles, that have a material effect on the financial statements; and (iii) either (A) the opinion of the independent public accountant with respect to the statements required under paragraphs (d)(3)(i)(A)(2), (3), (4), and (5) of Rule 17a-5 in the compliance report required under paragraph (d)(1)(i)(B)(1) of Rule 17a-5, or (B) the conclusion of the independent public accountant with respect to the statements required under paragraphs (d)(4)(i), (ii), and (iii) of Rule 17a-5. The specific references to the compliance report and

375 As proposed, paragraph (i)(3) did not contain a reference to the exemption report. See Broker-Dealer Reports, 76 FR at 37607. The final rule makes clear that the auditor's conclusion must be included in the independent public accountant's report covering the exemption report.

exemption report in paragraph (i)(3) are intended to provide a complete description of what must be contained in the report of the independent public accountant under current attestation standards, which require a conclusion in the case of an examination to be expressed in the form of an opinion and a conclusion in the case of a review that is not expressed in the form of an opinion, but in the form of "negative assurance."[376]

Paragraph (i)(4) of Rule 17a-5 has been modified from the proposal to add a reference to paragraph (d) to make it more clear that the annual reports referenced in the paragraph are the financial report, compliance report, and exemption report prescribed in paragraph (d). In addition – in the interest of using "plain English" in the Commission's rules – the word "must" has been substituted for the word "shall" and the word "thereto" has been eliminated. The rule as adopted therefore provides that "[a]ny matters to which the independent public accountant takes exception must be clearly identified, the exceptions must be specifically and clearly stated, and, to the extent practicable, the effect of each such exception on any related items contained in the annual reports required under paragraph (d) of [Rule 17a-5] must be given."

E. PCAOB Registration of Independent Public Accountant – Paragraph (f)(1) of Rule 17a-5

Prior to today's amendments, paragraph (f)(1) of Rule 17a-5 was titled "Qualification of accountants" and provided that: "The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of his

376 As noted above, the accountant's conclusion in an examination engagement will be expressed in the form of an opinion. For example, the accountant's conclusion based on an examination of an assertion could state that in the accountant's opinion, the assertion is fairly stated in all material respects. See, e.g., PCAOB Interim Attestation Standard, AT Section 101 at ¶ .84. The accountant's conclusion in a review engagement will be expressed, not in the form of an opinion, but in the form of "negative assurance." See, e.g., PCAOB Interim Attestation Standard, AT Section 101 at ¶ .68. For example, the accountant's conclusion based on a review of an assertion could state that no information came to the accountant's attention that indicates that the assertion is not fairly stated in all material respects. See, e.g., PCAOB Interim Attestation Standard, AT Section 101 at ¶ .88.

place of residence or principal office."[377] Paragraph (f)(3) of Rule 17a-5 provided that the accountant "shall be independent in accordance with the provisions of § 210.2-01 (b) and (c) of this chapter" and, paragraph (e)(1)(i) of Rule 17a-5 provided that the accountant "shall be in fact independent as defined in paragraph (f)(3) of this section."[378]

As discussed above, section 17(e)(1)(A) of the Exchange Act, as amended by the Dodd-Frank Act, requires registered broker-dealers to annually file financial statements with the Commission certified by "an independent public accounting firm, or by a registered public accounting firm if the firm is required to be registered under the Sarbanes-Oxley Act of 2002." Accordingly, the Commission proposed amending paragraph (f)(1) to provide that: "The independent public accountant must be qualified and independent in accordance with § 210.2-01 of this chapter and, in addition, the independent public accountant must be registered with the Public Company Accounting Oversight Board if required by the Sarbanes-Oxley Act of 2002."[379] The Commission further proposed deleting the accountant independence language in paragraph (e)(1)(i) of Rule 17a-5.[380] In addition, the Commission proposed deleting paragraph (f)(3) and re-designating paragraph (f)(4) as paragraph (f)(3).[381] These proposed amendments to paragraph (f) of Rule 17a-5 would consolidate the provisions of paragraphs (e)(1)(i), (f)(1), and (f)(3) of Rule 17a-5 into paragraph (f)(1) and make Rule 17a-5 consistent with other Commission requirements governing the qualifications of accountants. The Commission

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377 See 17 CFR 240.17a-5(f)(1).

378 See 17 CFR 240.17a-5(f)(3).

379 See Broker-Dealer Reports, 76 FR at 37593–37594.

380 Id.

381 Id.

received no comments on these proposals and is adopting them substantially as proposed.[382]

Although the underlying independence requirements have not changed, broker-dealers and their independent public accountants are reminded that they must comply with the independence requirements of Rule 2-01 of Regulation S-X.[383] As a result of the Sarbanes-Oxley Act of 2002, Rule 2-01 of Regulation S-X was strengthened, including increased restrictions on the provision of certain non-audit services to an audit client.[384]

Under the Commission's rules, an accountant will not be recognized as independent with respect to an audit client if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.[385] The standard is predicated largely on whether a relationship or the provision of a service: (1) creates a mutual or conflicting interest between the accountant and the audit client; (2) places the accountant in the position of auditing his or her own work; (3) results in the accountant acting as management or an employee of the audit client; or (4) places the accountant in a position of being an advocate for the audit client.[386]

382 See paragraph (f)(1) of Rule 17a-5. The Commission has revised paragraph (f)(1) of Rule 17a-5 from the proposal to: change the title from "Qualification of accountants" to "Qualifications of independent public accountant;" and deleting the words "in addition."

383 See 17 CFR 210.2-01.

384 See Strengthening the Commission's Requirements Regarding Auditor Independence, Exchange Act Release No. 47265 (Jan. 28, 2003), 68 FR 6006 (Feb. 5, 2003). See also Auditor Independence: SEC Review of Auditor Independence Rules, NASD Notice to Members 02-19 (Mar. 2002).

385 See 17 CFR 210.2-01(b).

386 See 17 CFR 210.2-01, Preliminary Note 2.

Further, Rule 2-01 of Regulation S-X sets forth a non-exclusive specification of circumstances that are inconsistent with the general standard. For example, the accountant is prohibited from providing the following non-audit services, among others, to an audit client:[387]

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- Financial information systems design and implementation; and
- Management functions or human resources.

With respect to bookkeeping or other services related to the accounting records or financial statements of the audit client, Rule 2-01(c)(4)(i) of Regulation S-X specifies that these services include: (1) maintaining or preparing the audit client's accounting records; (2) preparing financial statements that are filed with the Commission or the information that forms the basis of financial statements filed with the Commission; or (3) preparing or originating source data underlying the audit client's financial statements.[388]

Not all of the independence requirements in Rule 2-01 of Regulation S-X that are applicable to audits of issuers are applicable to engagements under Rule 17a-5. Specifically, auditors of broker-dealers are not subject to the partner rotation requirements or the compensation requirements of the Commission's independence rules because the statute mandating those requirements is limited to issuers.[389] Additionally, auditors of broker-dealers are not subject to the audit committee pre-approval requirements[390] or the cooling-off period requirements for employment[391] because those requirements only reference issuers.

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387 See 17 CFR 210.2-01(c).

388 See 17 CFR 210.2-01(c)(4)(i).

389 See 15 U.S.C. 78j-1.

390 See 17 CFR 210.2-01(c)(7).

391 See 17 CFR 210.2-01(c)(2).

F. Notification of Non-Compliance or Material Weakness

As discussed in detail below, the Commission is amending the notification provisions in Rule 17a-5 and amending Rule 17a-11 to align that rule with the amendments to Rule 17a-5. Under Rule 17a-11, a broker-dealer must provide notice to the Commission and its DEA in certain circumstances.[392] For example, paragraph (b)(1) of Rule 17a-11 requires a broker-dealer to give notice if its net capital declines below the minimum amount required under Rule 15c3-1.[393] Rule 15c3-1 and Rule 15c3-3 also require broker-dealers to provide notification in certain circumstances.[394] For example, paragraph (i) of Rule 15c3-3 requires a carrying broker-dealer to immediately notify the Commission and its DEA if it fails to make a deposit into its customer reserve account as required by paragraph (e) of Rule 15c3-3.[395]

1. New Notification Requirements – Paragraph (h) of Rule 17a-5

Prior to today's amendments, paragraph (h)(2) of Rule 17a-5 provided that if, during the course of the audit or interim work, the independent public accountant determined that any "material inadequacies" existed, then the independent public accountant was required to inform the chief financial officer ("CFO") of the broker-dealer, who, in turn, was required to give notice to the Commission and the broker-dealer's DEA within 24 hours in accordance with the provisions of Rule 17a-11.[396] The rule also provided that the broker-dealer must furnish the independent public accountant with the notice, and if the independent public accountant failed to receive the notice within the 24 hour period, or if the accountant disagreed with any statements

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392 See 17 CFR 240.17a-11.

393 See 17 CFR 240.17a-11(b)(1).

394 See, e.g., 17 CFR 240.15c3-1(a)(6)(iv)(B); 17 CFR 240.15c3-1(a)(6)(v); 17 CFR 240.15c3-1(a)(7)(ii); 17 CFR 240.15c3-1(c)(2)(x)(C)(1); 17 CFR 240.15c3-1(e); 17 CFR 240.15c3-1d(c)(2); 17 CFR 240.15c3-3(i).

395 See 17 CFR 240.15c3-3(i).

396 See 17 CFR 240.17a-5(h)(2).

contained in the notice, the independent public accountant was required to inform the Commission and the DEA within the next 24 hours.[397] In that event, the independent public accountant was required to describe any material inadequacies found to exist or, if the broker or dealer filed a notice, the independent public accountant was required to detail the aspects of the broker-dealer's notice with which the independent public accountant did not agree.[398]

i. The Proposed Amendments

The proposed amendments to Rule 17a-5 would have replaced references to material inadequacies, including the material inadequacy report, with a requirement applicable to carrying broker-dealers to identify an instance of "material non-compliance" with the financial responsibility rules and any material weakness in internal control over compliance with the financial responsibility rules in the compliance report and the requirement to engage an independent public accountant to examine the compliance report.[399] Consistent with those proposed changes, the Commission proposed amending the notification provisions of paragraph (h)(2) of Rule 17a-5 to replace the term "material inadequacy" with the term "material non-compliance," which would result in a requirement to notify the Commission upon the discovery by the accountant during the course of preparing a report based on an examination of the compliance report of an instance of material non-compliance as that term was proposed to be defined under the amendments.[400]

The Commission also proposed amending provisions regarding the notification

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397 Id.

398 Id.

399 See Broker-Dealer Reports, 76 FR at 37575–37579.

400 Id. at 37579.

process.[401] Under the proposal, the accountant would have been required to notify the Commission and the broker-dealer's DEA directly.[402] In the proposing release, the Commission stated that it preliminarily believed these changes would provide more effective and timely notice of broker-dealer compliance deficiencies and enable the Commission to react more quickly to protect customers and others adversely affected by those deficiencies.[403] The amendments also would have been consistent with the notification requirement in Rule 206(4)-2 that is triggered in the context of a "surprise" examination of an investment adviser.[404]

ii. Comments Received

The Commission received numerous comments in response to this proposal.[405] Most of these commenters objected to the proposed notification process.[406] Among the reasons given were that it would be inappropriate to require the accountant to notify the Commission and the DEA directly, because, among other things, the broker-dealer is principally responsible for compliance with the securities laws, including timely notification;[407] that PCAOB standards provide that "the practitioner should not take on the role of the responsible party;"[408] and that PCAOB attestation standards (which were referenced in the proposing release) clearly provide that management is responsible for the subject matter to which it is asserting, and not the

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401 Id.

402 Id.

403 Id.

404 Id. Rule 206(4)-2 provides, in pertinent part, that upon finding any "material discrepancies" during the "surprise" examination of an investment adviser to verify client funds and securities, the independent public accountant must notify the Commission within one business day. 17 CFR 275.206(4)-2(a)(4)(ii).

405 See ABA Letter; CAI Letter; CAQ Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter; PWC Letter; SIFMA Letter; Van Kampen/Invesco Letter.

406 See ABA Letter; CAI Letter; CAQ Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter; PWC Letter; Van Kampen/Invesco Letter.

407 See Deloitte Letter.

408 See KPMG Letter. See also PCAOB Interim Attestation Standard, AT Section 101 at ¶ .13.

accountant.[409] In addition, one commenter stated that alignment of notification procedures (that is, to require the accountant to notify the Commission directly) between Rule 17a-5 and Rule 206(4)-2 is not necessary, given the other auditing and reporting responsibilities in place or proposed.[410] In addition to suggestions that the notification process that existed prior to today's amendments should not be changed,[411] one commenter stated that the rule should require simultaneous notice by the accountant to the Commission and to the firm's management.[412]

In addition, one commenter asked whether the notification provisions apply to a review of the exemption report.[413] Another commenter stated that a report of non-compliance also will trigger a Rule 17a-11 notice, which would be duplicative and create confusion.[414]

iii. The Final Rule

In part in response to comments received, and to achieve consistency with other revisions to the proposed rule amendments described above, the notification provisions in the final rule have been modified from the proposed amendments.[415] First, the Commission is persuaded by comments received that the primary obligation to notify the Commission should remain with the broker-dealer.[416] Therefore, the notification process in place before today's amendments generally has been retained.

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409 See PWC Letter. See also PCAOB Interim Attestation Standard, AT Section 101 at ¶¶ .11–.13.

410 See E&Y Letter.

411 See, e.g., ABA Letter; E&Y Letter; McGladrey Letter.

412 See Van Kampen/Invesco Letter.

413 See KPMG Letter.

414 See ABA Letter.

415 See paragraph (h) of Rule 17a-5.

416 As the proposal noted, the proposed amendment to require the independent public accountant to notify the Commission directly of material non-compliance would have been consistent with the surprise examination notification requirement in Rule 206(4)-2 under the Advisers Act. A surprise examination of an investment adviser by an independent public accountant generally verifies that client funds and securities of which the investment adviser has custody are held by a qualified custodian, such as a bank or broker-dealer. The accountant's surprise examination report opines on the adviser's compliance with the custody rule

Second, the final rule amendments require that, if the independent public accountant determines that the broker-dealer "is not in compliance with" any of the financial responsibility rules during the course of preparing the accountant's reports, the independent public accountant must immediately notify the broker-dealer's CFO of the nature of the non-compliance.[417] As proposed, the independent public accountant would have been required to provide notification if the accountant determined that any "material non-compliance" existed. As discussed above in section II.D.3. of this release, the final rule does not include a definition of the term material

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requirement that client funds and securities are maintained by a qualified custodian and also opines on the adviser's compliance with certain recordkeeping obligations between surprise examinations. The difference in nature and scope of custodial and other activities between broker-dealers and advisers results in significantly broader examination requirements for broker-dealers. Broker-dealers are required to undergo an annual examination by an independent public accountant of their financial statements and certain supporting schedules: a computation of net capital under Rule 15c3-1, a computation for determining reserve requirements under Rule 15c3-3, and information relating to the possession and control requirements of Rule 15c3-3. Moreover, under today's amendments, the independent public accountant must examine the compliance report of broker-dealers that maintain custody of customer funds or securities. The differences in the overall nature of an examination also supports continuing to maintain today's model under which a broker-dealer has the primary notification obligation (e.g., unlike in the case of a surprise examination of an investment adviser, a broker-dealer would already be making its own assessment and preparing its own report in the case of a compliance report examination). Further, the Dodd-Frank Act provided the PCAOB with explicit authority to, among other things, establish (subject to Commission approval) auditing and related attestation, quality control, ethics, and independence standards for registered public accounting firms with respect to their preparation of audit reports to be included in broker-dealer filings with the Commission, and the authority to conduct and require an inspection program of registered public accounting firms that audit broker-dealers. The PCAOB oversight of broker-dealer examinations provides additional regulatory oversight with respect to the examination of the broker-dealer further supporting the retention of the primary obligation with the broker-dealer to provide notice to the Commission and the broker-dealer's DEA.

417 Id. Under the current provisions of paragraph (h) of Rule 17a-5 (which are being amended), the independent public accountant "shall call it to the attention" of the CFO of the broker-dealer any material inadequacies. See 17 CFR 240.17a-5(h)(2). In the final rule, the independent public accountant is required to "immediately notify" the CFO of the "nature" of any non-compliance with the financial responsibility rules or material weakness. This change from the current notification requirement is designed to make the rule more clear as "shall call it to the attention" does not specify when the notification must be given. Further, as proposed, the independent public accountant would have been required to provide the Commission with notice of any material non-compliance within one business day of determining that the material non-compliance exists. See Broker-Dealer Reports, 76 FR at 37606. Under the final rule, the independent public accountant provides notice to the broker-dealer's CFO of any non-compliance with the financial responsibility rules or material weakness and the CFO, in turn, is required to provide the Commission and other securities regulators with notice if the non-compliance requires notice under Rule 15c3-1, Rule 15c3-3, or Rule 17a-11 or in the case of a material weakness. Consequently, because there is an intermediate step before the Commission receives notice, it is important that the independent public accountant notify the CFO immediately so that the Commission and other securities regulators receive timely notice.

non-compliance, as in the proposal. Thus, the independent public accountant will be required to provide notification to the broker-dealer of all instances of non-compliance with the financial responsibility rules as opposed to the proposal, which required the independent public accountant to report to the Commission and the DEA only instances of material non-compliance. While this may increase the number of times the independent public accountant must provide notification of non-compliance with the financial responsibility rules, the independent public accountant will not have to analyze whether an instance of non-compliance is "material non-compliance" under the proposed definition.

If the independent public accountant provides notice to the broker-dealer of an instance of non-compliance with the financial responsibility rules, the broker-dealer must provide notice to the Commission and its DEA in accordance with the notification provisions of Rule 15c3-1, Rule 15c3-3, or Rule 17a-11, but only if the notice provided by the independent public accountant concerns an instance of non-compliance that requires the broker-dealer to provide notification under those rules. The proposal would have required the accountant to notify the Commission "upon determining that any material non-compliance exists."[418] Rule 15c3-1, Rule 15c3-3, and Rule 17a-11 specify instances of non-compliance that require notification by the broker-dealer, and paragraph (h) of Rule 17a-5, as amended, refers to the notification provisions in those rules.

The broker-dealer must provide a copy of the notification to the accountant within one business day and, if the accountant does not receive the notice or the accountant does not agree with any statements in the notice, the accountant must provide a report to the Commission and

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[418] See Broker-Dealer Reports, 76 FR at 37606.

the broker-dealer's DEA within one business day.[419] The report from the accountant must, if the broker-dealer failed to file a notification, describe any instances of non-compliance that required the broker-dealer to provide a notification.[420] If the broker-dealer filed a notification but the independent public accountant does not agree with the statements in the notice, the report from the accountant must detail the aspects of the notification of the broker-dealer with which the accountant does not agree.[421] This notification process is generally the same as that in place before today's amendments.

While the final rule incorporates the existing notification process, the Commission wants to emphasize the importance of broker-dealers providing notification to the Commission and other securities regulators of non-compliance with Rule 15c3-1 as required by Rule 17a-11 and non-compliance with paragraph (e) of Rule 15c3-3 as required by paragraph (i) of Rule 15c3-3.[422] Consequently, the Commission is adding a note to paragraph (h) of Rule 17a-5 calling the attention of the broker-dealer and independent public accountant to these notification requirements.[423] Further, an important element of this process is the back-up provided by the

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419 See paragraph (h) of Rule 17a-5.

420 Id.

421 Id.

422 Paragraph (b)(1) of Rule 17a-11 provides, among other things, that every broker-dealer whose net capital declines below the minimum amount required pursuant to Rule 15c3-1 shall give notice of such deficiency that same day in accordance with paragraph (g) of Rule 17a-11 and that the notice shall specify the broker-dealer's net capital requirement and its current amount of net capital. See 17 CFR 240.17a-11(b)(1). Paragraph (g) of Rule 17a-11 provides, among other things, that the notice shall be given or transmitted to the principal office of the Commission in Washington, D.C., the regional office of the Commission for the region in which the broker-dealer has its principal place of business, the DEA of which such broker-dealer is a member, and the CFTC if the broker-dealer is registered as a futures commission merchant with such Commission, and that the notice shall be given or transmitted by telegraphic notice or facsimile transmission. See 17 CFR 240.17a-11(g). Paragraph (i) of Rule 15c3-3 provides that if a broker-dealer shall fail to make a reserve bank account or special account deposit, as required by Rule 15c3-3, the broker-dealer shall by telegram immediately notify the Commission and the regulatory authority for the broker-dealer, which examines such broker-dealer as to financial responsibility and shall promptly thereafter confirm such notification in writing. See 17 CFR 240.15c3-3(i). The Commission staff is considering ways to modernize the process by which broker-dealers file these and other notices with the Commission.

423 See note to paragraph (h) of Rule 17a-5, as adopted.

independent public accountant in terms of the obligation under the rule to provide the Commission and DEA with notification of the instance of non-compliance if the accountant does not receive a copy of the broker-dealer's notification or the accountant does not agree with the statements in the notification. Therefore, of necessity, the independent public accountant would have to have measures in place to determine whether, and if so when, the accountant received a copy of the notification required to be provided by the broker-dealer to the Commission or the broker-dealer's DEA. An independent public accountant could decide not to rely solely on the receipt of a copy of the notice from the broker dealer and take other steps to check whether the broker-dealer provided notice to the Commission and the DEA, such as obtaining a copy of a facsimile transmission from the broker-dealer to the Commission and DEA.

Third, the proposal has been modified to add that, if the accountant determines in connection with the audit of a carrying broker-dealer's annual reports that any material weakness (as defined in paragraph (d)(3)(iii) of Rule 17a-5) exists, the independent public accountant must immediately notify the broker-dealer's CFO of the nature of the material weakness.[424] As discussed above, before today's amendments, paragraph (h)(2) of Rule 17a-5 required the accountant to notify the broker-dealer's CFO if the accountant determined that any "material inadequacies" existed. However, as explained above in section II.B.3. of this release, the final rules do not contain the concept of material inadequacy. Also, as the term material weakness is defined with respect to the compliance report, this notification requirement only applies to carrying broker-dealers, whereas the requirement to provide notification of a material inadequacy applied to carrying and non-carrying broker-dealers.

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[424] See paragraph (h) of Rule 17a-5.

As discussed in more detail below in section II.F.2. of this release, the Commission is amending Rule 17a-11 to provide that a broker-dealer must provide notification to the Commission and its DEA if the broker-dealer discovers, or is notified by its independent public accountant, of the existence of a material weakness.[425] Paragraph (h) of Rule 17a-5, as stated above, requires that the independent public accountant notify the broker-dealer if the accountant determines that a material weakness exists.[426] The rule also requires the broker-dealer to provide notice in accordance with the provisions of Rule 17a-11, which, among other things, require the broker-dealer to provide notice to the Commission and its DEA in accordance with paragraph (g) of Rule 17a-11 within 24 hours and transmit a report within 48 hours of the notice stating what the broker-dealer has done or is doing to correct the situation.[427] Paragraph (h) of Rule 17a-5 requires the broker-dealer to provide the accountant with a copy of the notice it sends to the Commission within one business day and, if the accountant does not receive the notice or the accountant does not agree with the statements in the notice, the accountant must provide a report to the Commission and the broker-dealer's DEA within one business day.[428] The report from the accountant must, if the broker-dealer failed to file a notification, describe any material weakness.[429] If the broker-dealer filed a notification and the accountant does not agree with the statements in the notification, the report from the accountant must detail the aspects of the notification of the broker-dealer with which the accountant does not agree.[430] Again, this

425 See paragraph (e) of Rule 17a-11.

426 See paragraph (h) of Rule 17a-5.

427 See paragraph (h) of Rule 17a-5; 17 CFR 240.17a-11(g).

428 See paragraph (h) of Rule 17a-5.

429 Id.

430 Id.

notification process is generally the same as the one in place before today's amendments.[431] In response to the comment that the rule should require simultaneous notice by the accountant to the Commission and to the firm's management, the notification procedures adopted today require that the accountant notify management of the broker-dealer and also ensure that the Commission receives timely notice.

As stated above, one commenter asked whether the notification provisions apply to a review of an exemption report.[432] The notification provisions in paragraph (h) of Rule 17a-5 with respect to non-compliance with the financial responsibility rules apply regardless of whether the independent public accountant is engaged to prepare a report based on examination of a broker-dealer's compliance report or a review of a broker-dealer's exemption report.[433] An independent public accountant may determine that a broker-dealer is not in compliance with a requirement in the financial responsibility rules (e.g., not in compliance with Rule 15c3-1) during the course of an audit engagement of a non-carrying broker-dealer that files an exemption report either as part of the examination of the broker-dealer's financial statements or the review of certain statements the broker-dealer's exemption report. In this case, the independent public accountant would need to immediately notify the CFO of the broker-dealer of the nature of the non-compliance. The notification provisions with respect to an instance of material weakness only apply to broker-dealers that file a compliance report because material weakness is defined for purposes of the compliance report.

431 One change from the current rule (which is being amended) is to provide that required actions be completed within "one business day" as opposed to within a "24 hour period." This change is designed to account for non-business days during which certain actions may not be feasibly completed.

432 See KPMG Letter.

433 See paragraph (h) of Rule 17a-5.

The rule as amended does not require the accountant to notify the Commission directly when the accountant determines that a non-compliance with the financial responsibility rules exists, which eliminates the concern of a commenter that a report of non-compliance by the accountant, as proposed, would also trigger a Rule 17a-11 notice, which would be duplicative and create confusion.[434] As adopted, the responsibility to provide notification rests with the broker-dealer in the first instance.

2. Conforming and Technical Amendments to Rule 17a-11

Before today's amendments, paragraph (e) of Rule 17a-11 provided that whenever a broker-dealer discovered, or was notified by an independent public accountant, pursuant to paragraph (h)(2) of Rule 17a-5 or paragraph (f)(2) of Rule 17a-12 of the existence of any material inadequacy as defined in paragraph (g) of Rule 17a-5 or paragraph (e)(2) of Rule 17a-12, the broker-dealer was required to give notice to the Commission within 24 hours of the discovery or notification and transmit a report to the Commission within 48 hours of the notice stating what the broker-dealer has done or was doing to correct the situation.[435] The Commission proposed amending paragraph (e) of Rule 17a-11 to delete the references to Rule 17a-5 and to correct the references to Rule 17a-12.[436]

One commenter stated that the current notification process under paragraph (h)(2) of Rule 17a-5 and paragraph (e) of Rule 17a-11 satisfies the objective of notifying the Commission in a

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434 See ABA Letter.

435 See 17 CFR 240.17a-11(e).

436 See Broker-Dealer Reports, 76 FR at 37579. Rule 17a-12 contains reporting requirements for over-the-counter ("OTC") derivatives dealers. See 17 CFR 240.17a-12. The rule is similar to Rule 17a-5. Compare 17 CFR 240.17a-12, with 17 CFR 240.17a-5. For example, paragraph (h)(2) of Rule 17a-12 describes material inadequacies and paragraph (i)(2) of Rule 17a-12 provides that if the accountant determines that any material inadequacy exists, the accountant must call it to the attention of the CFO of the OTC derivatives dealer, who must inform the Commission. See 17 CFR 240.17a-12(h)(2) and (i). The Commission did not propose amending Rule 17a-12. Consequently, Rule 17a-12 retains the concept of material inadequacy.

timely manner and that the commenter was concerned that the proposal could undermine the effectiveness of the notification process in part because it would require notice to the Commission only when the accountant determines that there is a deficiency, and not when it is independently discovered by the broker-dealer.[437]

The Commission agrees with the commenter that notification should be provided to the Commission when a deficiency in internal control is discovered by the broker-dealer, in addition to when it is notified by its accountant of the existence of any material weakness. Therefore, the final rule retains references to Rule 17a-5 in paragraph (e) of Rule 17a-11. The Commission is conforming paragraph (e) of Rule 17a-11 to today's amendments to Rule 17a-5 to substitute the term material weakness as defined in paragraph (d)(3)(iii) of Rule 17a-5 for the term material inadequacy with respect to Rule 17a-5 and to replace the reference to paragraph (h)(2) of Rule 17a-5 with a reference to paragraph (h) of Rule 17a-5. Specifically, the final rule provides that whenever a broker-dealer discovers, or is notified by its accountant under paragraph (h) of Rule 17a-5 of the existence of any material weakness, the broker-dealer must: (1) give notice of the material weakness within 24 hours of the discovery or notification; and (2) transmit a report within 48 hours of the notice stating what the broker or dealer has done or is doing to correct the situation.[438] The rule retains a reference to material inadequacy as defined in paragraph (h)(2) of Rule 17a-12, but the amendments correct citations to that rule.

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[437] See Deloitte Letter.

[438] See paragraph (e) of Rule 17a-11. As stated above, this provision only applies to broker-dealers that file compliance reports, as the tern material weakness is defined with respect to the compliance report.

G. Other Amendments to Rule 17a-5

1. Information Provided to Customers – Paragraph (c) of Rule 17a-5

i. Background

Paragraph (c) of Rule 17a-5 generally requires a broker-dealer that carries customer accounts to send its balance sheet with appropriate notes and certain other financial information to each of its customers twice a year.[439] The Commission did not propose to amend this requirement. Accordingly, a broker-dealer that carries customer accounts must continue to send its customers: (1) an audited balance sheet with footnotes, including a footnote specifying the amount of the broker-dealer's net capital and required net capital, under paragraph (c)(2) of Rule 17a-5;[440] and (2) an unaudited balance sheet dated six months after the date of the audited balance sheet with footnotes, including a footnote regarding the amount of the broker-dealer's net capital and required net capital, under paragraph (c)(3) of Rule 17a-5.[441] The information required by paragraphs (c)(2) and (c)(3) of Rule 17a-5 must either be mailed to customers, or, if the broker-dealer meets certain conditions under paragraph (c)(5) of Rule 17a-5, the broker-dealer can semi-annually send its customers summary information regarding its net capital, as long as it also provides customers with a toll-free number to call for a free copy of its balance sheet with appropriate notes, makes its balance sheet with appropriate notes available to customers on its website, and meets other specified requirements.[442]

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439 See 17 CFR 240.17a-5(c).

440 17 CFR 240.17a-5(c)(2).

441 17 CFR 240.17a-5(c)(3).

442 See 17 CFR 240.17a-5(c)(5). See also Broker-Dealer Exemption from Sending Certain Financial Information to Customers, Exchange Act Release No. 48282 (Aug. 1, 2003), 68 FR 46446 (Aug. 6, 2003).

ii. Availability of Independent Public Accountant's Comments on Material Inadequacies – Paragraph (c)(2) of Rule 17a-5

Prior to today's amendments, paragraph (c)(2)(iii) of Rule 17a-5 provided that if, in conjunction with a broker-dealer's most recent audit report, the broker-dealer's independent public accountant commented on any material inadequacies in the broker-dealer's internal controls, its accounting system, or certain of its practices and procedures[443] under paragraphs (g) and (h) of Rule 17a-5, and paragraph (e) of Rule 17a-11, the broker-dealer's audited statements sent to customers were required to include a statement that a copy of the auditor's comments were available for inspection at the Commission's principal office in Washington, DC, and the regional office of the Commission in which the broker-dealer had its principal place of business.[444]

As discussed above in sections II.D.3. and II.F. of this release, the Commission proposed deleting references to, and the definition of, the term material inadequacy in Rule 17a-5, and proposed amending paragraph (h) of Rule 17a-5 to require a broker-dealer's independent public accountant to notify the Commission and the broker-dealer's DEA if the accountant determined that any material non-compliance existed at the broker-dealer during the course of preparing its reports.[445] Consequently, the Commission proposed replacing paragraph (c)(2)(iii) of Rule 17a-5, which contained the term material inadequacies, with a requirement that, if a broker-dealer's accountant provided notice to the Commission of an instance of material non-compliance, the financial information sent to customers under paragraph (c)(2) of Rule 17a-5 must include a statement that a copy of the accountant's notice was available for customers' inspection at the

443 These practices and procedures include, for example, periodic net capital computations under Rule 15c3-1 and periodic counts of securities under Rule 17a-13.

444 See 17 CFR 240.17a-5(c)(2)(iii).

445 See Broker-Dealer Reports, 76 FR at 37579.

principal office of the Commission in Washington, DC.[446] Under this proposal, notices to the Commission regarding an accountant's determination that one or more instances of material non-compliance existed at a broker-dealer would be publicly available.

Three commenters responded to the proposed amendments to paragraph (c)(2) of Rule 17a-5.[447] These commenters each stated that the Commission should accord confidential treatment to accountants' notices to the Commission regarding determinations of material non-compliance.[448] One commenter stated that due to the technical nature of the financial responsibility rules, there was a risk that notices of material non-compliance could be misinterpreted by the media and others.[449]

The Commission is revising its proposal to amend paragraph (c)(2) of Rule 17a-5 to be consistent with the new notification provisions in paragraph (h) described above relating to the identification by a broker-dealer's accountant of a material weakness rather than an instance of material non-compliance.[450] Specifically, if, in connection with the most recent annual reports, the report of the independent public accountant covering the broker-dealer's compliance report identifies a material weakness, the broker-dealer must include a statement that one or more material weaknesses have been identified and that a copy of the report of the independent public accountant is currently available for the customer's inspection at the principal office of the Commission in Washington, DC, and the regional office of the Commission for the region in

446 This proposal would have been codified in paragraph (c)(2)(iv) of Rule 17a-5 as a result of paragraph (c)(2)(iii) being removed and paragraph (c)(2)(iv) being redesignated as paragraph (c)(iii). See Broker-Dealer Reports, 76 FR at 37603.

447 See ABA Letter; CAI Letter; Deloitte Letter.

448 Id.

449 See ABA Letter.

450 See paragraph (c)(2)(iv) of Rule 17a-5.

which the broker-dealer has its principal place of business.[451]

In response to commenters' concerns about making the report of material non-compliance available to the public, the report that now will be made publicly available is a report that identifies the existence of a material weakness – not a report of material non-compliance. In addition, making the report of the independent public accountant covering the compliance report publicly available if it identifies the existence of a material weakness is consistent with the previous treatment of a report of a material inadequacy. Providing customers notice of an accountant's finding that goes directly to the financial and operational condition of their broker-dealer and making the report containing the finding publicly available will make available to customers information that facilitates their ability to make more informed decisions in selecting broker-dealers through which they prefer to conduct business. For these reasons, the final rule does not accord confidential treatment to a report of an independent public accountant covering the compliance report if it identifies a material weakness as some commenters suggested should be the case with respect to the proposed – but not adopted – report of material non-compliance. Consequently, an independent public accountant's report covering the compliance report will be made available for the customer's inspection at the principal office of the Commission in Washington, DC, and the regional office of the Commission for the region in which the broker-dealer has its principal place of business if the report identifies the existence of a material weakness.[452]

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451 Id.

452 Paragraph (c)(2)(iv) of Rule 17a-5, as adopted, includes both the principal office of the Commission in Washington, DC and the regional office of the Commission for the region in which a broker-dealer has its principal place of business as locations where the accountant's reports are available. Including the applicable regional office of the Commission as a location where these notices are available will make them more accessible to customers and is consistent with the previous treatment of material inadequacy reports.

iii. Exemption from Mailing Financial Information to Customers – Paragraph (c)(5) of Rule 17a-5

Before today's amendments, paragraph (c)(5) of Rule 17a-5 provided a conditional exemption from the requirement that a broker-dealer send paper copies of financial information to customers if the broker-dealer mailed to customers a financial disclosure statement with summary information and an Internet link to its balance sheet and other information on the broker-dealer's website.[453] One of the conditions of the exemption, contained in paragraph (c)(5)(vi) of Rule 17a-5, was that the broker-dealer was not required by paragraph (e) of Rule 17a-11 to give notice of a material inadequacy during the prior year. The Commission proposed revising the condition in paragraph (c)(5)(vi) of Rule 17a-5 to provide that the broker-dealer's financial statements must receive an unqualified opinion from the independent public accountant and neither the broker-dealer, under proposed paragraph (d) of Rule 17a-5, nor the independent public accountant, under proposed paragraph (g) of Rule 17a-5, identified a material weakness or an instance of material non-compliance.[454]

The Commission received several comments on the proposal.[455] One commenter stated that broker-dealers should be able to deliver the financial information available to customers via its website regardless of whether an instance of material non-compliance or material weakness was identified.[456] Another commenter stated that the rule should not require a 100% rate of compliance with the financial responsibility rules to qualify for the exemption.[457] A third

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453 17 CFR 240.17a-5(c)(5).

454 See Broker-Dealer Reports, 76 FR at 37577.

455 See ABA Letter; CAI Letter; SIFMA Letter.

456 See ABA Letter.

457 See CAI Letter. This commenter stated that as FINRA has proposed that broker-dealers send customer account statements monthly instead of quarterly, broker-dealers are already potentially facing "extremely high" costs of sending information to customers. FINRA withdrew its proposals to send customer account statements monthly instead of quarterly on July 30, 2012. See Proposed Rule Change to Adopt FINRA

commenter stated that the proposed amendment should be eliminated, or replaced with the requirement that broker-dealers include a notice of the material weakness or non-compliance on customer account statements for a year following its identification.[458]

In response to comments received, the Commission has decided not to adopt the proposed condition in paragraph (c)(5)(vi) of Rule 17a-5 for qualifying for the conditional exemption. Requiring paper delivery of financial information to customers when a broker-dealer's financial statements do not receive an unqualified opinion from its independent public accountant, or when the broker-dealer fails to comply with certain regulatory requirements, will not necessarily result in a more effective means of communication to customers and runs counter to the dominant trend toward electronic communications between financial entities and their customers. Further, as discussed above, if a broker-dealer or its independent public accountant provides notice to the Commission of a material weakness in the broker-dealer's Internal Control Over Compliance, paragraph (c)(2)(iv) of Rule 17a-5 as adopted requires the broker-dealer to include with the semi-annual financial disclosure statement it sends its customers a statement that the independent public accountant identified a material weakness and that a copy of the report of the independent public accountant is available for the customers' inspection.

2. Technical Amendments

i. Deletion of Paragraph (b)(6) of Rule 17a-5

Before today's amendments, paragraph (b)(6) of Rule 17a-5 provided that "a copy of [a broker-dealers] annual audit report shall be filed at the regional office of the Commission for the

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Rule 2231 (Customer Account Statements) in the Consolidated FINRA Rulebook, File No. SR-2009-028, (July 30, 2012), available at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p143262.pdf (withdrawal of proposed rule change).

458 See SIFMA Letter.

region in which the broker or dealer has its principal place of business and the principal office of the designated examining authority for said broker or dealer. Two copies of said report shall be filed at the Commission's principal office in Washington, DC. Copies thereof shall be provided to all self-regulatory organizations of which said broker or dealer is a member." The Commission proposed to delete this paragraph because the same provisions are in paragraph (d)(6) of Rule 17a-5.[459] The Commission received no comments on this proposal and is deleting paragraph (b)(6) of Rule 17a-5 as proposed.

ii. Deletion of Provisions Relating to the Year 2000

Before today's amendments, paragraph (e)(5) of Rule 17a-5 required broker-dealers to file Form BD-Y2K. Form BD-Y2K elicited information with respect to a broker-dealer's readiness for the year 2000 and any potential problems that could arise with the advent of the new millennium.[460] Form BD-Y2K was required to be filed in April 1999 and only then. In the proposing release, the Commission proposed to delete paragraph (e)(5) of Rule 17a-5 in its entirety because the provisions of that paragraph are now moot.[461] The Commission received no comments on this proposal and is deleting paragraph (e)(5) of Rule 17a-5 as proposed.

iii. Deletion of Paragraph (i)(5) of Rule 17a-5

In the proposing release, the Commission proposed to delete paragraph (i)(5) of Rule

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459 See Broker-Dealer Reports, 76 FR at 37593. As discussed above in section II.B.6. of this release, the Commission is amending paragraph (d)(6) of Rule 17a-5 to require that a copy of a broker-dealer's annual report must be filed with SIPC. Specifically, the Commission is amending paragraph (d)(6) to provide that a broker-dealer's annual reports "must be filed at the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the Commission's principal office in Washington, DC, the principal office of the designated examining authority for the broker or dealer, and with the Securities Investor Protection Corporation ('SIPC') if the broker or dealer is a member of SIPC. Copies of the reports must be provided to all self-regulatory organizations of which the broker or dealer is a member, unless the self-regulatory organization by rule waives this requirement."

460 See Reports to be Made by Certain Brokers and Dealers, Exchange Act Release No. 40608 (Oct. 28, 1998), 63 FR 59208 (Nov. 3, 1998).

461 See Broker-Dealer Reports, 76 FR at 37593.

17a-5, which, before today's amendments, provided that "the terms audit (or examination), accountant's report, and certified shall have the meanings given in §210.1–02 of this chapter."[462] The Commission received no comments on this proposal and is deleting paragraph (i)(5) of Rule 17a-5 as proposed.

iv. Amendments to Paragraph (f)(2) of Rule 17a-5

Before today's amendments, paragraph (f)(2) of Rule 17a-5 provided that a broker-dealer that was required to file an annual audit report must file a statement with the Commission and its DEA that it has designated an independent public accountant responsible for performing the annual audit of the broker-dealer, which was called "Notice pursuant to Rule 17a-5(f)(2)".[463] Paragraph (f)(2)(iii) of Rule 17a-5 prescribed the items that were required to be included in the notice: the name, address, telephone number and registration number of the broker-dealer; the name, address and telephone number of the accounting firm; and the audit date of the broker-dealer for the year covered by the agreement.[464]

In addition to the proposed amendments discussed below in section III. of this release, the Commission proposed certain technical amendments to paragraph (f)(2) of Rule 17a-5.[465] First, the Commission proposed amending the language in paragraph (f)(2)(i) of Rule 17a-5 to streamline the paragraph and to add a reference to proposed paragraph (f)(2)(ii) of Rule 17a-5, which would have prescribed the information a broker-dealer would have been required to include in its notice designating its accountant. In addition, the Commission proposed to amend paragraph (f)(2)(i) of Rule 17a-5 to require that a broker-dealer include a statement in its notice as to whether the engagement with its independent public accountant was for a single year or was

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462 Id. at 37594.

463 See 17 CFR 240.17a-5(f)(2).

464 See 17 CFR 240.17a-5(f)(2)(iii)(A)–(C).

465 See Broker-Dealer Reports, 76 FR at 37583–37584, 37605–37606.

of a continuing nature. This statement was previously required by paragraph (f)(2)(ii) of Rule 17a-5, which the Commission proposed to delete as part of its revisions to that paragraph. The Commission did not receive any comments on these proposed changes and is adopting them as proposed. The Commission also proposed to retain the annual December 10 filing deadline for the statements provided pursuant to paragraph (f)(2), but also added the language "(or 30 calendar days after the effective date of its registration as a broker or dealer, if earlier)." The Commission did not receive any comments on this amendment and is adopting it as proposed. In addition, the final rule adds a conforming change to the date of the statement designating the independent public accountant. Under the proposal, the statement must be dated "no later than December 1." Under the final rules, the statement must be dated "no later than December 1 (or 20 calendar days after the effective date of its registration as a broker or dealer, if earlier)" to make the timing consistent with the filing deadlines described above.

As discussed in the proposing release, notices pursuant to paragraph (f)(2) of Rule 17a-5 currently on file with the Commission do not contain the representations that are required by the amendments to paragraph (f)(2) that the Commission is adopting today. Accordingly, broker-dealers subject to paragraph (f)(2) of Rule 17a-5 (i.e., all broker-dealers that are required to file audited annual reports) must file a new "statement regarding the independent public accountant under Rule 17a-5(f)(2)."[466] As specified in the new rule, if the engagement covered by the new statement is of a continuing nature, no subsequent filing would be required unless and until the broker-dealer changes its independent public accountant or amends the engagement with the accountant.[467]

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466 See paragraph (f)(2) of Rule 17a-5.

467 See paragraph (f)(2)(i) of Rule 17a-5.

v. Further Technical Amendments

In the proposing release, the Commission proposed additional technical amendments to Rule 17a-5, including changes that would consistently use the term "independent public accountant" throughout Rule 17a-5 when referring to a broker-dealer's accountant,[468] to make the rule gender neutral,[469] and to replace the term "balance sheet" with the term "Statement of Financial Condition" in all places where that term appeared in Rule 17a-5.[470] These technical amendments were designed to modernize the language of Rule 17a-5, and to make the rule easier to understand. The Commission received no comments on these amendments and is adopting them as proposed.

The Commission is making further technical amendments that are consistent with the Commission's "plain English" initiative and do not substantively affect the requirements of Rule 17a-5.[471] In addition, for clarity and consistency throughout Rule 17a-5, the Commission is amending Rule 17a-5 to replace the words "date selected for the annual audit of financial statements" that were previously contained in paragraphs (a)(2)(ii) and (iii) of Rule 17a-5 with the words "end of the fiscal year of the broker or dealer."[472] The phrase "date selected for the annual audit of the financial statements" has the same meaning as the phrase "end of the fiscal year of the broker or dealer." As discussed earlier, this change eliminates outdated language and conforms the text in paragraph (a) of Rule 17a-5 to the text in paragraph (n) of Rule 17a-5. The Commission is making a technical amendment to paragraph (a)(3) of Rule 17a-5. As proposed,

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468 See Broker-Dealer Reports, 76 FR at 37594.

469 Id.

470 Id. at 37593.

471 These amendments replace the term "shall" with "must," the term "pursuant to" with "under," the term "said" with "the" or "that," the term "such" with "the" or "that," the term "other than" with "not," and the term "therewith" with "with the."

472 For example, 17 CFR 240.17a-5(a)(5), (d)(3)(i)(B), and (d)(5) each refer to the "end of the fiscal year of the broker or dealer."

paragraph (a)(3) provided that the reports required under paragraph (a) of Rule 17a-5 were considered filed when received at the Commission's principal office and the regional office of the Commission where the broker-dealer has its principal place of business. However, Form Custody, which broker-dealers must file under paragraph (a)(5) of Rule 17a-5, as amended, must be filed with the broker-dealer's DEA and not with the Commission. The Commission is therefore amending paragraph (a)(3) of Rule 17a-5 to clarify that this provision applies to reports "that must be filed with the Commission." As a result, the Commission is making technical amendments to paragraphs (a)(2)(i) through (a)(2)(iv) of Rule 17a-5 to specify that the FOCUS Reports required under these provisions must be filed with the Commission.

The Commission also is making technical amendments to paragraph (m)(1) of Rule 17a-5, which relates to extensions and exemptions for filing annual reports, and (n)(2) of Rule 17a-5, which relates to a broker-dealer's notification requirements when changing its fiscal year, to replace the words "annual audit reports" and "audit report," respectively, with the words "annual reports." The Commission also is deleting an unnecessary citation to paragraph (d)(1)(i) of Rule 17a-5 that was previously included in paragraph (n)(2) of Rule 17a-5.

H. Coordination with Investment Advisers Act Rule 206(4)-2

1. Background

The amendments to Rule 17a-5 that the Commission is adopting today will permit carrying broker-dealers that either also are registered as investment advisers or maintain client assets of an affiliated investment adviser and are subject to the internal control report requirement in Rule 206(4)-2 to satisfy that requirement with a report prepared by the broker-dealer's independent public accountant based on an examination of certain of the broker-dealer's statements in the compliance report.

2. Rule 206(4)-2

Rule 206(4)-2 provides that a registered investment adviser is prohibited from maintaining custody of client funds or securities unless a "qualified custodian" maintains those funds and securities: (1) in a separate account for each client under that client's name; or (2) in accounts that contain only the investment adviser's clients' funds and securities, under the investment adviser's name as agent or trustee for the clients.[473] Under Rule 206(4)-2, only banks, certain savings associations, registered broker-dealers, FCMs, and certain foreign financial institutions may act as qualified custodians.[474]

In addition, when an investment adviser or its related person maintains client funds and securities as qualified custodian in connection with advisory services provided to clients, the adviser annually must obtain, or receive from its related person, a written internal control report prepared by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.[475] This report must be supported by the independent public accountant's examination of the qualified custodian's custody controls.[476]

The Commission has issued guidance identifying the control objectives that should be included in the scope of the internal control examination required under Rule 206(4)-2.[477] The

473 See 17 CFR 275.206(4)-2(a)(1)(i)–(ii).

474 See 17 CFR 275.206(4)-2(d)(6).

475 Id.

476 Rule 206(4)-2 provides that the internal control report must include an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date, and are suitably designed and are operating effectively to meet control objectives relating to custodial services, including the safeguarding of funds and securities held by either the adviser or its related person on behalf of advisory clients, during the year. The rule also requires that the accountant "verify that the funds and securities are reconciled to a custodian other than [the adviser or its] related person." See 17 CFR 275.206(4)-2.

477 See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940, Advisers Act Release No. 2969 (Dec. 30, 2009), 75 FR 1492 (Jan. 11, 2010) (identifying the following specified objectives: (1) documentation for the opening and modification of client accounts is received, authenticated, and established completely,

control objectives for the Rule 206(4)-2 examination are more general than the specific operational requirements in the financial responsibility rules.[478] This approach allows different types of qualified custodians (banks, certain savings associations, broker-dealers, FCMs, and certain foreign financial institutions) to establish controls and procedures that meet the identified control objectives in a manner that reflects differences in business models, regulatory requirements, and other factors.[479]

3. Broker-Dealers Acting as Qualified Custodians under Rule 206(4)-2

Broker-dealers that also are registered as investment advisers may, acting in their capacity as broker-dealers, maintain client securities and funds as qualified custodians in connection with advisory services provided to clients.[480] As a result of being the adviser and qualified custodian to its clients, under Rule 206(4)-2 these broker-dealers must obtain an internal control report relating to the custody of those assets from an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB. In addition, broker-dealers acting as qualified custodians also may maintain advisory client assets in connection with advisory services provided by related or affiliated investment advisers. Rule

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accurately, and timely on the applicable system; (2) client transactions, including contributions and withdrawals, are authorized and processed in a complete, accurate, and timely manner; (3) trades are properly authorized, settled, and recorded completely, accurately, and timely in the client account; (4) new securities and changes to securities are authorized and established in a complete, accurate and timely manner; (5) securities income and corporate action transactions are processed to client accounts in a complete, accurate, and timely manner; (6) physical securities are safeguarded from loss or misappropriation; (7) cash and security positions are reconciled completely, accurately and on a timely basis between the custodian and depositories; and (8) account statements reflecting cash and security positions are provided to clients in a complete, accurate and timely manner).

478 Compare the control objectives described in Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940, 75 FR at 1494, with the requirements in 17 CFR 240.15c3-1, 17 CFR 240.15c3-3, 17 CFR 240.17a-13, and the DEA Account Statement Rules.

479 See Broker-Dealer Reports, 76 FR at 37580.

480 The Commission staff has estimated that approximately 18% of FINRA-registered broker-dealers also are registered as investment advisers with the Commission or with a state. See Commission staff, Study on Investment Advisers and Broker-Dealers, as required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Jan. 2011).

206(4)-2 requires such a broker-dealer to provide an internal control report to its related investment adviser.[481]

4. Proposal to Allow Report Based on Examination of Compliance Report to Satisfy Rule 206(4)-2

i. The Proposal

Broker-dealers that maintain custody of customer funds and securities are subject to specific operational requirements in the financial responsibility rules with respect to handling and accounting for customer assets.[482] The operational requirements of the financial responsibility rules are consistent with the control objectives outlined in the Commission's guidance on Rule 206(4)-2.[483] As a result of the proposed amendments to Rule 17a-5, the Commission stated in the proposing release that a broker-dealer subject to an examination by an independent public accountant of its compliance report that also acts as a qualified custodian for itself as an investment adviser or for its related investment advisers under Rule 206(4)-2 would be able to use the independent public accountant's report resulting from the examination to satisfy the internal control report requirement under Rule 206(4)-2.[484]

ii. Comments on the Proposal

The Commission received several comments regarding the proposal that the independent public accountant's report based on an examination of the compliance report would satisfy the internal control report under Rule 206(4)-2. One commenter stated that it is "critically

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481 See 17 CFR 275.206(4)-2(a)(6). Based on data collected from the Investment Adviser Registration Depository as of August 2012, close to 200 investment advisers reported on Form ADV that client assets were being held at a qualified custodian that was related to the adviser.

482 While Rule 15c3-1 prescribes broker-dealer net capital requirements, it also contains provisions relating to custody. For example, a broker-dealer must take net capital charges for short security differences unresolved after specifically enumerated timeframes. See 17 CFR 240.15c3-1(c)(2)(v)(A).

483 See Broker-Dealer Reports, 76 FR at 37579-37580; Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940, 75 FR at 1493–1494.

484 See Broker-Dealer Reports, 76 FR at 37579–37580.

important" that there be a single independent public accountant engagement of the custody function at both the broker-dealer and investment adviser operations of any dually registered entity (or of affiliated broker-dealers and investment advisers) and that this engagement use a single, consistent standard for evaluating custody at both the broker-dealer and investment adviser operations.[485] Two commenters noted that there are non-carrying broker-dealers that act as qualified custodians under the Advisers Act and that these broker-dealers would not be subject to the proposed compliance report requirements and, consequently, would not be able to use the report of the independent public accountant covering the compliance report to satisfy the internal control report requirement in Rule 206(4)-2 because the broker-dealers would be filing exemption reports instead of compliance reports.[486] One commenter characterized this as an area of redundancy that could be eliminated by allowing an accountant's review of a non-carrying broker-dealer's transmittal procedures to be "recognized by the Investment Adviser regulatory regime promulgated by the Commission."[487]

In addition, two commenters asked for clarification regarding the interaction of the proposed compliance report requirements with the requirement in Rule 206(4)-2 that investment advisers undergo an annual surprise examination by an independent accountant to verify customer funds and securities held in custody.[488] Specifically, both asked that the Commission clarify whether the independent public accountant performing the surprise examination would be

485 See CFP Letter.

486 See CAI Letter; Deloitte Letter.

487 See Deloitte Letter.

488 See CAQ Letter; PWC Letter. Paragraph (a)(4) of Rule 206(4)-2 requires, among other things, that client funds and securities of which an investment adviser has custody must be verified by actual examination at least once during each calendar year by an independent public accountant, pursuant to a written agreement between the investment adviser and the accountant, at a time that is chosen by the accountant without prior notice or announcement to the investment adviser and that is irregular from year to year. See 17 CFR 275.206(4)-2.

able to place reliance on the proposed compliance report and related compliance examination to determine the nature and extent of the procedures for the surprise examination.[489] One of the commenters also asked that, if the Commission clarifies that the independent public accountant performing the surprise examination is expected to rely on the proposed compliance report requirements, what factors should the independent public accountant consider, given that the report based on an examination of the compliance report would not be required to be completed until 60 days after the fiscal year end while the surprise examination may occur at any time.[490]

5. Adoption of Proposal Relating to Rule 206(4)-2

As discussed above, under today's amendments, a carrying broker-dealer must prepare, and file with the Commission and its DEA, a compliance report on, among other things, its Internal Control Over Compliance, and must file with the compliance report a report prepared by its independent public accountant based on an examination of the compliance report.[491] As a result of the amendments to Rule 17a-5, the Commission has determined that the independent public accountant's report based on an examination of the compliance report will satisfy the internal control report requirement under Rule 206(4)-2 because the operational requirements of the financial responsibility rules are consistent with the control objectives outlined in the Commission's guidance on Rule 206(4)-2.[492] For example, to be able to include a statement that

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489 See CAQ Letter; PWC Letter.

490 See PWC Letter.

491 See 17 CFR 240.17a-5(d)(3) and (g)(2)(i).

492 See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940, 75 FR at 1494; Broker-Dealer Reports, 76 FR at 37579–37580. As discussed above in section II.D.3. of this release, the independent public accountant must examine the compliance report in accordance with attestation standards promulgated by the PCAOB. Consequently, the PCAOB's attestation standards are integral to the Commission's determination that the independent public accountant's report based on an examination of the compliance report satisfies the internal control report requirement under Rule 206(4)-2. The Commission could revisit this determination if the PCAOB's attestation standards do not support the determination.

the broker-dealer has established and maintained Internal Control Over Compliance (which is defined as internal controls that have the objective of providing the broker-dealer with reasonable assurance that non-compliance with the financial responsibility rules will be prevented or detected on a timely basis),[493] a broker-dealer's internal control over compliance with Rule 17a-13 will result in controls over the safeguarding of securities from loss or misappropriation and the completeness, accuracy, and timeliness of the securities reconciliation process.[494] To make a similar statement with respect to the Account Statement Rules, a broker-dealer would of necessity have internal controls over compliance with the Account Statement Rules designed to ensure that customers receive complete, accurate, and timely information concerning securities positions and other assets held in their accounts.[495] A statement that the broker-dealer has established and maintained Internal Control Over Compliance would cover these and other internal controls over compliance with the financial responsibility rules and would be examined by the independent public accountant during the examination of the compliance report.

As commenters noted, broker-dealers that are not carrying broker-dealers are not subject to the compliance report requirements and, therefore, those broker-dealers must comply with the

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493 See paragraphs (d)(3)(i)(A)(1) and (d)(3)(ii) of Rule 17a-5.

494 See 17 CFR 240.17a-13. As discussed above in section II.D.3. of this release, the PCAOB proposed attestation standards related to the compliance report. The PCAOB's proposed attestation standards include a requirement that the independent public accountant must perform procedures to obtain evidence about the existence of customer funds or securities held for customers, e.g., confirmation of customer security positions directly with depositories and clearing organizations. See PCAOB Proposing Release app. 1, at ¶ 26. This procedure would be consistent with the tests of the qualified custodian's reconciliation that the Commission specified in the guidance on Rule 206(4)-2. See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940, 75 FR 1494.

495 See, e.g., CBOE Rule 9.12; NASD Rule 2340. See also Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940, Advisers Act Release No. 2969 (Dec. 30, 2009), 75 FR 1494 (Jan. 11, 2010), which describes as a control objective for qualified custodians (including broker-dealer qualified custodians) that account statements reflecting cash and security positions are provided to clients in a complete, accurate and timely manner.

internal control report requirement in Rule 206(4)-2 if they are subject to that requirement. The exemption report is not redundant of the internal control report requirement in Rule 206(4)-2 because, among other things, the scope of the required statements included in a broker-dealer's exemption report is different than the scope of the internal control report requirement in Rule 206(4)-2.[496]

As noted above, commenters also asked whether the accountant would be able to place reliance on the proposed compliance report and related examination of the compliance report to determine the nature and extent of the procedures for the surprise examination. PCAOB attestation standards require an independent public accountant "to obtain an understanding of internal control over compliance sufficient to plan the engagement and to assess control risk for compliance with specified requirements."[497] The Commission agrees that the independent public accountant's understanding of internal controls related to custody at the broker-dealer acting as a qualified custodian, as well as other facts and circumstances, may affect the nature and extent of procedures performed for the annual surprise examination.[498] The Commission has provided interpretive guidance on the relationship between the annual surprise examination and the internal control report for engagements performed pursuant to Rule 206(4)-2.[499]

496 See supra notes 299, 300.

497 See PCAOB Interim Attestation Standard, AT Section 601. AT Section 601 requires an independent public accountant "to obtain an understanding of internal control over compliance sufficient to plan the engagement and to assess control risk for compliance with specified requirements. In planning the examination, such knowledge should be used to identify types of potential non-compliance, to consider factors that affect the risk of material noncompliance, and to design appropriate tests of compliance." Id. at ¶ .45.

498 Id.

499 See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940, Advisers Act Release No. 2969 (Dec. 30, 2009), 75 FR 1492 (Jan. 11, 2010).

III. ACCESS TO ACCOUNTANT AND AUDIT DOCUMENTATION

The Commission proposed amending paragraph (f)(2) of Rule 17a-5 to require that each clearing broker-dealer[500] include a representation in its statement regarding its independent public accountant that the broker-dealer agrees to allow Commission and DEA examination staff to review the audit documentation associated with its annual audit reports required under Rule 17a-5 and to allow its independent public accountant to discuss findings relating to the audit reports with Commission and DEA examination staff if requested for the purposes of an examination of the broker-dealer.[501] This proposed requirement was intended to facilitate examinations of clearing broker-dealers by Commission and DEA examination staff.[502] Access to information obtained from audit documentation and discussions with a clearing broker-dealer's independent public accountant would enhance the efficiency and effectiveness of Commission and DEA examinations by providing examiners with access to additional relevant information to plan their examinations.[503]

The Commission proposed to limit this requirement to clearing broker-dealers, which generally have more complex business operations than non-carrying firms.[504] Thus, access to accountants and audit documentation was considered of substantially greater value when preparing for regulatory examinations of these types of broker-dealers, as compared to firms with more limited business models.

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500 For the purpose of this release, a "clearing broker-dealer" is a broker-dealer that clears transactions or carries customer accounts.

501 See Broker-Dealer Reports, 76 FR at 37583–37584.

502 Id.

503 For example, where an independent public accountant has performed extensive testing of a carrying broker-dealer's custody of funds and securities by confirming holdings at custodians and sub-custodians, examiners could focus their efforts on other matters that had not been the subject of prior testing and review.

See Broker-Dealer Reports, 76 FR at 37583.

To facilitate Commission and DEA examination staff access to a clearing broker-dealer's independent public accountant and the accountant's audit documentation, the Commission proposed amending paragraph (f)(2) of Rule 17a-5 to require that a clearing broker-dealer's notice designating its independent public accountant include, among other things, representations: (1) that the broker-dealer agrees to allow representatives of the Commission or the broker-dealer's DEA, if requested for purposes of an examination of the broker-dealer, to review the documentation associated with the reports of its independent public accountant prepared pursuant to paragraph (g) of Rule 17a-5; and (2) that the broker-dealer agrees to permit its independent public accountant to discuss with representatives of the Commission and the DEA, if requested for the purposes of an examination of the broker-dealer, the findings associated with the reports of the accountant prepared pursuant to paragraph (g) of Rule 17a-5.[505] Proposed paragraph (f)(2)(iii) of Rule 17a-5 provided that a broker-dealer that does not clear transactions or carry customer accounts would not be required to include these representations in its notice.[506]

Eight commenters addressed the proposed changes to paragraph (f)(2) of Rule 17a-5.[507] Generally, commenters requested that the Commission do one or more of the following: (1) clarify the type of documentation that the Commission and DEA examiners would seek to access;[508] (2) grant confidential treatment to documentation obtained by the Commission under this provision;[509] (3) clarify the process by which Commission and DEA examiners would seek

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505 Id.

506 Id.

507 See CAI Letter; CAQ Letter; CFP Letter; Deloitte Letter; E&Y Letter; KPMG Letter; PWC Letter; SIFMA Letter.

508 See CAQ Letter; Deloitte Letter; E&Y Letter; KPMG Letter.

509 See CAI Letter; KPMG Letter; PWC Letter; SIFMA Letter.

access to a broker-dealer's independent public accountant and its audit documentation;[510] and (4) limit the use of information and documentation obtained from a broker-dealer's independent public accountant.[511] In addition, one commenter raised general concerns that providing Commission and DEA examiners with access to a broker-dealer's auditor and audit documentation will discourage communications between broker-dealers and their auditors and may require auditors to produce documentation protected by attorney-client and/or accountant-client privilege.[512] Finally, one commenter asserted that it is reasonable for securities regulators to be able to validate any concerns promptly with a broker-dealer's accountant.[513]

In response to requests for clarity as to the types of audit documentation that Commission and DEA examiners would seek to access under the proposal, the Commission revised proposed paragraph (f)(2)(ii)(F) of Rule 17a-5 to clarify that "audit documentation" has the meaning established by PCAOB standards.[514] This revision, which was specifically suggested by two commenters,[515] is not intended to alter an independent public accountant's obligations with respect to audit documentation; rather, it is intended to clarify the types of audit documentation that the Commission and DEA examiners may ask to review in connection with a broker-dealer examination.

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510 See Deloitte Letter; E&Y Letter; KPMG Letter.

511 See E&Y Letter; PWC Letter.

512 See CAI Letter.

513 See CFP Letter.

514 PCAOB Auditing Standard 3 defines "Audit documentation" as the "written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise. Audit documentation also facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Among other things, audit documentation includes records of the planning and performance of the work, the procedures performed, evidence obtained, and conclusions reached by the auditor. Audit documentation also may be referred to as work papers or working papers."

515 See CAQ Letter; KPMG Letter.

In response to questions regarding the process by which Commission and DEA examiners might seek to access audit documentation, the Commission agrees with a commenter that suggested that these requests be in writing because that will provide independent public accountants with a record of requests for information and specify the documentation the Commission or DEA examination staff would like to access.[516] Therefore, the Commission has modified the rule from the proposal to provide that a request to a broker-dealer's independent public accountant for the accountant to discuss audit findings or for access to audit documentation be made in writing.

Independent public accountants can seek to protect information obtained by examiners from being disclosed to Freedom of Information Act ("FOIA") requestors by specifically requesting confidential treatment of audit documentation following the process described in Rule 83 of the Commission's Rules on Information and Requests.[517] The Commission anticipates that it will accord confidential treatment to such documents to the extent permitted by law.[518]

Two commenters requested that the Commission clarify the intended use of information and documents obtained from an independent public accountant.[519] One recommended that the Commission clarify that the information obtained from the independent public accountant not be

516 See KPMG Letter. See also Deloitte Letter, which suggests that Commission and DEA examiners first provide notice to the broker-dealer, in writing, of plans to request access to the broker-dealer's audit documentation and then make a written request to the accountant. Although, in practice, Commission and DEA examiners may provide advance or simultaneous notice to a broker-dealer of requests to access audit documentation from the broker-dealer's accountant, the Commission is not adopting a requirement that examiners so notify broker-dealers of such requests. This additional notification would likely delay an examiner's ability to gain access to the broker-dealer's audit documentation and is not necessary given the broker-dealer's prior consent. In addition, a broker-dealer can request that its accountant provide notice when examiners request audit documentation, and, expects that, in practice, accountants will provide such notice. See also E&Y Letter.

517 17 CFR 200.83. Generally, persons who submit information to the Commission may request that the Commission accord confidential treatment to the information for any reason permitted by federal law.

518 The Commission believes that this audit documentation likely would fall under exemptions (b)(8) and/or (b)(4) of FOIA. See 5 U.S.C. 522(b)(8); 5 U.S.C. 522(b)(4).

519 See E&Y Letter; PWC Letter.

used for any purpose other than in connection with a regulatory examination of the broker-dealer.[520] The other suggested that the rule text state that the requests for information should be solely for the purposes of conducting a regulatory examination of the clearing broker-dealer.[521] The Commission does not believe that it is necessary to modify the proposed rule text in response to these comments. The Commission stated that it did not propose that examiners would use the requested information for the purpose of inspecting independent public accountants.[522] As the Commission stated in the proposing release, the purpose of this access requirement is to enhance and improve the efficiency and effectiveness of Commission and DEA examinations of broker-dealers.[523] The PCAOB is responsible for inspections of independent public accountants that audit broker-dealers.[524] In response to these comments, the Commission reiterates its intention, as stated in the proposing release, that any requests for audit documentation under this provision would be made exclusively in connection with conducting a regulatory examination of a broker-dealer.[525]

One commenter stated that Commission and DEA examiners should be limited to inspecting audit documentation relating to a broker-dealer in the offices of the broker-dealer's independent public accountant and that the broker-dealer should be permitted to be present during conversations between Commission or DEA staff and the accountant.[526] The Commission has considered these comments and decided not to modify the proposal in response to these comments. However, Commission and DEA examiners may exercise discretion in

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520 See PWC Letter.

521 See E&Y Letter.

522 See Broker-Dealer Reports, 76 FR at 37583.

523 Id.

524 Id.

525 Id.

526 See SIFMA Letter.

determining whether to review audit documentation in the offices of the broker-dealer's accountant and whether to permit the broker-dealer to be present during conversations with the accountant. This commenter also requested that the Commission establish a process by which broker-dealers can object to overly broad or unduly burdensome requests.[527] The rule will not be modified in response to this comment and the Commission recommends that any concerns regarding the scope of audit documentation requests be directed to the examiner from whom the request was received. The examiner will consider the concerns and determine whether and how to limit the scope of the audit documentation request, if appropriate. The independent public accountant also can express concerns to senior examination staff if the scope of the audit documentation request remains a concern after discussions with the examiner.

Another commenter stated that the Commission must be responsible for returning all audit work papers that it receives for purposes of an examination of the broker-dealer to either the broker-dealer or its accountant.[528] The purpose of requesting access to audit documentation is to assist examiners in conducting a regulatory examination of the clearing broker-dealer. Upon completion of the examination, if the Commission and DEA, and any offices and divisions thereof, no longer need the audit documentation, the Commission and DEA will, upon the request of the independent public accountant and in the absence of unusual circumstances, return audit documentation to the independent public accountant or the broker-dealer within a reasonable time after the examination is complete.

One commenter stated that, if adopted, this requirement will discourage or "chill" communications between a broker-dealer and its auditor because "the broker-dealer knows that regardless of the nature of an auditing issue and how it was discovered . . . it cannot freely seek

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527 Id.

See CAI Letter.

advice from, or discuss the issue openly with[] the auditor[] without fear of the auditor misunderstanding the broker-dealer's response or simply drawing a conclusion that a broker-dealer's questions indicate the broker-dealer's lack of knowledge or admission of an issue."[529] Presumably, this "chilling effect" would result from a broker-dealer's desire to avoid the creation of audit documentation memorializing misunderstandings and miscommunications, which, when accessed by Commission and DEA examiners, could result in regulatory scrutiny. The Commission is not persuaded by this comment; while it is possible for miscommunications to occur between representatives of a broker-dealer and its auditor, potential misunderstandings or miscommunications should not limit the ability of the Commission or a DEA to have access to audit documentation or a broker-dealer's independent public accountant. Further, to the extent a misunderstanding or miscommunication between a broker-dealer and its accountant is reflected in the accountant's audit documentation relating to the broker-dealer, the broker-dealer could clarify the nature of the misunderstanding or miscommunication to examiners and explain how it was rectified if such clarification and rectification is not already described in subsequent audit documentation.

The same commenter also asserted that the requirement that broker-dealers allow regulators to access audit documentation may, in effect, require auditors to produce documentation protected by attorney-client privilege or accountant-client privilege.[530] The rule language providing Commission and DEA examiners with access to a broker-dealer's auditor and audit documentation is not designed to affect the circumstances in which privilege can be asserted. Any claims of privilege can be addressed on a case-by-case basis by appropriate Commission and DEA staff as those claims arise.

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529 Id.

530 Id.

IV. FORM CUSTODY

A. Background

Proposed Form Custody was comprised of nine line items (each, an "Item") designed to elicit information about a broker-dealer's custodial activities.[531] As is discussed below, several Items on the proposed form contained multiple questions, and some required the completion of charts and the disclosure of custody-related information specific to the broker-dealer completing the form.[532]

The Commission received nine comment letters on proposed Form Custody.[533] While commenters generally supported the proposed form, the Commission received several comments on the timing of, exemptions from, and the compliance date for filing the form and whether a broker-dealer also would be required to file an accountant's attestation covering the form.[534] In addition, several commenters suggested that the Commission make certain revisions to the form and address certain technical interpretative questions.[535] One commenter, who agreed "in concept" that Form Custody is appropriate for custodial broker-dealers, also stated that the aggregate cost estimate of the proposed form was "staggering."[536]

The Commission is adopting the requirement that broker-dealers file Form Custody with their DEAs, subject to modifications that, in part, respond to issues raised by commenters. A description of the comments on the proposed process for filing Form Custody is set forth below

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531 See Broker-Dealer Reports, 76 FR at 37584–37592.

532 Id.

533 See Angel Letter; Barnard Letter; CAI Letter; CFP Letter; E&Y Letter; IMS Letter; KPMG Letter; Shatto Letter; SIFMA Letter.

534 See CAI Letter; E&Y Letter; KPMG Letter; Shatto Letter; SIFMA Letter.

535 See Angel Letter; CFP Letter; SIFMA Letter.

536 See IMS Letter. This commenter, however, did not provide any suggestion for reducing the costs associated with Form Custody. See section VII. below for an economic analysis of the costs and benefits relating to Form Custody.

in section IV.B. of this release, together with a discussion of the final rule amendments that the Commission is adopting today. A description of the comments on the proposed form is set forth below in section IV.C. of this release, together with a discussion of the final form the Commission is adopting today.

B. Filing of Form Custody

1. Requirement to File Form Custody with FOCUS Reports

Under paragraph (a) of Rule 17a-5, a broker-dealer is required to file periodic FOCUS Reports with the Commission and the broker-dealer's DEA.[537] In the proposing release, the Commission proposed adding paragraph (a)(5) to Rule 17a-5 to require the filing of Form Custody, which was designed to elicit information concerning whether a broker-dealer maintained custody of customer and non-customer assets, and, if so, how such assets were maintained.[538] Under this proposed amendment, a broker-dealer would be required to file Form Custody with its DEA at the same time it filed its periodic FOCUS Report with its DEA under paragraph (a) of Rule 17a-5.[539] The DEA, in turn, would be required to maintain the information obtained through the filing of Form Custody and to transmit such information to the Commission

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537 See 17 CFR 240.17a-5(a); 17 CFR 249.617. FOCUS Reports are one of the primary means of monitoring the financial and operational condition of broker-dealers and enforcing the broker-dealer financial responsibility rules. The completed forms also are used to determine which firms are engaged in various securities-related activities and how economic events and government policies might affect various segments of the securities industry. The FOCUS Report was designed to eliminate overlapping regulatory reports required by various SROs and the Commission and to reduce reporting burdens as much as possible. FOCUS Reports and Form Custody are deemed confidential under paragraph (a)(3) of Rule 17a-5.

538 See Broker-Dealer Reports, 76 FR at 37592. For purposes of Form Custody, the term "customer" means a person that is a "customer" for purposes of Rule 15c3-3(a), and a "non-customer" means a person other than a "customer" as that term is defined in Rule 15c3-3(a). See 17 CFR 240.15c3-3(a); FINRA, Interpretations of Financial and Operational Rules, Rule 15c3-3(a)(1)/01, available at http://www.finra.org/Industry/Regulation/Guidance/FOR/.

539 See Broker-Dealer Reports, 76 FR at 37592.

at such time as it transmits FOCUS Report data to the Commission under paragraph (a)(4) of Rule 17a-5.[540]

A broker-dealer's FOCUS Report provides the Commission and a broker-dealer's DEA with information relating to the broker-dealer's financial and operational condition but does not solicit detailed information on how a broker-dealer maintains custody of assets.[541] Proposed Form Custody was intended to provide additional information about a broker-dealer's custodial activities and to make it easier for examiners to identify risks and possible violations of laws and regulations concerning the broker-dealer's custody of assets.[542] If, upon reviewing Form Custody, regulatory authorities were to become aware of inconsistencies or other red flags in information contained on the form, they could initiate a more focused and detailed analysis of the broker-dealer's custodial activities. Such an analysis could, in turn, identify potential abuses related to customer assets. Moreover, proposed Form Custody was intended to expedite the examination of a broker-dealer's custodial activities and reduce examination costs, as examiners would no longer need to request basic custody-related information already disclosed on the form.[543]

The Commission proposed that a broker-dealer file Form Custody with its DEA within 17 business days after the end of each calendar quarter and within 17 business days after the date selected for the broker-dealer's annual report where that date was other than the end of a calendar quarter.[544] The Commission received one comment regarding proposed paragraph

540 Id.

541 See Form X-17A-5 Schedule I, Part II, Part IIa, Part IIb, and Part III.

542 See Broker-Dealer Reports, 76 FR at 37585.

543 Id.

544 Id. at 37592.

(a)(5) of Rule 17a-5, which supported the Commission's proposal as to when a broker-dealer should be required to file Form Custody.[545]

The Commission is adopting paragraph (a)(5) of Rule 17a-5 substantially as proposed. As to when a broker-dealer must file its Form Custody with its DEA, the Commission is adopting its proposal that a broker-dealer file Form Custody with its DEA within 17 business days after the end of each calendar quarter.[546] However, for year end filings of Form Custody by a broker-dealer that has selected a fiscal year end date that is not the end of a calendar year, the Commission has modified its proposal to provide that a broker-dealer also must file Form Custody with its DEA within 17 business days after the end of the broker-dealer's fiscal year.[547]

The Commission did not receive any comments relating to when DEAs are required to transmit Form Custody information to the Commission and is adopting this requirement as proposed.

2. Requests for Exemption from Filing Form Custody

One commenter recommended that the Commission include a provision in Rule 17a-5 that would enable the Commission to exempt broker-dealers from the requirement to file Form Custody if the Commission determined that receiving the form for a particular firm, or type of firm, would serve no useful purpose.[548] For example, the commenter stated that no useful

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545 See Shatto Letter.

546 See paragraph (a)(5) of Rule 17a-5.

547 Id. Consistent with the proposal, a broker-dealer must file Form Custody with its DEA at the same time that the broker-dealer files its FOCUS Report with its DEA. However, since the final rule changes the date for the filing of the year end FOCUS Report to "within 17 business days after the end of the fiscal year where that date is not the end of a calendar quarter," the deadline for the year end filing of Form Custody is correspondingly changed to "within 17 business days after the end of the fiscal year of the broker or dealer where that date is not the end of a calendar quarter."

548 See CAI Letter.

purpose would be served by receiving Form Custody from a firm that has no customer or non-customer accounts.[549]

The Commission intends for all broker-dealers to file Form Custody without exception. The Commission is concerned about circumstances where broker-dealers falsely represent to regulators and others that they do not handle funds or securities or issue trade confirmations or account statements. One of the purposes of Form Custody is to assist Commission and DEA examiners in identifying potential misrepresentations relating to broker-dealers' custody of assets. Through Form Custody, examiners will be in a position to better understand a broker-dealer's custody profile and identify custody-related violations and misconduct. For example, if a broker-dealer represents on Form Custody that it does not issue account statements, but an examiner receives an account statement issued by the broker-dealer (e.g., in connection with a customer complaint or in the course of an examination of the broker-dealer), the examiner will be able to react more quickly to the misrepresentation. Further, the requirements to file the form will promote greater focus and attention to custody practices by requiring that broker-dealers make specific representations in this regard.

In addition, although the Commission does not currently contemplate any circumstance in which it would exempt a broker-dealer from having to file Form Custody, if the Commission subsequently determines that it is appropriate to exempt a broker-dealer, or type of broker-dealer, from such requirements, the Commission can act under existing authority. In particular, under section 36 of the Exchange Act, the Commission, by rule, regulation, or order, may exempt any person, or any class or classes of persons, from any rule under the Exchange Act to the extent

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Id.

that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors.[550]

Nonetheless, the Commission understands that a number of Items on Form Custody may not apply to certain types of broker-dealers (e.g., broker-dealers that do not carry customer, non-customer, or proprietary securities accounts) and has modified the form's instructions to make clear that questions on the form that cannot be answered because the broker-dealer does not engage in a particular activity do not need to be answered.[551]

3. Attest Engagement Not Required for Form Custody

In response to a question posed by the Commission in the proposing release, one commenter stated that the Commission should not require a broker-dealer to engage a PCAOB-registered independent public accountant to audit Form Custody.[552] This commenter stated that an audit of Form Custody is not necessary since the intent of the form is to gather custody-related information, which in some cases may not be derived from the broker-dealer's books and records.[553] This commenter also does not believe that the benefits of performing an audit of the information included on Form Custody would outweigh the costs or that an audit is necessary for the Commission to achieve its principal objective of using the information in the examination of a broker-dealer's custody activities.[554]

The Commission did not propose to require that a broker-dealer engage an independent public accountant to review Form Custody, and agrees that such a requirement should not be imposed. Accordingly, under today's amendments, broker-dealers are not required to enter into

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550 15 U.S.C. 78mm.

551 See General Instruction A to Form Custody.

552 See KPMG Letter. See also Broker-Dealer Reports, 76 FR at 37592.

553 See KPMG Letter.

554 Id.

an attestation engagement with an independent public accountant for purposes of reviewing Form Custody.

C. Form Custody

As is discussed above, proposed Form Custody was comprised of nine Items designed to elicit information about a broker-dealer's custodial activities. Set forth below is a description of each of the Items.

1. Item 1 – Accounts Introduced on a Fully Disclosed Basis

Item 1 consists of two subparts. Item 1.A, as proposed, would have elicited information concerning whether the broker-dealer introduced customer accounts to another broker-dealer on a fully disclosed basis by requiring the broker-dealer to check the appropriate "Yes" or "No" box.[555] Item 1.B of Form Custody would require broker-dealers that check "Yes" on Item 1.A to identify each broker-dealer to which customer accounts are introduced on a fully disclosed basis.[556] The Commission did not receive any comments on Item 1.A or 1.B and is adopting this Item as proposed.

As is discussed in the proposing release, many broker-dealers enter into agreements ("carrying agreements") with another broker-dealer in which the two firms allocate certain responsibilities with respect to the handling of accounts.[557] These carrying agreements are governed by applicable SRO rules, which require a broker-dealer entering into a carrying agreement to allocate certain responsibilities associated with introduced accounts.[558]

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555 See Broker-Dealer Reports, 76 FR at 37585. See AICPA Broker-Dealer Audit Guide glossary (defining the term fully disclosed basis as a "situation in which a nonclearing broker introduces a customer to a clearing broker and the customer's name and statement are carried by, and disclosed to, that clearing broker.").

556 See Broker-Dealer Reports, 76 FR at 37585.

557 Id.

558 See, e.g., FINRA Rule 4311.

Typically, under a carrying agreement, one broker-dealer ("introducing broker-dealer") agrees to act as the customer's account representative (e.g., by providing the customer with account opening documents, ascertaining the customer's investment objectives, and making investment recommendations). The carrying broker-dealer typically agrees to receive and hold the customer's cash and securities, clear transactions, make and retain records relating to the transactions and the receipt and holding of assets, and extend credit to the customer in connection with the customer's securities transactions.

Item 1.A, as adopted, elicits information concerning whether the broker-dealer introduces customer accounts to another broker-dealer on a fully disclosed basis, rather than asking whether the broker-dealer is an "introducing broker-dealer." The Commission is presenting the question in this manner because some broker-dealers operate as carrying broker-dealers (i.e., they hold cash and securities) for one group of customers but also introduce the accounts of a second group of customers on a fully disclosed basis to another broker-dealer. For example, a broker-dealer may incur the capital expense and cost of acting as a carrying broker-dealer for certain products (e.g., equities) but not for other products (e.g., options). In this case, the firm operates as a hybrid introducing/carrying broker-dealer by introducing on a fully disclosed basis to a carrying broker-dealer those customers that trade securities for which the broker-dealer is not prepared to provide a full range of services. Broker-dealers also may introduce customer accounts on an omnibus basis, as is discussed below in section IV.C.2. of this release.

If the broker-dealer answers Item 1.A by checking the "Yes" box, the broker-dealer will be required under Item 1.B to identify each broker-dealer to which customer accounts are introduced on a fully disclosed basis. The carrying broker-dealer in such an arrangement maintains the cash and securities of the introduced customers and is therefore obligated to return cash and securities to the introduced customers. Commission and DEA examiners could use the identification information provided by a broker-dealer in response to Item 1.B to confirm the existence of an introducing/carrying relationship.

2. Item 2 – Accounts Introduced on an Omnibus Basis

Item 2 of Form Custody consists of two subparts. Item 2.A, as proposed, would have elicited information concerning whether the broker-dealer introduced customer accounts to another broker-dealer on an omnibus basis by requiring the broker-dealer to check the appropriate "Yes" or "No" box.[559] Item 2.B, as proposed, would require a broker-dealer that checks "Yes" in response to Item 2.A to identify each broker-dealer to which customer accounts are introduced on an omnibus basis.[560] The Commission did not receive any comments on Items 2.A or 2.B and is adopting this Item as proposed.

An omnibus account is an account carried and cleared by another broker-dealer that contains accounts of undisclosed customers on a commingled basis and that are carried individually on the books of the broker-dealer introducing the accounts.[561] Disclosure of this information is important because when a broker-dealer introduces customer accounts to another broker-dealer on an omnibus basis, the introducing broker-dealer (in addition to the broker-dealer carrying the omnibus account) is considered to be a carrying broker-dealer with respect to those accounts under the Commission's broker-dealer financial responsibility rules.[562] Thus, in these arrangements, the broker-dealer introducing the omnibus account is obligated to return

559 See Broker-Dealer Reports, 76 FR at 37585–37586.

560 Id. at 37586.

561 See AICPA Broker-Dealer Audit Guide at ¶¶ 5.144–5.145.

562 See Net Capital Rule, Exchange Act Release No. 31511 (Nov. 24, 1992), 57 FR 56973, 56978 n.16 (Dec. 2, 1992).

cash and securities in the account to customers.[563]

If the broker-dealer checks the "Yes" box in Item 2.A, it will be required to identify in Item 2.B each broker-dealer to which accounts are introduced on an omnibus basis. Commission and DEA examiners could use this information to confirm whether the cash and securities introduced to the carrying broker-dealer are in fact being held in an omnibus account at the carrying broker-dealer and that the books and records of the broker-dealer that introduced the customer accounts to the carrying broker-dealer reflect the correct amounts of customer cash and securities held in the omnibus account.

3. Item 3 – Carrying Broker-Dealers

Item 3 of Form Custody, as proposed, would have elicited information concerning how a carrying broker-dealer held cash and securities.[564] Proposed Item 3 was comprised of five subparts, as described below.[565] Two commenters specifically addressed this Item, in particular regarding subparts 3.C., 3.D, and 3.E, which also are discussed below.[566]

i. Items 3.A and 3.B

The first question of Item 3 of proposed Form Custody – Item 3.A – would have elicited information concerning whether the broker-dealer carried securities accounts for customers by requiring the broker-dealer to check the appropriate "Yes" or "No" box.[567] The General Instructions to Form Custody specify that the term "customer" as used in the Form means a "customer" as defined in Rule 15c3-3.

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563 Id.

564 See Broker-Dealer Reports, 76 FR at 37586.

565 Id. at 37586–37589.

566 See CFP Letter; SIFMA Letter.

567 See Broker-Dealer Reports, 76 FR at 37586.

The next question of Item 3 – Item 3.B – would have elicited information concerning whether the broker-dealer carried securities accounts for persons that are not "customers" under the definition in Rule 15c3-3.[568] For example, under Rule 15c3-3, persons that are not "customers" include an accountholder that is a general partner, director, or principal officer of the carrying broker-dealer, and accountholders that are themselves broker-dealers.[569] The Commission did not receive any comments on Item 3.A or 3.B and is adopting these questions as proposed.

ii. Item 3.C

a. Background

Item 3.C, as proposed, would have required the broker-dealer to identify in three charts the types of locations where it held securities and the frequency with which it performed reconciliations between the information on its stock record and information on the records of those locations.[570] Each of these charts, which are set forth in Items 3.C.i through 3.C.iii, is discussed in more detail below.

b. General Comments to Item 3.C

One commenter suggested that it would be helpful to require the broker-dealer to disclose the identities of specific entities at which it custodies securities.[571] This commenter stated that such disclosure would allow regulators to identify potential discrepancies more easily, as well as changes in custody relationships that may warrant further investigations.[572]

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568 Id.

569 See 17 CFR 240.15c3-3(a)(1).

570 See Broker-Dealer Reports, 76 FR at 37586–37587.

571 See CFP Letter.

572 Id.

The Commission has considered this suggestion and determined that providing the identities of a broker-dealer's custodians instead of the types of locations would significantly increase the burden on broker-dealers in preparing the form, which is intended to be a starting point for Commission and DEA examiners in assessing a broker-dealer's compliance with its custody requirements. Large broker-dealers often maintain custody of customers' securities in many locations, which can total in the hundreds, particularly if the broker-dealer carries a large number of uncertificated investments for customers, such as alternative investments. Requiring broker-dealers to disclose this level of detail on Form Custody could significantly increase the costs of preparing the form for a number of broker-dealers. Although the Commission acknowledges that requiring the additional information the commenter suggested would enhance the ability of regulators to identify discrepancies, the Commission believes that the information on Form Custody provides sufficient information to allow examiners to determine whether it is appropriate to seek additional information from a particular broker-dealer. To the extent a Commission or DEA examiner believes that it is appropriate to obtain this information from a particular broker-dealer, the examiner could do so in a document request to that firm, a method that the Commission expects would be less costly than requiring this information from all broker-dealers on Form Custody. Accordingly, the Commission has determined not to require that broker-dealers identify on the form the specific identities of all of their custodians.

Another commenter to Item 3.C requested that the Commission clarify the distinction between "locations where the broker-dealer holds securities directly in the name of the broker-dealer" and "locations where the broker-dealer holds securities only through an intermediary."[573] In making this distinction, the Commission intended to distinguish between locations that are

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See SIFMA Letter.

aware of the identity of the broker-dealer and act directly upon the broker-dealer's instructions and locations that are not aware of the identity of the broker-dealer or that will not act on instructions directly from the broker-dealer. In the latter scenario, the location holding securities for the broker-dealer would act only on instructions relating to the broker-dealer's securities from the broker-dealer's intermediary. The Commission has modified the instructions to Item 3.C of Form Custody to reflect this clarification.

c. Item 3.C.i

The first chart in Item 3.C – set forth in Item 3.C.i – identifies the most common locations where broker-dealers hold securities. Many of the locations identified on the first chart, and described below, are locations deemed to be satisfactory control locations under paragraph (c) of Rule 15c3-3.[574] The Commission did not receive any comments on Item 3.C.i of proposed Form Custody and is adopting it as proposed.

The first location identified in the chart is the broker-dealer's vault. Broker-dealers primarily hold securities in fungible bulk at other institutions. In some cases, however, broker-dealers may physically hold securities certificates (e.g., in the case of restricted securities).

The second location identified in the chart is another U.S. registered broker-dealer. For example, a broker-dealer may hold customers' foreign securities at another U.S. broker-dealer, or may hold securities in an omnibus account at another broker-dealer.

The third and fourth locations identified in the chart are the Depository Trust Company and the Options Clearing Corporation. These are the two most common securities clearing and depository organizations for equities and options in the U.S. and, consequently, are identified by name rather than by type of location.

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574 See 17 CFR 240.15c3-3(c).

The fifth location identified in the chart is a U.S. bank. Broker-dealers may have arrangements with U.S. banks to receive and hold securities for the accounts of the broker-dealer's customers and non-customers, as well as for the broker-dealer's own account. Obtaining information about a broker-dealer's relationships with U.S. banks could enable examiners to test and confirm the accuracy of the broker-dealer's representations on Form Custody (i.e., that a U.S. bank holds securities for the broker-dealer), and, in addition, facilitate the collection of information regarding the relationship between the broker-dealer and the bank. For instance, customer fully paid and excess margin securities must be in the possession or control of the broker-dealer and therefore cannot be pledged as collateral for a loan to the broker-dealer, among other things, and customer margin securities may not be commingled with proprietary securities that are pledged as collateral for a bank loan. Form Custody could, for example, lead examiners to seek account statements and documentation governing the broker-dealer's relationship with the U.S. bank to ensure customer fully paid and excess margin securities are not pledged as collateral for a loan to the broker-dealer.

The sixth location identified in the chart is the transfer agent of an open-end investment management company registered under the Investment Company Act of 1940 (i.e., a mutual fund). Generally, mutual funds issue securities only in book-entry form. This means that the ownership of securities is not reflected on a certificate that can be transferred but rather through a journal entry on the books of the issuer maintained by the issuer's transfer agent. A broker-dealer that holds mutual funds for customers generally holds them in the broker-dealer's name on the books of the mutual fund.

d. **Item 3.C.ii**

The second chart in Item 3.C – set forth in Item 3.C.ii – is intended to capture all other types of U.S. locations where a broker-dealer may hold securities that are not specified in the chart included in Item 3.C.i. This category would include, for example, securities held in book-entry form by the issuer of the securities or the issuer's transfer agent. A broker-dealer that holds securities at such locations must list the types of locations in the spaces provided in the chart and indicate the frequency with which the broker-dealer performs asset reconciliations with those locations. The Commission did not receive any comments on Item 3.C.ii of proposed Form Custody and is adopting it as proposed.

e. **Item 3.C.iii**

The third chart in Item 3.C – set forth in Item 3.C.iii – pertains to foreign locations where the broker-dealer maintains securities. Under the proposal, the Commission did not list categories of foreign locations because terminology used to identify certain locations may differ by jurisdiction.[575] For example, in some foreign jurisdictions, banks may operate a securities business, making it difficult to classify whether securities are held at a bank or a broker-dealer. A broker-dealer that holds securities in a foreign location must list the types of foreign locations where it maintains securities in the spaces provided in the chart and indicate the frequency with which reconciliations are performed with the location. The Commission did not receive any comments on Item 3.C.iii of proposed Form Custody and is adopting it as proposed.

iii. **Items 3.D and 3.E**

Items 3.D and 3.E of proposed Form Custody each contained three identical subparts (discussed in more detail below) designed to elicit information about the types and amounts of

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See Broker-Dealer Reports, 76 FR at 37587.

securities and cash the broker-dealer held, whether those securities were recorded on the broker-dealer's stock record and, if not, why they were not recorded, and where the broker-dealer held free credit balances.[576] The General Instructions to proposed Form Custody defined "free credit balances" as liabilities of a broker-dealer to customers or non-customers which are subject to immediate cash payment to customers or non-customers on demand, whether resulting from sales of securities, dividends, interest, deposits, or otherwise.[577]

The difference between proposed Item 3.D and proposed Item 3.E is that the former would have elicited information with respect to securities and free credit balances held for the accounts of customers, whereas the latter would have elicited information with respect to securities and free credit balances held for the accounts of persons who are not customers.[578] Accordingly, the proposed form asked two sets of identical questions to elicit information about each category of accountholder – customer and non-customer.[579]

a. **Items 3.D.i and 3.E.i**

Items 3.D.i and 3.E.i of proposed Form Custody would have elicited information about the types and dollar amounts of the securities the broker-dealer carried for the accounts of customers and non-customers, respectively.[580] Specifically, for each Item, the broker-dealer would have been required to complete information on a chart to the extent applicable.[581] The proposed charts were comprised of twelve rows, with each row representing a category of

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576 Id. at 37587–37589.

577 This definition is similar to the definition of the term free credit balance in Rule 15c3-3, except that the definition in the rule is limited to liabilities to customers whereas the definition in the Form contemplates liabilities to customers and non-customers. See 17 CFR 240.15c3-3(a)(8).

578 See Broker-Dealer Reports, 76 FR at 37587–37589.

579 Id.

580 Id. at 37587.

581 Id.

security. These categories included: (1) U.S. Equity Securities; (2) Foreign Equity Securities; (3) U.S. Listed Options; (4) Foreign Listed Options; (5) Domestic Corporate Debt; (6) Foreign Corporate Debt; (7) U.S. Public Finance Debt; (8) Foreign Public Finance Debt; (9) U.S. Government Debt; (10) Foreign Sovereign Debt; (11) U.S. Structured Debt; and (12) Foreign Structured Debt. A thirteenth row was included in each chart to identify any securities not specifically listed in the first twelve rows. The types of securities were categorized this way because the various categories ordinarily are associated with certain types of locations. Thus, as examiners review the form, they could assess whether the types of securities held by the broker-dealer were maintained at locations generally known to hold such securities. If a broker-dealer's completed form indicated that some types of securities were held at a location atypical for such securities, the examiner could refine the focus of the examination to evaluate whether customer assets were properly safeguarded. The Commission is adopting these requirements, with modifications, as discussed below.

One commenter requested that the Commission clarify whether alternative investments, mutual funds, and exchange traded funds fall within the scope of "Other" securities within the thirteenth row of Items 3.D.i and 3.E.i.[582] The Commission has considered this comment and determined that those investments are other types of securities that should be part of Items 3.D.i and 3.E.i, but that it would be useful to separately identify each of these categories of securities in Items 3.D.i and 3.E.i, rather than group them together in the "Other" category. By identifying these types of investments separately on Form Custody, Commission and DEA examiners will have a better understanding of a broker-dealer's business activities and a more refined understanding of the types of securities held by the broker-dealer. This information, in turn,

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582 See SIFMA Letter.

could facilitate more focused examinations by Commission and DEA examiners. Accordingly, Items 3.D.i and 3.E.i of Form Custody, as adopted, will contain six additional rows to account for both domestic and foreign alternative investments (referred to on the form as "private funds"), mutual funds, and exchange traded funds. The Commission is referring to the term "private funds" on the form, rather than the term "alternative investments," for purposes of clarity; while both terms are often used interchangeably in practice, the term "private fund" is a regulatory term defined in other contexts of the securities laws (e.g., on Form ADV), whereas the term "alternative investments" is not. For purposes of Form Custody, the term "private fund" is given the same meaning as is used by the Commission on Form ADV – that is, an investment company as defined in section 3 of the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that Act. Items 3.D.i and 3.E.i of Form Custody and the related Instructions to those Items, as adopted, reflect these changes.

The charts in Items 3.D.i and 3.E.i, as proposed, would have each had eight columns. The first column contained boxes for each category of security specified in the Item (and identified in the second column), as discussed above.[583] The broker-dealer would have been required to check the box in each chart for every applicable category of security it holds for the accounts of customers and non-customers, respectively. The second column would have identified the category of security. The third through eighth columns represented ranges of dollar values: (1) up to $50 million; (2) greater than $50 million up to $100 million; (3) greater than $100 million up to $500 million; (4) greater than $500 million up to $1 billion; (5) greater than $1 billion up to $5 billion; and (6) greater than $5 billion. In each chart, the broker-dealer would have been required to check the box in the column reflecting the approximate dollar value

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See Broker-Dealer Reports, 76 FR at 37587.

for every category of security that the broker-dealer carried for the accounts of customers and non-customers, respectively.[584]

The Commission proposed identifying dollar ranges for the values of the securities, as opposed to actual values, to ease compliance burdens.[585] The intent was to elicit information about the relative dollar value of securities the broker-dealer held for customers and non-customers in each category of security. Values would be reported as of the date specified in the broker-dealer's accompanying quarterly FOCUS Report.

One commenter noted that the charts set forth in Items 3.D.i and 3.E.i of proposed Form Custody did not include boxes to check to reflect the approximate dollar values for the categories of securities the broker-dealer carried for the accounts of customers and non-customers.[586] This commenter requested guidance on whether broker-dealers would be required to populate the chart with checkmarks or more precise estimates of market value.[587] The Commission intended to include boxes to check to reflect approximate dollar values in the charts set forth in Items 3.D.i and 3.E.i of proposed Form Custody, and the form, as adopted, includes these boxes.

b. Items 3.D.ii and 3.E.ii

Items 3.D.ii and 3.E.ii of proposed Form Custody would have elicited information concerning whether the broker-dealer had recorded all the securities it carried for the accounts of customers and non-customers, respectively, on its stock record by requiring the broker-dealer to check the appropriate "Yes" or "No" box.[588] If the broker-dealer checked "No," it would have been required to explain in the space provided why it had not recorded such securities on its

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584 Id.

585 Id.

586 See SIFMA Letter.

587 Id.

588 See Broker-Dealer Reports, 76 FR at 37587.

stock record and indicate the type of securities and approximate U.S. dollar market value of such unrecorded securities.[589] The Commission did not receive any comments on Items 3.D.ii and 3.E.ii of proposed Form Custody and is adopting these Items as proposed.

The Commission anticipates that a broker-dealer ordinarily would answer "Yes" in response to Items 3.D.ii and 3.E.ii because the stock record – which a broker-dealer is required to create pursuant to Rule 17a-3[590] – is a record of custody of securities. A long position in the stock record indicates ownership of the security or a right to the possession of the security. Thus, the "long side" of the stock record indicates the person to whom the broker-dealer owes the securities. Common examples of "long side" positions are securities received from customers (e.g., fully paid or excess margin securities), securities owned by the firm (i.e., securities held in the broker-dealer's inventory for its own account), securities borrowed, and fails-to-deliver (i.e., securities sold to or through another broker-dealer but not delivered).

A short position in the stock record indicates either the location of the securities or the responsibility of other parties to deliver the securities to the broker-dealer. Every security owned or held by the broker-dealer must be accounted for by its location. Since securities are fungible, the short side of the stock record does not in fact designate where particular securities are located. Rather, it indicates the total amount of securities, on a security-by-security basis, held at each location, which could include, for example, securities depositories. Common short-side stock record locations also include banks (e.g., when a broker-dealer pledges securities to a bank as collateral for a loan), stock loan counterparties (e.g., when a broker-dealer lends securities to another firm as part of a securities lending transaction), and counterparties failing to deliver

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[589] Id.

[590] See 17 CFR 240.17a-3(a)(5).

securities to the broker-dealer (e.g., when the broker-dealer has purchased securities that have not yet been received from the counterparty).

The Commission's goals in asking this question were twofold. First, the question would elicit the disclosure of the unusual circumstance in which a broker-dealer carries securities for the account of a customer or non-customer but does not reflect them on its stock record.[591] The Commission and other securities regulators could use this information to assess whether the broker-dealer is properly accounting for securities. Second, this question could prompt a broker-dealer to identify, and self-correct, circumstances in which it did not include securities on its stock record as required by Rule 17a-3.[592]

c. Items 3.D.iii and 3.E.iii

Items 3.D.iii and 3.E.iii of proposed Form Custody would have elicited information as to how the broker-dealer treated free credit balances in securities accounts of customers and non-customers, respectively.[593] The information would have been elicited through a chart the broker-dealer would be required to complete. The chart in Item 3.D.iii of proposed Form Custody had five rows with each row representing a different process for treating free credit balances. The chart would have disclosed whether free credit balances were: (1) included in a computation under Rule 15c3-3(e); (2) held in a bank account under Rule 15c3-3(k)(2)(i); (3) swept to a U.S. bank; (4) swept to a U.S. money market fund; and/or (5) "other," with a space to describe such other treatment. The options were not intended to be mutually exclusive in that a broker-dealer may treat free credit balances in several different ways (e.g., a broker-dealer may be instructed by certain customers to sweep their free credit balances to a bank, and by other customers to

591 See Broker-Dealer Reports, 76 FR at 37588.

592 Id.

593 Id.

sweep their free credit balances to a U.S. money market fund). The Commission did not receive any comments on Items 3.D.iii and 3.E.iii of proposed Form Custody and is adopting these Items as proposed.

A broker-dealer will be required to check the box in the first column of the chart for every process that applies to the broker-dealer's treatment of free credit balances in customer and non-customer accounts, respectively. The first process identified on each chart is that the broker-dealer treats customer and non-customer free credit balances in accordance with the customer reserve computation required under paragraph (e) of Rule 15c3-3. Paragraph (e) of Rule 15c3-3 requires a broker-dealer to maintain a special reserve bank account for the exclusive benefit of its customers and maintain deposits in that account (to the extent a deposit is required) in amounts computed in accordance with Exhibit A to Rule 15c3-3.[594] Rule 15c3-3 requires that a broker-dealer comply with these reserve account provisions only with respect to customer-related credit balances. The Commission has, however, proposed amendments to Rule 15c3-3 that would require a broker-dealer to maintain a reserve account and perform a reserve computation for non-customer accountholders that are domestic and foreign broker-dealers.[595]

The second process identified on the chart is that the broker-dealer handles free credit balances by placing funds in a "bank account under Rule 15c3-3(k)(2)(i)." Paragraph (k)(2)(i) of Rule 15c3-3 prescribes a process by which a broker-dealer can qualify for an exemption from the requirements of Rule 15c3-3. Specifically, the exemption applies to a broker-dealer that does not carry margin accounts, promptly transmits all customer funds and delivers all securities received

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594 See Rule 15c3-3(e) and Rule 15c3-3a.

595 See Amendments to Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 55431 (Mar. 9, 2007), 72 FR 12862 (Mar. 19, 2007); Amendments to Financial Responsibility Rules for Broker-Dealers (Reopening of Comment Period), Exchange Act Release No. 34-66910 (May 3, 2012), 77 FR 27150 (May 9, 2012). See also letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Raymond J. Hennessy, Vice President, New York Stock Exchange ("NYSE"), and Thomas Cassella, Vice President, NASD Regulation, Inc. (Nov. 10, 1998).

in connection with its activities, does not otherwise hold funds or securities for, or owe money or securities to, customers and effectuates all financial transactions between the broker-dealer and its customers through one or more bank accounts that are each designated as a "Special Account for the Exclusive Benefit of Customers of (the name of broker or dealer)."[596]

The third process identified in the chart – "swept to a U.S. bank" – is included because some broker-dealers engage in "bank sweep programs." Rather than hold customer funds in securities accounts, some broker-dealers require or offer the option to transfer free credit balances in securities accounts to a specific money market fund or interest bearing bank account ("Sweep Programs"). The customer earns dividends on the money market fund or interest on the bank account until such time as the customer chooses to liquidate the position in order to use the cash, for example, to purchase securities.[597] Customers must make a request to the broker-dealer for the return of funds swept from their securities accounts to the bank.

The fourth option identified in the chart is that the broker-dealer sweeps free credit balances into a money market fund as part of a Sweep Program. In most cases when a broker-dealer sweeps free credit balances into a money market fund, the broker-dealer purchases shares in the money market fund, which are registered in the name of the broker-dealer. The money market fund understands that these shares are not proprietary positions of the broker-dealer, and any interest earned on the shares from the money market fund are payable to the customers.

Finally, the fifth option in the chart covers any other process that is not described in the other options.

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596 See 17 CFR240.15c3-3(k)(2)(i).

597 See Amendments to Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 55431 (Mar. 9, 2007), 72 FR 12862 (Mar. 19, 2007) at 12866.

4. Item 4 – Carrying for Other Broker-Dealers

Item 4 of proposed Form Custody would have required a broker-dealer to disclose whether it acted as a carrying broker-dealer for other broker-dealers.[598] There were two sets of questions in Item 4 – Item 4.A.i, ii, and iii and Item 4.B.i, ii, and iii. The first set of questions would have elicited information from a broker-dealer as to whether it carried transactions for other broker-dealers on a fully disclosed basis.[599] The second set of questions would have elicited information from a broker-dealer as to whether it carried transactions for other broker-dealers on an omnibus basis.[600] The Commission did not receive any comments to Item 4 of proposed Form Custody and is adopting this Item as proposed.

Items 4.A.i and 4.B.i require a broker-dealer to indicate by checking the appropriate "Yes" or "No" box whether it carries customer accounts for another broker-dealer on a fully disclosed basis and on an omnibus basis, respectively. Items 4.A.ii and 4.B.ii require a broker-dealer, if applicable, to indicate the number of broker-dealers with which it has an arrangement to carry accounts on a fully disclosed basis and on an omnibus basis, respectively. Items 4.A.iii and 4.B.iii require a broker-dealer, if applicable, to identify any affiliated broker-dealers that introduce accounts to the broker-dealer on a fully disclosed basis and on an omnibus basis, respectively.

As the Commission has noted, related person custody arrangements can present higher risks to "advisory clients" than maintaining assets with an independent custodian.[601] Consistent with the definition of the term in other contexts applicable to broker-dealers, including Form

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598 See Broker-Dealer Reports, 76 FR at 37589.

599 Id.

600 Id.

601 See Custody of Funds or Securities of Clients by Investment Advisers, 75 FR at 1462.

BD,[602] the General Instructions for Form Custody define the term "affiliate" as any person who directly or indirectly controls the broker-dealer or any person who is directly or indirectly controlled by or under common control with the broker-dealer. The definition also specifies that ownership of 25% or more of the common stock of the broker-dealer introducing accounts to the broker-dealer submitting the Form Custody is deemed prima facie evidence of control; this provision also is consistent with the definition used in Form BD.[603]

Item 4 in Form Custody elicits information about broker-dealers' custodial responsibilities with respect to accounts held for the benefit of other broker-dealers, and requires broker-dealers to identify such broker-dealers that are affiliates of the broker-dealer.[604] The Commission believes that this information will provide the Commission with an enhanced understanding of, and useful and readily available information relating to, the scope of broker-dealer introducing/carrying relationships and activities, and the custodial practices of broker-dealers involved in such relationships.

5. Item 5 – Trade Confirmations

Item 5 of Form Custody, as proposed, would have required broker-dealers to disclose whether they send transaction confirmations to customers and other accountholders by checking

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602 Form BD is the uniform application for broker-dealer registration with the Commission. Form BD states that a person is presumed to control a company if, among other things, that person has directly or indirectly the right to vote 25% or more of a class of a voting security or has the power to sell or direct the sale of 25% or more of a class of voting securities, or, in the case of a partnership, the right to receive upon dissolution, or has contributed, 25% or more of the firm's capital.

603 This definition of the term affiliate is the same as the definition in Form BD, including the specification that ownership of 25% or more of the common stock is deemed prima facie evidence of control.

604 Form Custody does not require a broker-dealer to identify unaffiliated broker-dealers for which it carries accounts, though, as discussed above, it would need to indicate that it carries accounts for such broker-dealers. The Commission believes that this approach provides the Commission and DEA examiners with access to useful information involving a broker-dealer's custody practices while alleviating potential time and cost burdens associated with completing Form Custody given that some broker-dealers carry accounts for hundreds of unaffiliated broker-dealers. The Commission notes that information about these broker-dealers would be part of the books and records of the carrying broker-dealer. Therefore, an affirmative answer to Item 4 could prompt the Commission and DEA examiners to request information about the identities of the unaffiliated broker-dealers. See Broker-Dealer Reports, 76 FR at 37589 n.143.

the appropriate "Yes" or "No" box.[605] Confirmations are important safeguards that enable customers to monitor transactions that occur in their securities accounts. Timely confirmations alert customers of unauthorized transactions and provide customers with an opportunity to object to the transactions. The Commission received one comment on Item 5 of proposed Form Custody. As discussed below, the Commission is modifying the instructions to Item 5 in response to this comment and is otherwise adopting Item 5 as proposed.

Exchange Act Rule 10b-10 specifies the information a broker-dealer must disclose to customers on a trade confirmation at or before completion of a securities transaction.[606] Generally, Rule 10b-10 requires a confirmation to include, among other things: (1) the date and time of the transaction and the identity, price, and number of shares or units (or principal amount) of such security purchased or sold by such customer; (2) the broker-dealer's capacity (agent or principal) and its compensation; (3) the source and amount of any third party remuneration it has received or will receive; and (4) other information, both general (e.g., that the broker-dealer is not a SIPC member, if such is the case) and transaction-specific (e.g., certain yield information in most transactions involving debt securities).[607]

The information contained on a trade confirmation should reconcile with customer statements and the broker-dealer's journal entries.[608] In this regard, there is a link between trade confirmations sent by a broker-dealer and the broker-dealer's records pertaining to custody of

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605 See Broker-Dealer Reports, 76 FR at 37589–37590.

606 17 CFR 240.10b-10.

607 Id.

608 See 17 CFR 240.17a-3(a)(1), which requires the broker-dealer to make "[b]lotters (or other records of original entry) containing an itemized daily record of all purchases and sales of securities, all receipts and deliveries of securities (including certificate numbers), all receipts and disbursements of cash and all other debits and credits. Such records shall show the account for which each such transaction was effected, the name and amount of securities, the unit and aggregate purchase or sale price (if any), the trade date, and the name or other designation of the person from whom purchased or received or to whom sold or delivered."

customer assets.[609] How a broker-dealer answers Item 5 could assist examiners in focusing their inspections. For example, if the form indicates that a third party is responsible for sending trade confirmations, the examiners can confirm with that third party that it is in fact sending confirmations.

With respect to Item 5.A, one commenter requested clarification as to whether a broker-dealer should indicate that it sends trade confirmations directly to customers (by checking "yes") where it employs a vendor to do so.[610] The Commission has considered this comment and determined that a broker-dealer should affirmatively respond to Item 5 of Form Custody, as adopted, by checking the "yes" box on the form if it employs a vendor to send trade confirmations to customers on its behalf because, in such an arrangement, the broker-dealer is ultimately responsible for complying with its trade confirmation obligations, not the vendor. The Commission has modified the instructions to Item 5 to reflect this clarification.

6. Item 6 – Account Statements

Item 6 of proposed Form Custody would have required broker-dealers to disclose whether they send account statements directly to customers and other accountholders by checking the appropriate "Yes" or "No" box.[611] The Commission received one comment on Item 6 of proposed Form Custody.[612] As is discussed below, the Commission is modifying the instructions to Item 6 in response to this comment and is otherwise adopting Item 6 as proposed.

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609 Although broker-dealers may allocate the function of sending confirmations to other broker-dealers or to service providers, the allocating broker-dealer retains the responsibility for sending confirmations. See New York Stock Exchange, Inc.; Order Approving Proposed Rule Change, Exchange Act Release No. 18497 (Feb. 19, 1982), 47 FR 8284 (Feb. 25, 1982) at n.2 (providing "no contractual arrangement for the allocation of functions between an introducing and carrying organization can operate to relieve either organization from their respective responsibilities under the federal securities laws and applicable SRO rules").

610 See SIFMA Letter.

See Broker-Dealer Reports, 76 FR at 37590–37591.

See SIFMA Letter.

Account statements generally are sent to customers and other accountholders on a monthly or quarterly basis and typically set forth the assets held in the investor's securities account as of a specific date and the transactions that occurred in the account during the relevant period. SROs impose requirements on broker-dealers with respect to the statements they must send to their customers.[613] For example, FINRA generally requires any member that conducts a general securities business and also carries customer accounts or holds customer funds or securities, at least once each calendar quarter, to send an account statement to each customer whose account had a security position, money balance, or account activity since the last statement was sent.[614] The account statement must contain a description of any securities positions, money balances, or account activity in the account. In addition, the account statement must include a statement that advises the customer to report promptly any inaccuracy or discrepancy in that person's account to the brokerage firm.[615] The statement also is required to advise the customer that any oral communications made to the broker-dealer regarding inaccuracies or discrepancies should be re-confirmed in writing to further protect the customer's rights, including rights under SIPA.[616]

Like trade confirmations, account statements are important safeguards that allow investors to monitor transactions that occur in their securities accounts. If the account statements

613 See, e.g., NASD Rule 2340.

614 See NASD Rule 2340. NASD Rule 2340 defines a general securities member as any member that conducts a general securities business and is required to calculate its net capital pursuant to Rule 15c3-1. NASD Rule 2340(d)(2). Additionally, NASD Rule 2340 defines account activity broadly so that it includes, but is not limited to, purchases, sales, interest credits or debits, charges or credits, dividend payments, transfer activity, securities receipts or deliveries and/or journal entries relating to securities or funds in the possession or control of the member. NASD Rule 2340(d)(1). See also Order Approving Proposed Rule Change Relating to Rule 2340 Concerning Customer Account Statements, Exchange Act Release No. 54411 (Sept. 7, 2006), 71 FR 54105 (Sept. 13, 2006) (order granting approval of a proposed rule change relating to Rule 2340 concerning customer account statements).

615 If the customer's account is serviced by both an introducing broker-dealer and a clearing broker-dealer, the statement must inform customers that such reports must be made to both firms. See NASD Rule 2340(a).

616 Id.

are sent by a broker-dealer other than the broker-dealer completing Form Custody, this fact will need to be disclosed on the Form in Item 6.B. Item 6.C asks whether the broker-dealer sends account statements to anyone other than the beneficial owner of the account.[617] In response to a request for clarification raised by one commenter to proposed Item 6.C,[618] a broker-dealer also would check "Yes" to Item 6.C if the broker-dealer sends account statements to the beneficial owner of an account and duplicate account statements to persons other than the beneficial owner of the account. The Commission has modified the instructions to Item 6 to reflect this clarification.

The Commission is requiring broker-dealers to answer the questions in Item 6 to enhance its understanding of a broker-dealer's relationship with customers, particularly in the context of the broker-dealer's custodial responsibilities. Broker-dealers do not currently disclose to the Commission whether they send account statements directly to customers. Collecting this information on Form Custody will provide examiners with additional background information that could be used to refine the focus of their inspections. Further, the Commission anticipates that examiners would make further inquiries to the extent the Form reveals answers that are inconsistent with industry practice.

A review of Item 6 also may facilitate an examiner's preparation for an inspection. For example, if a broker-dealer indicates on Form Custody that it holds customer accounts and sends account statements to customers, the examiner could prepare a more targeted document request to the broker-dealer. In this regard, an examiner could request customer account statements from the broker-dealer, as well as statements from the custodian(s) of the broker-dealer's customer

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617 Generally, the beneficial owner of an account represents the person entitled to the economic benefits of ownership. With respect to securities, the term beneficial owner is defined in Rule 13d-3 under the Exchange Act. See 17 CFR 240.13d-3.

618 See SIFMA Letter.

securities and cash.[619] Examiners could then review and reconcile these documents to verify whether customer securities and cash are held at the custodian(s) identified by the broker-dealer.

7. Item 7 – Electronic Access to Account Information

Item 7 of proposed Form Custody would have required broker-dealers to indicate whether they provided customers and other accountholders with electronic access to information about the securities and cash positions in their accounts by checking the appropriate "Yes" or "No" box.[620] Electronic access to account information can provide investors with an efficient means of monitoring transactions that occur in their securities accounts. This inquiry would inform the Commission as to how readily customers are able to access and review their account information. The Commission did not receive any comments to Item 7 of proposed Form Custody and is adopting this Item as proposed.

The Commission believes that electronic access to account information is beneficial to customers, who can more easily monitor the performance of their accounts and perhaps more quickly identify any discrepancies or inaccuracies. The Commission is including this Item in Form Custody because it will help to inform examiners as to how readily customers can access and review account information.

8. Item 8 – Broker-Dealers Registered as Investment Advisers

Item 8 of Form Custody, as proposed, would have elicited information, if applicable, as to whether and how the broker-dealer operated as an investment adviser.[621] Proposed Item 8 was comprised of three subparts, as described below.

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619 As is discussed above in section IV.C.3. of this release, the fact that a broker-dealer uses a custodian to hold customer securities and cash, and the type of custodian, will be disclosed in response to Items 3.C and 3.D of Form Custody.

620 See Broker-Dealer Reports, 76 FR at 37591.

621 Id. at 37591–37592.

The first question of Item 8 – Item 8.A – would have required the broker-dealer to indicate whether it was registered as an investment adviser with the Commission under the Advisers Act or with one or more states pursuant to the laws of a state.[622] If the broker-dealer indicated that it was registered with the Commission under the Advisers Act or pursuant to state law (or both), then it would have been required to respond to the remaining questions under Item 8.[623]

The next question of Item 8 of proposed Form Custody – Item 8.B – would have required the broker-dealer to disclose the number of its investment adviser clients.[624] This would provide the Commission with information about the scale of the broker-dealer's investment adviser activities.

The third question of Item 8 of proposed Form Custody – Item 8.C – would have required the broker-dealer to complete a chart, consisting of six columns, in which the broker-dealer would have provided information about the custodians where the assets of the investment adviser clients were held.[625] In the first column, the broker-dealer would have been required to disclose

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622 Id. Section 203A of the Advisers Act prohibits certain investment advisers from registering with the Commission based on the advisers' assets under management, among other factors. See 17 CFR 275.203A.

623 See Broker-Dealer Reports, 76 FR at 37591.

624 Id.

625 Id. Under Rule 206(4)-2, it is a "fraudulent, deceptive, or manipulative act, practice or course of business" for an investment adviser registered or required to be registered under section 203 of the Advisers Act (15 U.S.C. 80b-3) to have custody of client funds or securities unless, among other things, a qualified custodian maintains those funds or securities. See 17 CFR 275.206(4)-2(a)(1). A qualified custodian is: (1) a bank as defined in section 202(a)(2) of the Advisers Act or savings association as defined in section 3(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(b)(1)) that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (2 U.S.C. 1811); (2) a broker-dealer registered under section 15(b)(1) of the Exchange Act holding the client assets in customer accounts; (3) an FCM registered under section 4f(a) of the Commodity Exchange Act (7 U.S.C. 6f(a)), holding the client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and (4) a foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets. See 17 CFR 275.206(4)-2(d)(6). A qualified custodian must maintain client funds and securities: (1) in a separate account for each client under that client's name;

the name of the custodian, and in the second column, the broker-dealer would have been required to identify the custodian by either SEC file number or CRD number, as applicable.[626]

The third and fourth columns of the chart would have elicited information about the scope of the broker-dealer/investment adviser's authority over the accounts held at the custodian by requiring the broker-dealer/investment adviser to check the appropriate "Yes" or "No" box.[627] Specifically, in the third column, the broker-dealer/investment adviser would have been required to indicate whether it had the authority to effect transactions in the advisory client accounts at the custodian. In the fourth column, the broker-dealer/investment adviser would have been required to indicate whether it had the authority to withdraw funds and securities from those accounts.

In the fifth column, the broker-dealer/investment adviser would have been required to indicate whether the custodian sends account statements directly to the broker-dealer's investment adviser clients.[628] The Commission recently adopted amendments to Rule 206(4)-2 to require that investment advisers have a reasonable basis, after due inquiry, for believing that qualified custodians of advisory client assets send account statements to the investment advisers' clients. As stated in the release adopting that requirement, the Commission believes that the direct delivery of account statements by qualified custodians provides greater assurance of the integrity of account statements received by clients.[629]

In the sixth column, the broker-dealer/investment adviser would have been required to indicate whether investment adviser client assets were recorded on the broker-dealer's stock

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or (2) in accounts that contain only the clients' funds and securities, under the investment adviser's name as agent or trustee for the clients. See 17 CFR 275.206(4)-2(a)(1).

626 See Broker-Dealer Reports, 76 FR at 37591.

627 Id.

628 Id.

629 See, e.g., Custody of Funds or Securities of Clients by Investment Advisers, 75 FR at 1465.

record.[630] If the broker-dealer was acting as custodian for such assets, the Commission anticipates that those assets would be recorded on the broker-dealer's stock record.[631]

The Commission received one comment in response to Item 8 of Form Custody, as proposed.[632] This commenter stated that the information sought in Item 8 was largely redundant with information collected from investment advisers on Form ADV. The Commission is aware that some overlap exists between the information collected from investment advisers on Form ADV and the information that would be collected from broker-dealers dually-registered as investment advisers in Item 8 of proposed Form Custody. However, these two forms also contain a significant amount of non-overlapping material, reflecting their different purposes and uses. Form Custody is intended to be a single source of readily-available information to assist Commission and DEA examiners in preparing for and performing focused custody exams, and it is particularly important that such information be readily available in the case of dually-registered firms. Accordingly, the Commission is adopting Item 8 of Form Custody substantially as proposed.[633]

9. Item 9 – Broker-Dealers Affiliated with Investment Advisers

Item 9 of Form Custody consists of two subparts. Item 9.A, as proposed, would have elicited information concerning whether the broker-dealer was an affiliate of an investment

630 See Broker-Dealer Reports, 76 FR at 37591.

631 If the broker-dealer acts as custodian for an investment adviser client's securities, and does not record those securities on its stock record, the broker-dealer would need to explain why those securities were not recorded on its stock record in response to the question in Item 3.D.ii of Form Custody.

632 See Angel Letter.

633 Column 2 of Item 8.C of Form Custody, as proposed, would have required a broker-dealer/investment adviser to identify the SEC File No. or CRD No. of each custodian where assets of investment adviser clients were held. However, not all custodians of investment adviser client assets have an SEC File No. or CRD No. Accordingly, the instructions applicable to Column 2 of Item 8.C, as adopted, have been modified to provide that a broker-dealer needs to identify custodians in the column by SEC File No. or CRD No., "if applicable." Thus, a broker-dealer can leave Column 2 of Item 8.C blank if assets of its investment adviser clients are held at a custodian that does not have an SEC File No. or CRD No.

adviser.[634] Item 9.B.i, as proposed, would have elicited information from a broker-dealer that checks "Yes" in response to Item 9.A to identify whether it has custody of client assets of the adviser, and, if Item 9.B.i is checked "Yes," to indicate the approximate U.S. dollar market value of the adviser client assets of which the broker-dealer has custody.[635] The Commission did not receive any comments to Item 9 of proposed Form Custody and is adopting this Item as proposed. The additional information obtained from a broker-dealer in response to Item 9 will provide SEC and DEA examiners with a better understanding of a broker-dealer's custody profile and, in particular, custodial relationships with investment adviser affiliates.

For purposes of Item 9, an affiliate is any person who directly or indirectly controls the broker-dealer or any person who is directly or indirectly controlled by or under common control with the broker-dealer. Ownership of 25% or more of the common stock of the investment adviser is deemed prima facie evidence of control.[636]

V. EFFECTIVE DATES

As discussed below, the Commission has established December 31, 2013 as the effective date for the requirement to file Form Custody and the requirement to file annual reports with SIPC. The Commission is delaying the effective date for the requirements relating to broker-dealer annual reports to June 1, 2014. These delayed effective dates are intended to provide time for broker-dealers, broker-dealer independent public accountants, and broker-dealer DEAs to prepare for the changes that will result from these new requirements. The amendments relating to broker-dealer annual reports and the other amendments to Rule 17a-5 (including the technical amendments) affect numerous paragraphs in that rule and two paragraphs in Rule 17a-11. Given

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634 See Broker-Dealer Reports, 76 FR at 37592.

635 Id.

See supra note 603 and corresponding text which specifies the same ownership percentage on Form BD.

the complexity and practical difficulty of having certain provisions become effective before others, the amendments to Rule 17a-5 and the amendments to Rule 17a-11 will become effective on June 1, 2014, regardless of whether they relate to the annual report requirements, except that there will be different effective dates for the amendments to paragraph (a) of Rule 17a-5 (which includes the filing requirement for Form Custody), Form Custody, the deletion of paragraph (e)(5) of Rule 17a-5 (which sets forth the requirement to file Form BD-Y2K), and the requirement to file annual reports with SIPC. The effective dates for the remaining paragraphs of Rule 17a-5 and Rule 17a-11 are discussed further below.

A. Amendments Effective 60 Days of After Publiction in the Federal Register

Before today's amendments, paragraph (e)(5) of Rule 17a-5 required a broker-dealer to file Form BD-Y2K, which elicits information with respect to a broker-dealer's readiness for the year 2000 and any potential problems that could arise with the advent of the new millennium. The Commission is deleting this paragraph from Rule 17a-5 as the requirement is no longer applicable. The amendment deleting paragraph (e)(5) of Rule 17a-5 will be effective 60 days after this release is published in the Federal Register.

B. Amendments Effective on December 31, 2013

The amendments to paragraph (a) of Rule 17a-5 and the rule establishing Form Custody (17 CFR 249.639) are effective on December 31, 2013. The amendments to paragraph (a) include the requirement for a broker-dealer to file Form Custody with its DEA.[637] Consequently, broker-dealers subject to this filing requirement must begin filing Form Custody with their DEAs 17 business days after the calendar quarter or fiscal year, as applicable, ended December 31, 2013.

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[637] See paragraph (a)(5) of Rule 17a-5.

Two commenters requested that the Commission provide broker-dealers with sufficient time to develop, test, and implement the systems that they will use to comply with the Form Custody filing requirements.[638] The Commission understands that broker-dealers will need to allocate personnel and systems resources to comply with the Form Custody filing requirements, particularly for a broker-dealer's initial filing. DEAs also will need to be prepared to receive the forms that are filed by broker-dealers. Establishing December 31, 2013 as the effective date of the Form Custody requirements is designed to accommodate the efforts that need to be undertaken by both broker-dealers and DEAs in connection with the filing and receipt of Form Custody.

Additionally, the amendment to paragraph (d)(6) of Rule 17a-5 is effective on December 31, 2013. Broker-dealer annual reports must be filed with SIPC for fiscal years ending on or after December 31, 2013.

C. Amendments Effective on June 1, 2014

The amendments to paragraphs (b), (c), (d)(1), (d)(2), (d)(3), (d)(4), (d)(5), (e)(1), (e)(2), (e)(3), (e)(4), (f), (g), (h), (i), (k), (l), (m) and (n) and the deletion of paragraph (j) of Rule 17a-5 and the amendments to Rule 17a-11 are effective on June 1, 2014. Consequently, all of the amendments to Rule 17a-5 not discussed above in sections V.A. and V.B. of this release and the amendments to Rule 17a-11 are effective on that date. This includes the amendments relating to the annual report requirements, with the exception of the requirement to file annual reports with SIPC, which is effective on December 31, 2013. In 2014, therefore, the annual report requirements will apply to all broker-dealers subject to these requirements that have a fiscal year ending on or after June 1, 2014.

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638 See E&Y Letter; SIFMA Letter.

The Commission proposed that the amendments would apply for fiscal years ending on or after December 15, 2011, with a first-year transition period for carrying broker-dealers required to file compliance reports with fiscal years ending on or after December 15, 2011 but before September 15, 2012.[639] The Commission received 14 comments concerning the compliance date of the amendments.[640] Most commenters recommended that the Commission delay the compliance date. One commenter, however, stated that broker-dealers should start working on compliance immediately.[641] Several stated that the compliance date of the amendments should be aligned with the effective date of the proposed PCAOB standards for engagements related to compliance reports and exemption reports.[642] One commenter suggested that the Commission postpone the assertion requirements until the rule has been in effect for one year.[643] Another commenter stated that the rules should be effective for fiscal years ending on or before December 15, 2012 "to allow sufficient time to complete robust documentation and testing of the processes related to the Financial Responsibility Rules and the Financial Statements."[644] Similarly, another commenter stated that the effective date should be deferred to fiscal years ending on or before December 15, 2012 "to give broker-dealers and their auditors time to adequately address the final rules," and that the effective date should be aligned with the effective date of PCAOB standards.[645] Another commenter stated that the rule amendments

639 See Broker-Dealer Reports, 76 FR at 37581. During the transition period, the statement in the compliance report as to whether internal control was effective would have been a point-in-time statement as of the date of the report, rather than covering the entire fiscal year.

640 See, e.g., ABA Letter; AICPA Letter; CAQ Letter; Citrin Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter; PWC Letter; SIFMA Letter; Shatto Letter; CAI Letter; Van Kampen/Invesco Letter.

641 See Shatto Letter.

642 See, e.g., CAQ Letter; Deloitte Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter.

643 See ABA Letter.

644 See Van Kampen/Invesco Letter.

645 See E&Y Letter.

should apply only to annual reports filed on or after December 15, 2012, and that implementation of the proposal must be postponed until after the PCAOB establishes auditing and attestation standards and broker-dealers have had ample time to plan and budget for the new standards.[646] Finally, a commenter stated that broker-dealers should be required to file the first compliance report or exemption report no earlier than one quarter after the adoption of the final rule amendments and to report identified instances of material non-compliance or material weaknesses in annual reports filed no earlier than five quarters after the adoption of the final rule amendments, with a transition period as proposed of no less than five quarters after the adoption of the final rule amendments.[647] This commenter also suggested that the Commission require the filing of the first Form Custody no earlier than three quarters after the effective date of the final rule.[648]

The amendments, among other things, establish important new safeguards with respect to broker-dealer custody of customer funds and securities. However, the Commission recognizes that broker-dealers and other affected parties may need additional time to prepare to comply with the new requirements.

Amendments to provisions regarding broker-dealer annual reports and the engagement of an independent public accountant in paragraphs (d)(1), (d)(2), (d)(3), (d)(4), (d)(5), (e)(1), (e)(2), (e)(3), (e)(4), (g), and (i) of Rule 17a-5 and the deletion of paragraph (j) of Rule 17a-5 generally will apply for broker-dealers with fiscal years ending on or after June 1, 2014. In particular, broker-dealers must file compliance reports or exemption reports, as applicable, and broker-dealers must file reports of independent public accountants covering compliance reports or

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646 See CAI Letter.

647 See SIFMA Letter.

648 Id.

exemption reports in accordance with Rule 17a-5 as amended, for fiscal years ending on or after June 1, 2014, with no transition period. Similarly, PCAOB standards, rather than GAAS, apply to examinations of financial reports for fiscal years ending on or after June 1, 2014. For broker-dealers with fiscal years that end before June 1, 2014, applicable reports must be filed in accordance with the provisions of Rule 17a-5 as they existed before today's amendments.

Amendments to the customer statement provisions of paragraph (c) of Rule 17a-5 apply for fiscal years ending on or after June 1, 2014, and in the interim broker-dealers must comply with those provisions as they existed before today's amendments.

Paragraph (f)(2) of Rule 17a-5 requires a broker-dealer to file a statement regarding its independent public accountant on December 10 of each year. As a result of today's amendments, all broker-dealers that are required by Rule 17a-5 to engage an independent public accountant must file a new statement by December 10, 2013 that contains the information and representations required under paragraph (f)(2) of Rule 17a-5 as amended. For example, after today's amendments, the statement must include a representation that the accountant has undertaken the engagement of the accountant provisions of paragraph (g) of Rule 17a-5 as amended. The statement also must include, if applicable, representations regarding access to the broker-dealer's independent public accountant and the audit documentation of the independent public accountant.

The amendments to the notification provisions in paragraph (h) of Rule 17a-5 and amendments to Rule 17a-11 are effective on June 1, 2014. In the interim, these provisions as they existed before today's amendments continue to apply.

Finally, the amendments to paragraphs (b), (c), (d)(1), (d)(2), (d)(3), (d)(4), (d)(5), (e)(1), (e)(2), (e)(3), (e)(4), (f), (g), (h), (i), (k), (l), (m), and (n) of Rule 17a-5 and the amendments to Rule 17a-11 not discussed above, including technical amendments, are effective on June 1, 2014.

With respect to the annual report requirements, the June 1, 2014 effective date should provide sufficient time for the PCAOB to finalize, and for the Commission to consider, proposed standards applicable to broker-dealer examinations and reviews and for broker-dealers and their accountants to become familiar with, and be prepared to comply with, those standards. The Commission has chosen a specific effective date, instead of aligning that date with the date of adoption of the rule amendments or the date that the Commission approves PCAOB standards applicable to broker-dealer examinations and reviews, as suggested by commenters, to provide certainty regarding the date by which broker-dealers and their accountants must comply with the new requirements. Certain commenters referenced AICPA guidance with respect to broker-dealer audits. However, this guidance will no longer be applicable for fiscal years ending on or after June 1, 2014, when standards of the PCAOB begin to apply.

One commenter suggested that the effective date for non-carrying and smaller broker-dealers to comply with amendments to the annual reporting requirements should be one year after the adoption of the amendments.[649] The Commission notes that most smaller broker-dealers are non-carrying firms and, therefore, will be required to file the exemption report and a report of the independent public accountant based on a review of the exemption report. As discussed in sections VI. and VII. of this release, the hour burdens and costs of the exemption report requirements will be substantially less than the hour burdens and costs of the compliance

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[649] See Citrin Letter.

report requirements. Consequently, the Commission does not believe the effective date should be extended further for smaller broker-dealers.

As stated above, another commenter suggested that the Commission postpone the assertion requirements until the rule has been in effect for one year.[650] The Commission recognizes that all broker-dealers subject to these requirements and their independent public accountants will need time to prepare to comply with the requirements. The effective date the Commission is establishing should provide sufficient time for small or non-carrying firms, as well as larger carrying firms, to prepare for compliance with the new requirements.

VI. PAPERWORK REDUCTION ACT

Certain provisions of the final rule amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[651] The Commission solicited comment on the estimated burden associated with the collection of information requirements in the proposed amendments.[652] The Commission submitted the proposed collection of information requirements to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11.

The titles and OMB control numbers for the collections of information are:

(1) Rule 17a-5, Reports to be made by certain brokers and dealers (OMB Control Number 3235-0123);

(2) Rule 17a-11, Notification provisions for brokers and dealers (OMB Control Number 3235-0085); and

(3) Form Custody (OMB Control Number 3235-0691).

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650 See ABA Letter.

651 44 U.S.C. 3501 et seq.

652 See Broker-Dealer Reports, 76 FR at 37594–37598.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information requirement unless it displays a currently valid OMB control number. As discussed above, the Commission received 27 comment letters on the proposed rulemaking. Some of these comments relate directly or indirectly to the PRA. These comments are addressed below. Finally, some initial burden estimates have been adjusted, as discussed below, to reflect updated information used to make the estimates.

A. Summary of the Collection of Information Requirements

As discussed in greater detail above in sections II., III., and IV. of this release, the Commission is adopting amendments to Rules 17a-5 and 17a-11 and is adopting new Form Custody for broker-dealers to file with their DEA.

Under the amendments to Rule 17a-5, broker-dealers must, among other things, file with the Commission annual reports consisting of a financial report and one of two new reports – either a compliance report or an exemption report that are prepared by the broker-dealer, and generally must also file reports prepared by an independent public accountant registered with the PCAOB covering those reports in accordance with PCAOB standards.[653] The financial report must contain the same types of financial statements that were required to be filed under Rule 17a-5 prior to these amendments (a statement of financial condition, a statement of income, a statement of cash flows, and certain other financial statements).[654] In addition, the financial report must contain, as applicable, the supporting schedules that were required to be filed under Rule 17a-5 prior to these amendments (a computation of net capital under Rule 15c3-1, a computation of the reserve requirements under Rule 15c3-3, and information relating to the possession or control requirements under Rule 15c3-3).

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[653] See discussion above in sections II.B.1., II.B.2., II.B.3., and II.B.4. of this release.

[654] See discussion above in section II.B.2. of this release.

A broker-dealer that does not claim an exemption from Rule 15c3-3 through the most recent fiscal year – generally a carrying broker-dealer – must file the compliance report, and a broker-dealer that claimed an exemption from Rule 15c3-3 throughout the most recent fiscal year must file the exemption report. In the compliance report and exemption report, a broker-dealer must make certain statements and provide certain information relating to the financial responsibility rules.

In addition to preparing and filing the financial report and the compliance report or exemption report, a broker-dealer must engage a PCAOB-registered independent public accountant to prepare a report based on an examination of the broker-dealer's financial report in accordance with PCAOB standards.[655] A broker-dealer that files a compliance report also must engage the PCAOB-registered independent public accountant to prepare a report based on an examination of certain statements in the compliance report.[656] A broker-dealer that files an exemption report must engage the PCAOB-registered independent public accountant to prepare a report based on a review of certain statements in the broker-dealer's exemption report. In each case, the examination or review must be conducted in accordance with PCAOB standards. A broker-dealer must file these reports of the independent public accountant with the Commission along with the financial report and the compliance report or exemption report prepared by the broker-dealer.

The amendments add a requirement that the annual reports also be filed with SIPC if the broker-dealer is a member of SIPC.[657] In addition, broker-dealers must generally file with SIPC

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655 See discussion above in section II.D.3. of this release.

656 See paragraphs (f)(1) and (g)(2)(i) of Rule 17a-5.

657 See discussion above in section II.B.6. of this release.

a supplemental report on the status of the membership of the broker-dealer in SIPC.[658] The supplemental report must include a report of the independent public accountant based on certain procedures specified in the rule in accordance with PCAOB standards. In the future, SIPC may determine the format of this report by rule, subject to Commission approval.

Under the amendments, the PCAOB-registered independent public accountant must immediately notify the broker-dealer if the accountant determines during the course of preparing the accountant's reports that the broker-dealer was not in compliance at any time during the fiscal year with the financial responsibility rules or if the accountant determines that any material weakness existed in the broker-dealer's Internal Control Over Compliance during the fiscal year.[659] The broker-dealer, in turn, must file a notification with the Commission and its DEA under Rule 15c3-1, Rule 15c3-3, or Rule 17a-11 if the accountant's notice concerns an instance of non-compliance that would trigger notification under those rules. Under amendments to Rule 17a-11, a broker-dealer also must file a notification with the Commission and its DEA if the accountant's notice concerns (or if the broker-dealer discovers) a material weakness in the broker-dealer's Internal Control Over Compliance.

The amendments also require a broker-dealer that clears transactions or carries customer accounts to agree to allow representatives of the Commission or the broker-dealer's DEA to review the documentation associated with the reports of the broker-dealer's independent public accountant and to allow the accountant to discuss its findings with the representatives, if requested in writing for purposes of an examination of the broker-dealer.[660]

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658 See discussion above in section II.C.4. of this release.

659 See discussion above in section II.F. of this release.

660 See discussion above in section III. of this release.

Finally, the amendments require broker-dealers to file a new Form Custody, which elicits information concerning the custody practices of the broker-dealer.[661] Form Custody must be filed with the DEA each quarter. The DEA must transmit the information obtained from Form Custody to the Commission at the same time that it transmits FOCUS Report data to the Commission under paragraph (a)(4) of Rule 17a-5.

The burdens associated with the collection of information requirements in the amendments are discussed below.

B. Use of Information

The proposed amendments relating to the reports to be filed by the broker-dealer are designed to enhance the ability of the Commission to oversee broker-dealer custody practices and, among other things, to: (1) increase the focus of carrying broker-dealers and their independent public accountants on compliance, and internal control over compliance, with the financial responsibility rules; (2) facilitate the ability of the PCAOB to implement the explicit oversight authority of broker-dealer audits provided to the PCAOB by the Dodd-Frank Act; and (3) with respect to broker-dealers that are dually-registered as investment advisers, satisfy the internal control report requirement that was added by the amendment to Rule 206(4)-2 noted above with the accountant's report based on an examination of the compliance report. Securities regulators will use these reports to monitor the financial condition of broker-dealers. In addition, the components of the reports that are made public may be used by investors to review the financial condition of broker-dealers with which they have accounts or obtain other securities related services. SIPC can use the annual reports to monitor the financial strength of broker-dealers and to assess the adequacy of the SIPC Fund.

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[661] See discussion above in section IV. of this release.

The amendment requiring a broker-dealer that clears transactions or carries customer accounts to allow Commission and DEA examination staff to review the audit documentation associated with its annual audit reports required under Rule 17a-5 and to allow its independent public accountant to discuss findings relating to the audit reports with Commission and DEA examination staff is intended to facilitate examinations of clearing broker-dealers by Commission and DEA examination staff. Commission and DEA examiners will use the information obtained from audit documentation and discussions with the broker-dealer's independent public accountant to plan their examinations.

Finally, Commission and DEA examiners will use Form Custody to understand a broker-dealer's custody profile and identify custody-related violations and misconduct. For example, if a broker-dealer represents on Form Custody that it does not issue account statements, but an examiner discovers that an account statement has been issued by the broker-dealer (e.g., in connection with a customer complaint or in the course of an examination of the broker-dealer), the examiner will be able to react more quickly to the misrepresentation. Further, the requirement to prepare and file the form should motivate broker-dealers to focus more attention on their custody practices.

C. Respondents

The Commission estimated in the proposal that there were 5,063 registered broker-dealers that would be affected by the proposed amendments and that, of these, 305 were carrying broker-dealers, 528 were carrying or clearing broker-dealers, and 4,752 were broker-dealers that claimed exemptions from Rule 15c3-3.[662] The Commission did not receive comments regarding

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[662] See Broker-Dealer Reports, 76 FR at 37595.

these estimates, but the Commission has updated the estimates to reflect more recent information.[663]

As of December 31, 2011, 4,709 broker-dealers filed FOCUS Reports with the Commission. Of these, 4,417 broker-dealers claimed exemptions from Rule 15c3-3. Consequently, the Commission estimates that there are approximately 292 carrying broker-dealers (4,709 – 4,417 = 292). Based on FOCUS Report data, the Commission further estimates that there are approximately 513 carrying or clearing broker-dealers. According to SIPC, as of March 31, 2012, 217 broker-dealers claimed exemptions from SIPC membership. Therefore, the Commission estimates that 4,492 (4,709 – 217 = 4,492) broker-dealers are members of SIPC.

D. Total Initial and Annual Burdens

As discussed in detail below, the Commission estimates that the total PRA burden resulting from the amendments to Rules 17a-5 and 17a-11 and new Form Custody include an initial, one-time burden of approximately 13,522 hours[664] and an annual burden of approximately 276,717 hours.[665] There is significant variance between the largest broker-dealers and the smallest broker-dealers. Consequently, the estimates described below are averages across all types of broker-dealers expected to be affected by the amendments.

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663 The updated estimates are based on FOCUS Report data as of year end 2011. As discussed above, FOCUS Reports are deemed confidential pursuant to paragraph (a)(3) of Rule 17a-5.

664 As discussed below, the total one-time burden relates to the requirement to draft and file a revised statement regarding the independent public accountant under Rule 17a-5(f)(2). The Commission estimated a total one-time burden of 10,214 hours in the proposing release for the statement regarding the independent public accountant and for SIPC forms. See Broker-Dealer Reports, 76 FR at 37595.

665 As discussed below, the total annual hour burden relates to the compliance report (17,520 hours), the exemption report (30,919 hours), the filing of annual reports with SIPC (2,246 hours), and Form Custody (226,032 hours). The Commission estimated a total annual burden of 287,325 hours in the proposing release. See Broker-Dealer Reports, 76 at FR 37595.

1. Annual Reports to be Filed

i. The Financial Report

The Commission's amendments to Rule 17a-5 retain the current requirement that broker-dealers annually file financial statements and supporting schedules that must be audited by a PCAOB-registered accountant. As a result, the Commission's estimate of the hour burden for broker-dealers to prepare and file the financial report has not changed as a result of the amendments to Rule 17a-5.

ii. The Compliance Report

Under the amendments, a carrying broker-dealer must prepare and file with the Commission a new compliance report each year. The compliance report must contain statements as to whether: (1) the broker-dealer has established and maintained Internal Control Over Compliance; (2) the Internal Control Over Compliance of the broker-dealer was effective during the most recent fiscal year; (3) the Internal Control Over Compliance of the broker-dealer was effective as of the end of the most recent fiscal year; (4) the broker-dealer was in compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3 as of the end of the most recent fiscal year; and (5) the information the broker-dealer used to state whether it was in compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3 was derived from the books and records of the broker-dealer. In addition, if applicable, the compliance report must contain a description of: (1) each identified material weakness in the broker-dealer's Internal Control Over Compliance during the most recent fiscal year, including those that were identified as of the end of the fiscal year; and (2) any instance of non-compliance with Rule 15c3-1 or paragraph (e) of Rule 15c3-3 as of the end of the most recent fiscal year.

The Commission estimated that, on average, carrying broker-dealers would spend approximately 60 hours each year to prepare the compliance report, as proposed.[666] One commenter stated that the proposal did not "address the additional costs broker-dealers would incur in preparing Compliance Reports."[667] The commenter, however, did not comment directly on the estimated hour burden or provide specific examples of costs, in addition to the hour burdens, that broker-dealers would bear.[668] Another commenter also stated that the proposed estimate of 60 hours "is not an accurate estimate of the time burden to complete the Compliance Report" and that the burdens in the proposing release are understated.[669] The commenter stated that completing the compliance report will require extensive collaboration between management, internal audit and the independent public accountants resulting in added hours to perform the validation and evidence gathering of the existing processes necessary to make the assertions in the proposed compliance report.[670] The commenter, however, did not provide a different estimate of the number of hours it would take to complete the compliance report.

In response to these comments, the Commission notes that the final rule modifies the proposal in ways that may modestly reduce the time burden. For example, the final rule requires a statement as to whether the broker-dealer was in compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3 as of the end of the most recent fiscal year and, if applicable, a description of any instances of non-compliance with these rules as of the fiscal year end, rather than the proposed assertion that the broker-dealer is in compliance with the financial responsibility rules

666 See Broker-Dealer Reports, 76 FR at 37596.

667 See SIFMA Letter.

668 Id.

669 See Van Kampen/Invesco Letter.

670 Id.

in all material respects and proposed description of any material non-compliance with the financial responsibility rules. This reflects two changes from the proposal: (1) elimination of the concepts of "material non-compliance" and "compliance in all material respects" with Rule 15c3-1 and 15c3-3 for the purposes of reporting in the compliance report; and (2) a narrowing of these statements and description requirements from compliance with all of the financial responsibility rules to compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3.

As modified, the final rule no longer requires the broker-dealer to evaluate whether an instance of non-compliance with the financial responsibility rules was material, a component of the proposal that generated significant comment. In addition, the broker-dealer only needs to report instances of non-compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3. In this regard, broker-dealers currently are required to include supporting schedules to their financial statements containing a computation of net capital and the reserve requirement under paragraph (e) of Rule 15c3-3. Consequently, the work required under this pre-existing requirement should provide the broker-dealer with the information it needs to make the statement as to whether it is in compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3 as of the fiscal year end.

Given these modifications, the statements in the compliance report concerning the broker-dealer's Internal Control Over Compliance likely will be responsible for the bulk of the hour burden associated with preparing the compliance report. For example, the broker-dealer will need to evaluate whether its Internal Control Over Compliance with the financial responsibility rules was effective during the most recent fiscal year.

The Commission believes that the modifications to the final rule discussed above may modestly reduce the hour burden of the final rule as compared to the hour burden that would have resulted from the proposed rule; namely, because a broker-dealer will not need to evaluate whether instances of non-compliance with the financial responsibility rules are material and will only need to report instances of non-compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3. In light of the comments suggesting that the proposing release underestimated the burden, the Commission is not reducing the hour burden estimate for the rule to reflect the potential reduction in hour burden associated with the requirement. Thus, to the extent the proposing release underestimated the burden associated with making the statements in the compliance report about the broker-dealer's Internal Control Over Compliance, the amount of the burden reduction realized through the modifications discussed above is now attributed to the burden associated with the statements about Internal Control Over Compliance.

For these reasons, the Commission is retaining the rule's overall hour burden estimate without revision. The Commission, however, is updating the number of carrying broker-dealers to reflect more recently available data from the broker-dealer FOCUS Reports. The Commission now estimates that there are 292 carrying broker-dealers. Consequently, the Commission estimates that the total annual reporting burden to prepare and file the compliance report is approximately 17,520 hours per year for all carrying broker-dealers.[671]

iii. The Exemption Report

Under the amendments, a non-carrying broker-dealer must file the exemption report.[672] In the exemption report, the broker-dealer must provide to its best knowledge and belief: (1) a statement that identifies the provisions in paragraph (k) of Rule 15c3-3 under which the broker-dealer claimed an exemption from Rule 15c3-3; (2) a statement that the broker-dealer met the identified exemption provisions in paragraph (k) throughout the most recent fiscal year without

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671 60 hours x 292 carrying broker-dealers = 17,520 hours. See the discussion below regarding the external costs associated with obtaining the accountant's report on the compliance report.

672 See discussion above in sections II.B.1. and II.B.4. of this release.

exception or that it met the identified exemption provisions in paragraph (k) throughout the most recent fiscal year except as described in the exemption report; and (3) if applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified provisions in paragraph (k) and that briefly describes the nature of each exception and the approximate date(s) on which the exception existed.

The Commission estimated that it would take a non-carrying broker-dealer approximately five hours to prepare and file the proposed exemption report.[673] The Commission did not receive any comments on this hour estimate. As discussed above in section II.B.4. of this release, the Commission is adopting, with modifications, the requirements regarding the exemption report. These provisions generally clarified the scope and application of the report. However, one modification provides that if the broker-dealer states that it met the identified exemption provisions in paragraph (k) of Rule 15c3-3 throughout the most recent fiscal year except as described in the report, the broker-dealer must identify each exception during the most recent fiscal year in meeting the identified provisions in paragraph (k) of Rule 15c3-3 and that briefly describes the nature of each exception and the approximate date(s) on which the exception existed. The Commission expects that non-carrying broker-dealers generally track exceptions as part of monitoring compliance with the exemption provisions in paragraph (k) of Rule 15c3-3. The requirement to identify and describe exceptions would create an incremental burden over the rule as proposed. Based on staff experience with the application of Rule 17a-5, the Commission estimates that the additional work associated with describing exceptions in the exemption report would take two hours. Therefore, the Commission is revising the hour estimate associated with the exemption report to seven hours.

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673 See Broker-Dealer Reports, 76 FR at 37596.

The Commission now estimates that there are approximately 4,417 non-carrying broker-dealers that must file exemption reports. Therefore, the Commission estimates that the annual reporting burden for all non-carrying broker-dealers to prepare and file the exemption report is approximately 30,919 hours per year.[674]

iv. Additional Burden and Cost to File the Annual Reports

The filing requirements for the annual reports are being amended.[675] In particular, Rule 17a-5 previously provided that a broker-dealer must file two copies of its annual reports with the Commission's principal office in Washington, DC. The final rule no longer requires that two copies be filed, so that, in accordance with paragraph (d)(6) of Rule 17a-5, broker-dealers must file only one copy of the annual reports with the Commission's principal office. This change could reduce slightly the hour burden and cost associated with filing the annual reports with the Commission.[676]

Amendments to paragraph (d)(6) of Rule 17a-5 require that a broker-dealer also file a copy of its annual reports with SIPC. The Commission estimated that it would take 30 minutes to prepare an additional copy of the annual reports and mail it to SIPC as required by the proposed amendments.[677] The Commission did not receive comments regarding this estimate. In addition, the clarification to the final rule that only broker-dealers that are members of SIPC must file a copy of their annual reports with SIPC will not affect the final PRA hour burden estimate. Therefore, the Commission is retaining this estimate without revision. The

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674 7 hours x 4,417 non-carrying broker-dealers = 30,919 hours. See the discussion below regarding the external costs associated with obtaining the accountant's report on the exemption report.

675 See discussion above in section II.B.6. of this release.

676 The Commission does not expect the compliance report, exemption report, and related reports of the independent public accountant to increase the mailing costs of the annual reports because these additional reports in the aggregate should not significantly increase the size and weight of the package of annual reports.

677 See Broker-Dealer Reports, 76 FR at 37596.

Commission now estimates that 4,492 broker-dealers are members of SIPC.[678] Therefore, the Commission estimates that the annual industry-wide reporting burden associated with this amendment is approximately 2,246 hours per year.[679]

There would be postage costs associated with sending a copy of the annual reports to SIPC that are estimated to be, on average,[680] approximately $12.05 per broker-dealer per year.[681] Thus, the Commission estimates that the total annual postage costs associated with sending a copy of the annual reports to SIPC would be approximately $54,128 per year for all broker-dealers that are SIPC members.[682]

Finally, the Commission notes that paragraph (d)(1)(ii) of Rule 17a-5 of the final rule was amended to require that a copy of a DEA's written approval to change a broker-dealer's fiscal year end must be sent to the Commission's principal office in Washington DC, in addition to the regional office of the Commission for the region in which the broker-dealer has its principal place of business. Based on the number of copies of approvals received by the Commission and staff experience in the application of Rule 17a-5, the Commission estimates that approximately 75 broker-dealers will receive approval each year to change their fiscal year

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678 As discussed in subsection C. above, according to SIPC, as of March 31, 2012, 217 broker-dealers claimed exemptions from SIPC membership. The Commission therefore estimates that 4,492 (4,709 – 217 = 4,492) broker-dealers are members of SIPC.

679 1/2 hour x 4,492 broker-dealers = 2,246 hours.

680 The number of pages of an annual report, and consequently the associated postage costs, likely will vary significantly based on the size of the broker-dealer and the types of business in which it engages.

681 Based on Commission staff experience with annual report filings of broker-dealers under Rule 17a-5, the Commission staff estimates that approximately 50% of broker-dealers file their annual reports using an overnight mail delivery service. These broker-dealers would consequently incur higher postage costs than broker-dealers which choose to mail their annual reports using first class mail or delivery methods other than overnight mail. Therefore, postage costs will vary depending on the size of the annual report and method of delivery. The Commission estimates that the cost to mail the additional reports would be, on average, $12.05 per broker-dealer. As of October 2012, the $12.05 rate is an average rate of the cost of an Express Mail Flat Rate Envelope of $18.95 and a Priority Mail Flat Rate Envelope of $5.15, based on costs obtained on the website of the U.S. Postal Service at: www.usps.gov. ($18.95 + $5.15) = $24.10/2 = $12.05.

682 4,492 broker-dealers x $12.05 = $54,128.

end. The Commission estimates that it would take 10 minutes to copy and send an additional copy of the approval to the Commission's principal office in Washington, DC for a total industry-wide annual hour burden of approximately 12.5 hours,[683] and a total industry-wide cost of approximately $33.75 per year to mail the approval.[684]

v. Supplemental Report on SIPC Membership

Prior to today's amendments, paragraph (e)(4) of Rule 17a-5 provided that a broker-dealer must file with its annual report a supplemental report on the status of the membership of the broker-dealer in SIPC, which was required to be "covered by an opinion of the independent public accountant" if the annual report of the broker-dealer was required to be audited. The Commission is adopting amendments to paragraph (e)(4) of Rule 17a-5 to provide that broker-dealers must file with SIPC – but no longer with the Commission after an interim period if SIPC adopts a rule under paragraph (e)(4)(i) that is approved by the Commission – a report of an independent public accountant designed to help administer the collection of assessments from broker-dealers for purposes of establishing and maintaining SIPC's broker-dealer liquidation fund.[685] The Commission is adopting the proposed amendments to paragraph (e)(4) of Rule 17a-5 substantially as proposed. One modification is that, as adopted, the final rule provides that the accountant must perform the procedures specified in the rule in accordance with PCAOB standards. SIPC may determine the format of this report by rule, subject to Commission approval.

Because broker-dealers are currently required to file these reports with both the Commission and SIPC, the final rule amendment does not result in any change to the

683 (75 approvals x 10 minutes)/60 = 12.5 hours.

684 75 approvals x $0.45 (current price of a letter sent first class) = $33.75.

685 See discussion above in section II.C.4. of this release.

Commission's current estimate of the hour burden for broker-dealers to comply with this requirement under the current PRA collection for Rule 17a-5. Although broker-dealers will file the supplemental report on SIPC membership only with SIPC if a SIPC rule change to implement this amendment is approved by the Commission, as noted in the current PRA collection, the variation in the size and complexity of broker-dealers subject to Rule 17a-5 makes it difficult to calculate the burden of the information collection of Rule 17a-5. Therefore, the Commission will determine whether it is appropriate to revise the PRA estimate for Rule 17a-5 after any SIPC rule filing is approved or after the end of the two-year sunset provision.

In the proposing release the Commission estimated, however, that SIPC would incur a one-time burden associated with filing a rule change with the Commission to implement this proposed amendment of approximately 100 hours.[686] The process and requirements for SIPC to file rule changes with the Commission, however, is set out in SIPA.[687] Any burden on SIPC to file a rule change with the Commission would be associated with the requirements under SIPA. Therefore, the Commission is deleting the proposed one-time 100 hours from the final rule amendments.

vi. Statement Regarding Independent Public Accountant

The Commission is amending paragraph (f)(2) of Rule 17a-5 to revise the statement regarding identification of a broker-dealer's independent public accountant that broker-dealers must file each year with the Commission and their DEA (except that if the engagement is of a

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686 See Broker-Dealer Reports, 76 FR at 37597.

687 15 U.S.C. 78ccc(e)(2). The statute generally requires that the Board of Directors of SIPC file with the Commission a copy of any proposed rule change accompanied by a concise general statement of the basis and purpose of such proposed rule change. In addition, the statute states that "the Commission shall, upon the filing of any proposed rule change, publish notice thereof, together with the terms of substance of such proposed rule change or a description of the subjects and issues involved" and that the "Commission shall give interested persons an opportunity to submit written data, views, and arguments with respect to such proposed rule change." 15 U.S.C. 78ccc(e)(2)(A).

continuing nature, no further filing is required).[688] The revised statement contains additional information that includes a representation that the independent public accountant has undertaken to provide a report regarding the broker-dealer's financial reports and a report regarding the broker-dealer's compliance report or exemption report, as applicable.[689] In addition, the statement provided by a clearing or carrying broker-dealer must include representations regarding the access to its accountant requirements described above.[690] Therefore, all broker-dealers will generally be required to file a new statement regarding their independent public accountant. The Commission estimated that the one-time hour burden associated with amending its existing statement and filing the new statement with the Commission, in order to comply with the proposed amendments, would be an average of approximately two hours on a one-time basis for each broker-dealer, as the statement can be continuing in nature.[691]

The Commission is revising this estimate for clearing and carrying broker-dealers, as these broker-dealers will likely need to renegotiate their agreements with their independent public accountants. The Commission estimates, based on staff experience, that it will take a carrying or clearing broker-dealer approximately ten hours on a one-time basis to renegotiate its agreement with its accountant, amend its statement regarding its accountant, and file the new statement with the Commission. The Commission estimates that the one-time burden for all carrying or clearing broker-dealers is approximately 5,130 hours[692] and the one-time burden for all broker-dealers that neither carry customer accounts nor clear transactions is approximately

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688 See discussion above in section III. of this release.

689 See Rule 17a-5(f)(2)(ii). 17 CFR 240.17a-5(f)(2)(ii).

690 See Rule 17a-5(f)(2)(ii)(F) and (G).

691 See Broker-Dealer Reports, 76 FR at 37596.

692 10 hours x 513 carrying or clearing broker-dealers = 5,130 hours.

8,392 hours,[693] for a total industry-wide reporting burden of approximately 13,522 hours on a one-time basis.

Finally, the Commission believes there will be postage costs associated with sending the amended statement regarding the accountant, which must be sent to the Commission's principal office in Washington, DC, the regional office of the Commission for the region in which the broker-dealer's principal place of business is located, and to its DEA. The Commission estimates that each mailing will cost approximately $0.45, for a total cost of approximately $6,357 for all broker-dealers on a one-time basis.[694]

vii. External Costs of Engagement of Accountant

The amendments to Rule 17a-5 retain the current requirement that broker-dealers annually file with the Commission a financial report and a report prepared by a PCAOB-registered accountant based on an audit of the financial report.[695] However, the financial report must be audited in accordance with standards of the PCAOB, instead of in accordance with GAAS, as previously required. The amendments also require a broker-dealer to file with the Commission either a compliance report or an exemption report and to obtain an independent accountant's report based on an examination or review of those reports, respectively.[696]

Broker-dealers incur annual external costs associated with the PRA burden in terms of hiring outside auditors and accountants to comply with the requirements of Rule 17a-5. Any external costs of accountants' reports included in the PRA collection of information for these final rule amendments are averages across all broker-dealers. The external PRA costs incurred

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693 2 hours x 4,196 non-carrying and non-clearing broker-dealers = 8,392 hours.

694 4,709 broker-dealers x $0.45 cost for first class postage x 3 mailings = $6,357.15.

695 See discussion above in section II.D.3. of this release.

696 Id.

by a broker-dealer to comply with the final rule amendments will generally depend on its size and the complexity of its business activities. Because the size and complexity of broker-dealers varies significantly, the Commission provides estimates of the average external cost per broker-dealer across all broker-dealers.[697]

The Commission received various comments regarding the costs of the proposed requirements and engagement of the accountant provisions. More specifically, the Commission received comments addressing: (1) the costs of the change from GAAS to PCAOB standards for the financial report; (2) the costs of the examination of the new compliance report; and (3) the costs of the review of the new exemption report. The comments received with respect to these three areas and the Commission's responses are addressed in detail in each subsection below.

a. Financial Report (including Change from GAAS to PCAOB Standards)

Two commenters stated that the Commission did not address the costs associated with the change from GAAS to PCAOB standards.[698] These costs would affect the external costs of broker-dealers under the PRA burden to the extent the change in standards caused an increase in external accounting fees incurred by broker-dealers. One commenter also stated that the Commission may need to consider the PCAOB's proposed rules before it can make a reasonable estimate, and that transition to PCAOB standards may require substantial revisions to audit programs.[699] Another commenter stated that the economic analysis was "inconclusive" because

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697 In the proposing release, these costs were included in the Economic Analysis. The Commission is also including these costs in the PRA amendments to more accurately reflect external costs incurred by broker-dealers as a result of the PRA hour burdens imposed by the final rule amendments, and in response to comments.

698 See, e.g., McGladrey Letter; SIFMA Letter.

699 See ABA Letter.

the PCAOB has not yet established auditing and attestation standards for broker-dealers.[700] In response to this comment, the Commission estimates the costs of its rules using the best information available to it at the time.

Based on information currently available, including the proposed PCAOB standards, the Commission does not expect that the move to PCAOB standards for audits of broker-dealer financial reports will result in significant one-time implementation costs or recurring annual costs. The proposed PCAOB standards for audits of financial reports (financial statements and supporting schedules) generally incorporate concepts and requirements contained within GAAS, thereby minimizing the potential costs to broker-dealer auditors of this change. As such, the Commission is not including any additional external PRA costs related to the change from GAAS to PCAOB auditing standards.[701] However, in response to the comment, the Commission will examine the effect of any final PCAOB standards on the external costs associated with this collection of information in subsequent extensions of this collection of information and make any necessary cost adjustments.

b. Compliance Report

The Commission estimated that the incremental external cost to a carrying broker-dealer of obtaining the independent public accountant's report based on an examination of the proposed compliance report would be an average incremental cost of approximately $150,000 per carrying broker-dealer per year.[702] The Commission is including these external costs in this collection of information.

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[700] See CAI Letter.

[701] See section VII. of this release (discussing benefits and costs of changing from GAAS to PCAOB auditing standards).

[702] See Broker-Dealer Reports, 76 FR at 37599.

One commenter stated that the Commission underestimated the cost of examining the compliance report.[703] This commenter believed that the auditing costs associated with the compliance examinations were underestimated given that the proposing release contemplated a move from GAAS to PCAOB auditing standards.[704] This commenter stated that the transition may require substantial revisions to independent public accountant audit programs, including implementation of new auditing techniques and processes and the associated training programs and noted that the proposed PCAOB standards were not released until after the publication of the proposing release.[705] Another commenter stated that completing both the compliance reports and exemption reports "will require extensive collaboration between management, internal audit, and the independent public accountants" and that due to the "significant increase in hours," the proposed amendments have "the potential to double the total current audit fees and have a material impact" on firms.[706] These commenters did not quantify their cost estimates in terms of dollars; nor did they provide data to support their conclusions.

As explained above in section II.D. of this release, before today's amendments, Rule 17a-5 required a broker-dealer to engage an independent public accountant to prepare a material inadequacy report based on, among other things, a review of the accounting system, internal accounting control, and procedures for safeguarding securities of the broker-dealer, including appropriate tests, for the period since the prior examination date. In addition, the accountant was required to review the practices and procedures followed by the broker-dealer in, among other things, (1) making periodic computations of net capital and under paragraph (e) of Rule 15c3-3,

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703 See ABA Letter.

704 Id.

Id.

See Van Kampen/Invesco Letter.

(2) making quarterly securities examinations, counts, verifications, and comparisons under Rule 17a-13, and (3) obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3.

Consequently, under requirements before today's amendments relating to a material inadequacy report that are being replaced by the examination of the compliance report, the broker-dealer was required to engage the independent public accountant to review the internal controls, practices, and procedures of the broker-dealer with respect to key elements of the financial responsibility rules.

For these reasons, the Commission continues to believe that the average incremental cost of $150,000 per carrying broker-dealer to obtain the accountant's report covering the compliance report is reasonable. Moreover, as stated above, the Commission is adopting the proposed amendments to Rule 17a-5 with respect to the compliance report with modifications. For example, the final rule requires a statement as to whether the broker-dealer was in compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3 as of the end of the most recent fiscal year and, if applicable, a description of any instances of non-compliance with these rules as of the fiscal year end, rather than the proposed assertion that the broker-dealer is in compliance with the financial responsibility rules in all material respects and the proposed description of any material non-compliance with the financial responsibility rules. This reflects two changes from the proposal: (1) elimination of the concepts of "material non-compliance" and "compliance in all material respects" with Rule 15c3-1 and 15c3-3 for the purposes of reporting in the compliance report; and (2) a narrowing of these statements and description requirements from compliance with all of the financial responsibility rules to compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3.

As modified, the final rule no longer requires the independent public accountant to evaluate whether an instance of non-compliance with the financial responsibility rules was material. While there may be an increase in the number of reported instances of non-compliance than under the proposal, the independent public accountant will not be required to determine whether an instance of non-compliance is material. Consequently, the reporting of instances of non-compliance (as compared to instances of material non-compliance) is not expected to increase costs of the engagement of the accountant from those estimated for the proposal and may decrease costs.

In addition, the final rule has been modified from the proposal so that the independent public accountant will not be required to examine a broker-dealer statement that encompassed compliance with all the financial responsibility rules. Instead, the independent public accountant must examine a statement about compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3. In this regard, the Commission has not amended the requirement, which existed before today's amendments, that the independent public accountant examine the supporting schedules to the broker-dealer's financial statements, which contain a computation of net capital under Rule 15c3-1 and the reserve requirement under paragraph (e) of Rule 15c3-3.

Given these modifications, the statements in the compliance report concerning the broker-dealer's Internal Control Over Compliance will likely account for the bulk of the work of the independent public accountant and, as noted above, before today's amendments, the independent public accountant was required to include internal control within the scope of the audit.

The Commission believes that the modifications to the final rule discussed above should modestly reduce the external cost of the final rule as compared to the cost that would have resulted from the proposed rule. Further, elimination of the requirement that the accountant prepare a material inadequacy report will result in some cost savings.[707] While these modifications to the final rule may result in reduced costs, the Commission continues to believe that the average estimated incremental cost of $150,000 per carrying broker-dealer, which may be at the high end of the range of estimated costs, is reasonable.

For these reasons, the Commission has not changed its average estimate of the incremental cost of the accountants' reports covering the compliance report. The Commission therefore estimates that the average industry-wide annual external reporting incremental cost of this requirement is approximately $43,800,000 per year ($150,000 x 292 carrying broker-dealers = $43,800,000).

c. Exemption Report

The Commission estimated that the external cost to a non-carrying broker-dealer of obtaining the independent public accountant's report based on a review of the proposed exemption report would be an average of approximately $3,000 per non-carrying broker-dealer per year, for a total estimated annual cost associated with this proposal of $14,256,000.[708] The Commission did not receive any specific comments regarding this cost estimate.

In the proposing release, the Commission stated its belief that an independent public accountant's review of the exemption assertion would add an incremental cost to that incurred as

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707 The Commission also stated in the proposing release that the Commission estimated that amendments to the IA Custody Rule would impose external costs of $250,000 per investment adviser, and that the Commission estimated that the examination of the compliance report would incrementally cost $150,000 because the IA Custody Rule imposed new requirements on investment advisers, and, unlike the final rule amendments being adopted today, was not based on existing obligations. See Broker-Dealer Reports, 76 FR at 37599. Based on this comparison, the Commission continues to believe that the average estimated incremental cost of $150,000 per carrying broker-dealer is reasonable and that the changes discussed above generally should not materially impact the cost estimate as they may, in some cases, result in a modest reduction in burden.

708 See Broker-Dealer Reports, 76 FR at 37599–37600. The Commission estimated that there were 4,752 non-carrying broker-dealers. 4,752 x $3,000 = $14,256,000.

a result of the annual financial audit.[709] As discussed above, independent public accountants engaged by broker-dealers were required, before today's amendments, to "ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to [the independent public accountant's] attention to indicate that the exemption had not been complied with during the period since [the independent public accountant's] last examination."[710]

The Commission continues to believe that $3,000 is a reasonable estimate of the cost of obtaining the accountant's report covering the exemption report. The Commission now estimates that there are approximately 4,417 non-carrying broker-dealers. The Commission therefore estimates that the total industry-wide external annual reporting cost of this requirement is approximately $13,251,000 per year (4,417 non-carrying broker-dealers x $3,000 = $13,251,000).

d. Access to Accountant and Audit Documentation

The amendments to Rule 17a-5 require that carrying or clearing broker-dealers agree to allow Commission and DEA staff, if requested in writing for purposes of an examination of the broker-dealer, to review the work papers of the independent public accountant and to allow the accountant to discuss its findings with the examiners.

In the proposing release, the Commission estimated that a carrying or clearing broker-dealer's accountant would charge the broker-dealer for time its personnel spend speaking with the Commission or the broker-dealer's DEA and providing them with audit documentation.[711]

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709 Id. at 37599.

710 See 17 CFR 240.17a-5(g)(2).

711 In the proposing release, the Commission estimated that a broker-dealer's accountant would spend approximately 5 hours per year speaking with Commission or DEA staff and providing them with audit documentation.

Thus, the Commission estimated that the additional cost of accountant time associated with this amendment to all clearing and carrying broker-dealers would be approximately $660,000 annually.[712] As the Commission now estimates that the number of carrying or clearing broker-dealers is 513, the new estimate is approximately $641,250.[713]

2. Conforming and Technical Amendments to Rule 17a-11

The Commission proposed technical amendments to Rule 17a-5 and proposed amending paragraph (e) of Rule 17a-11 to eliminate a reference to Rule 17a-5.[714] The Commission stated that these changes should not result in an additional hour burden for the Rule 17a-11 collection of information. As discussed above in section II.F.2. of this release, in response to a comment, paragraph (e) of Rule 17a-11, as adopted, retains a reference to Rule 17a-5. In addition, the Commission is adopting conforming amendments to substitute the term material weakness as defined in paragraph (d)(3)(iii) of Rule 17a-5 for the term material inadequacy with respect to Rule 17a-5. Specifically, the final rule provides that whenever a broker-dealer discovers, or is notified by its accountant under paragraph (h) of Rule 17a-5 of the existence of any material weakness, the broker-dealer must: (1) give notice of the material weakness within 24 hours of the discovery or notification; and (2) transmit a report within 48 hours of the notice stating what the broker-dealer has done or is doing to correct the situation.[715]

The Commission does not expect any change in the number of notices filed per year as a result of the final amendments because the material inadequacy notification requirement is being replaced by a material weakness notification requirement. Therefore, the final amendments to

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712 In the proposing release, the Commission multiplied 528 clearing and carrying broker-dealers x 5 hours x $250/hour = $660,000.

713 513 clearing and carrying broker-dealers x $1,250 in increased costs per clearing broker-dealer = $641,250.

714 See Broker-Dealer Reports, 76 FR at 37597.

715 See paragraph (e) of Rule 17a-11. This provision retains references to material inadequacy with respect to Rule 17a-12.

Rule 17a-11 should not result in a change in the current PRA burden for Rule 17a-11. However, the Commission will take into account any changes in the number of notices associated with this collection of information in subsequent extensions of this collection of information and make any necessary adjustments, as appropriate.

3. Form Custody

As described more fully above, the amendments require that all broker-dealers registered with the Commission file Form Custody quarterly with their DEA. The Commission estimated that the hour burden associated with completing and filing proposed Form Custody would be approximately 12 hours per quarter, or 48 hours per year, on average, for each broker-dealer.[716]

In section IV. of this release, in adopting the final amendments to Form Custody, the Commission received one comment in response to Item 8 of Form Custody, as proposed, noting that the information sought in Item 8 was largely the same as information collected from investment advisers on Form ADV.[717] As stated above in section IV. of this release, the Commission is aware that some overlap exists between the information collected from investment advisers on Form ADV and the information that would be collected from broker-dealers dually-registered as investment advisers in Item 8 of proposed Form Custody. However, these two forms also contain a significant amount of non-overlapping material, reflecting their different purposes and uses. Form Custody is intended to be a single source of readily-available information to assist Commission and DEA examiners in preparing for and performing focused custody exams, and it is particularly important that such information be readily available in the case of dually-registered firms. Consequently, the Commission believes that the PRA burden for Form Custody is reasonable in light of its intended purpose, as discussed above in section IV. of

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716 See Broker-Dealer Reports, 76 FR at 37597.

717 See Angel Letter.

this release. Additionally, the commenter did not indicate disagreement with the hour burden estimate as proposed. Therefore, the Commission is retaining the hour burden estimate without revision.

The Commission now estimates that there are approximately 4,709 broker-dealers that must file Form Custody. The Commission therefore estimates that the total annual burden associated with completing and filing Form Custody for all 4,709 broker-dealers is approximately 226,032 hours per year (4,709 broker-dealer times 4 responses per year times 12 hours = 226,032 hours).

One commenter stated that the estimated costs to the industry of $69,179,670 is "staggering," and that such costs would likely indirectly be passed on to customers.[718] The commenter did not disagree with the PRA estimate in the proposing release; rather, the commenter focused on size of the total estimated costs. The Commission recognizes that the requirement to file Form Custody will increase compliance costs for broker-dealers and, consequently, the PRA estimates reflect these costs. The PRA hour burden estimates (and associated internal burden costs), however, are averages across all broker-dealers. The costs incurred by a broker-dealer to comply with the requirement to file Form Custody will depend on its size and the complexity of its business activities. Because the size and complexity of broker-dealers varies significantly, the Commission provides estimates of the average cost per broker-dealer across all broker-dealers.

For these reasons, the Commission believes the internal costs related to the PRA for this hour burden are reasonable and, therefore, the Commission is not adjusting the final cost

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718 See IMS Letter. The cost of $69,179,670 was reflected in the Economic Analysis in the proposing release. See Broker-Dealer Reports, 76 FR at 37601. This cost was calculated as an internal cost of the estimated PRA hours and is the total cost divided among 5,057 firms. Id. at 37601 n.215. This internal cost would amount to an average of $13,680 per broker-dealer.

estimate, except to reflect updated data with respect to the number of broker-dealers and compensation.[719]

E. Collection of Information Is Mandatory

The collection of information obligations imposed by the rule amendments are mandatory for broker-dealers that are registered with the Commission.

F. Confidentiality

The Commission expects to receive confidential information in connection with the proposed collections of information. Paragraph (e)(3) of Rule 17a-5, as amended, provides that broker-dealer annual reports filed with the Commission are not confidential, except that if the Statement of Financial Condition is bound separately from the balance of the annual reports, and each page of the balance of the annual reports is stamped "confidential," then the balance of the annual reports shall be deemed confidential to the extent permitted by law.[720] However, under paragraph (c)(2)(iv) of Rule 17a-5, if there are material weaknesses, the accountant's report on the compliance report must be made available for customers' inspection and, consequently, it would not be deemed confidential. In addition, paragraph (c)(2)(i) of Rule 17a-5 requires a broker-dealer to furnish to its customers annually a balance sheet with appropriate notes prepared in accordance with GAAP and which must be audited if the broker-dealer is required to file audited financial statements with the Commission.[721] With respect to the other information collected under the amendments, a broker-dealer can request the confidential treatment of the information.[722] If such a confidential treatment request is made, the Commission anticipates that

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719 Id.

720 See paragraph (e)(3) of Rule 17a-5.

721 See 17 CFR 240.17a-5(c)(2)(i).

See 17 CFR 200.83. Information regarding requests for confidential treatment of information submitted to the Commission is available at http://www.sec.gov/foia/howfo2.htm#privacy.

it will keep the information confidential to the extent permitted by law.[723]

VII. ECONOMIC ANALYSIS

The Commission is sensitive to the costs and benefits of its rules. When engaging in rulemaking that requires the Commission to consider or determine whether an action is necessary or appropriate in the public interest, section 3(f) of the Exchange Act requires that the Commission consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[724] In addition, section 23(a)(2) of the Exchange Act requires that the Commission consider the effects on competition of any rules the Commission adopts under the Exchange Act, and prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[725]

In the proposing release, the Commission solicited comment on the costs and benefits of the proposed amendments and new form, including whether estimates of the costs and benefits were accurate and comprehensive.[726] The Commission further encouraged commenters to provide specific data and analysis in support of their views.[727] The Commission also requested comment on whether the proposed amendments would place a burden on competition, and promote efficiency, competition, and capital formation.[728]

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723 See, e.g., 15 U.S.C. 78x (governing the public availability of information obtained by the Commission); 5 U.S.C. 552 et seq.

724 15 U.S.C. 78c(f).

725 15 U.S.C. 78w(a)(2).

726 See Broker-Dealer Reports, 76 FR at 37598. An economic analysis was included in the proposing release. Id. at 37598–37601.

Id. at 37598.

Id.

The Commission received 27 comment letters on the proposed amendments. A number of commenters addressed the Commission's estimates of the cost and benefits of the proposed amendments.[729] Generally, these commenters stated that the Commission's cost and benefit estimates failed to include all of the costs associated with the proposed amendments and that the costs that the Commission did include in its analysis were underestimated. For example, one commenter stated that the proposed amendments "place unnecessary regulatory burdens and costs on industry, in general, and smaller firms, in particular" and that "broker-dealers compete against investment advisers who are not burdened by the same regulatory requirements," including the requirements in the proposed amendments.[730] While commenters stated that the Commission underestimated costs, they did not provide alternative quantified estimates of the costs.[731]

As discussed throughout this release, in part in response to comments, the Commission has modified the proposed rules to reduce compliance burdens where consistent with investor protection. In addition, as discussed below, where commenters identified costs the Commission did not consider, the Commission has revised its economic analysis of the final rules to take these costs into account.

In adopting the rule amendments and new form, the Commission has been mindful of the associated costs and benefits. The costs and benefits that the Commission has considered in adopting these amendments and new form are discussed below. The discussion focuses on the

729 See ABA Letter; AICPA Letter; Angel Letter; CAI Letter; Citrin Letter; IMS Letter; KPMG Letter; McGladrey Letter; SIFMA Letter; Van Kampen/Invesco Letter.

730 See IMS Letter.

731 For example, one commenter stated that the Commission's estimate of the costs of the compliance report have "the potential to double the total current audit fees and have a material impact" on firms. See Van Kampen/Invesco Letter. The commenter, however, did not provide a quantified baseline estimate of current audit fees incurred by broker-dealers with which to compare the Commission's estimate of the incremental cost that the compliance report amendments will have on audit fees.

Commission's reasons for adopting these amendments and new form, the affected parties, and the costs and benefits of the amendments and new form compared to the baseline, described below, and to alternative courses of action.

Many of the benefits and costs discussed below are difficult to quantify, in particular when discussing increases in investor confidence and improvements in investor protection. For example, the extent to which the increased ability of the Commission and DEAs to oversee compliance with the financial responsibility rules will help limit future violations of the rules is unknown. Similarly, it is unknown how much increasing the focus of broker-dealers on the financial responsibility rules will result in enhanced compliance with those rules. Moreover, limited public data exists to study the costs of broker-dealer audits. Therefore, much of the discussion is qualitative in nature but, where possible, the Commission attempted to quantify the costs.

A. Motivation for the Amendments

The rule amendments and new form being adopted today are designed to provide additional safeguards with respect to broker-dealer custody of customer securities and funds. The motivation for these amendments, which are discussed throughout this release, are summarized below.

First, as mentioned above in section I.A. of this release, over the last several years, the Commission has brought several cases alleging fraudulent conduct by investment advisers and broker-dealers, including among other things, alleged misappropriation or other misuse of customer securities and funds.[732] These cases highlight the need for enhancements to the rules

[732] See, e.g., SEC v. Donald Anthony Walker Young, et al., Litigation Release No. 21006 (Apr. 20, 2009); SEC v. Isaac I. Ovid, et al., Litigation Release No. 20998 (Apr. 14, 2009); SEC v. The Nutmeg Group, LLC, et al., Litigation Release No. 20972 (Mar. 25, 2009); SEC v. WG Trading Investors, L.P., et al., Litigation Release No. 20912 (Feb. 25, 2009); SEC v. Stanford International Bank, et al., Litigation

governing broker-dealer custody of customer assets. Such enhancements include both increased focus on compliance and internal compliance controls by broker-dealers and their auditors, as well as measures to increase the ability of the Commission and broker-dealer DEAs to oversee broker-dealer custody practices by requiring broker-dealers to provide more information about these practices.

Second, as discussed above in section II.D. of this release, certain provisions of Rule 17a-5 before today's amendments were inconsistent with current audit practices, standards, and terminology, which have evolved since these provisions were adopted. This inconsistency has resulted in disparate audit practices and inconsistent compliance with the rule. As discussed above in section II.D.3.iii. of this release, the PCAOB has published a report containing observations from inspections of portions of 23 broker-dealer audits conducted by ten accounting firms.[733] According to the report, PCAOB inspections staff identified deficiencies in all of the audits inspected.[734] The deficiencies noted in the report provide support for the need to strengthen and clarify broker-dealer audit and reporting requirements in order to facilitate consistent compliance with these requirements.

Third, as discussed in section II.D. of this release, prior to today's amendments, Rule 17a-5 required that broker-dealer audits be conducted in accordance with GAAS, which are established by the Auditing Standards Board of the AICPA. The amendments – by requiring that the audits be conducted in accordance with PCAOB standards – recognize the PCAOB's explicit oversight authority over broker-dealer audits as provided by the Dodd-Frank Act,

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Release No. 20901 (Feb. 17, 2009); SEC v. Bernard L. Madoff, et al., Litigation Release No. 20889 (Feb. 9, 2009). The Commission also has brought an enforcement action against an accountant that purported to audit financial statements and disclosures of one of these broker-dealers. See SEC v. David G. Friehling, C.P.A., et al., Litigation Release No. 20959 (Mar. 18, 2009).

See PCAOB Inspection Report at p. ii.

Id.

including the authority to establish (subject to Commission approval) and enforce auditing and related attestation, quality control, ethics, and independence standards.[735] In addition, the Commission has direct oversight authority over the PCAOB, including the authority to approve or disapprove the PCAOB's rules and standards.[736] Consequently, requiring that broker-dealer audits be conducted in accordance with standards the Commission has approved will better ensure alignment between broker-dealer audits and the regulatory policy objectives reflected in the Commission's financial responsibility rules.

Fourth, as discussed in section II.B.6. of this release, because broker-dealers have not been required to file with SIPC their annual audited financial statements, SIPC has received limited information regarding the financial condition of its broker-dealer members. SIPC can use this information, among other things, to assess whether the SIPC Fund is appropriately sized to the risks of a large broker-dealer failure. In addition, at least one court, the New York Court of Appeals, has held that in cases where SIPC is required to fund the liquidation of a broker-dealer, SIPC could not maintain a claim against the auditor of the broker-dealer based on an alleged failure to comply with auditing standards because SIPC did not receive the audited financial statements and therefore could not have relied upon them.

Fifth, as discussed in section III. of this release, the audit work performed by independent public accountants with respect to audits of carrying and clearing broker-dealers can provide useful information to Commission and DEA examiners in terms of planning the scope and focus

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735 See discussion in section II.D.3. of this release.

736 Section 107(a) of the Sarbanes-Oxley Act provides that the Commission "shall have oversight and enforcement authority over the [PCAOB] as provided by the [Sarbanes-Oxley Act]." Section 107(b) of the Sarbanes-Oxley act provides that "[n]o rule of the [PCAOB] shall become effective without prior approval of the Commission" other than certain initial or transitional standards. Section 107(c) of the Sarbanes-Oxley Act provides for Commission review of disciplinary action taken by the PCAOB. Section 107(d) of the Sarbanes-Oxley Act provides that the Commission may censure and impose other sanctions on the PCAOB in certain circumstances.

of the examination of the broker-dealer. Providing Commission and DEA examiners with access to the independent public accountant that audited the broker-dealer and audit documentation related to the audit will allow the examiners to gain an understanding of the work the accountant did in auditing the broker-dealer and any areas of concern highlighted by the auditor. This will enable the examiners to conduct risk-based examinations of carrying and clearing broker-dealers and assist the examiners in determining areas of focus for their examinations. Furthermore, the amendments will make it clear to the independent public accountant that the broker-dealer has agreed that the accountant can provide this information and, consequently, eliminate uncertainty as to whether the broker-dealer consents to the disclosure of the information.

Sixth, as discussed in section IV. of this release, because broker-dealers were not required to provide comprehensive or consolidated information about their custody practices to the Commission or their DEA, the Commission and the broker-dealer's DEA had a fragmented and incomplete picture of whether a broker-dealer maintained custody of customer and non-customer assets, and if so, how such assets were maintained. This hindered the ability of the Commission and DEAs to efficiently plan, prioritize, and perform examinations.

B. Economic Baseline

The regulatory changes adopted today amend requirements that apply to broker-dealers registered with the Commission and independent public accountants that audit or attest to broker-dealer annual reports. The discussion below includes approximate numbers of broker-dealers and accountants that would be affected by today's amendments and a description of the economic baseline against which the costs and benefits, as well as the impact on efficiency, competition, and capital formation, of today's amendments and new form are measured.

1. Broker-Dealers

The broker-dealers registered with the Commission vary significantly in terms of their size, business activities, and the complexity of their operations. For example, carrying broker-dealers hold customer securities and funds.[737] Clearing broker-dealers clear transactions as members of security exchanges and the Depository Trust & Clearing Corporation and the Options Clearing Corporation.[738] Many clearing broker-dealers are carrying broker-dealers, but some clearing broker-dealers clear only their own transactions and do not hold customer securities and cash.

As stated in section I.B.1. above, a broker-dealer that claims an exemption from Rule 15c3-3 is generally referred to as "non-carrying broker-dealer." Non-carrying broker-dealers include "introducing brokers."[739] These non-carrying broker-dealers accept customer orders and introduce their customers to a carrying broker-dealer that will hold the customers' securities and cash along with the securities and cash of customers of other introducing broker-dealers and those of direct customers of the carrying broker-dealer. The carrying broker-dealer generally receives and executes the orders of the introducing broker-dealer's customers.[740] Carrying

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737 Rule 15c3-1, the Commission's net capital rule, specifies that a broker-dealer shall be deemed to carry customer or broker-dealer accounts "if, in connection with its activities as a broker or dealer, it receives checks, drafts, or other evidences of indebtedness made payable to itself or persons other than the requisite registered broker or dealer carrying the account of a customer, escrow agent, issuer, underwriter, sponsor, or other distributor of securities" or "if it does not promptly forward or promptly deliver all of the securities of customers or of other brokers or dealers received by the firm in connection with its activities as a broker or dealer." 17 CFR 240.15c3-11(a)(2)(i). Further, Rule 15c3-3, the Commission's customer protection rule governing reserves and custody of securities, defines the term "securities carried for the account of a customer" to mean "securities received by or on behalf of a broker or dealer for the account of any customer and securities carried long by a broker or dealer for the account of any customer," as well as securities sold to, or bought for, a customer by a broker-dealer. 17 CFR 240.15c3-3(a)(2).

738 See Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks, Final Rule, Exchange Act Release No. 56501(Sept. 24, 2007), 72 FR 56514, 56541 n.269 (Oct. 3, 2007).

739 Id. at ¶ 1.15; see also Exchange Act Release No. 31511 (Nov. 24, 1992), 57 FR 56973 (Dec. 2, 1992) (describing role of introducing broker-dealers).

740 Exchange Act Release No. 31511 (Nov. 24, 1992), 57 FR 56973 (Dec. 2, 1992).

broker-dealers also prepare trade confirmations, settle trades, and organize book entries of the securities.[741] Introducing broker-dealers also may use carrying broker-dealers to clear the firm's proprietary trades and carry the firm's securities. Another group of non-carrying broker-dealers effects transactions in securities such as mutual funds on a subscription-way basis, where customers purchase the securities by providing the funds directly to the issuer.[742] Finally, some non-carrying broker-dealers act as finders by referring prospective purchasers of securities to issuers.[743]

The broker-dealer industry is the primary industry affected by the rule amendments and the new form. In some cases, the amendments impose different requirements on different types of broker-dealers. For example, carrying broker-dealers must file the compliance report and an independent public accountant's report covering the compliance report, while non-carrying broker-dealers must file the exemption report and an independent public accountant's report covering the exemption report. Only carrying and clearing broker-dealers must agree to allow Commission and DEA examiners to review the audit documentation of their independent public accountants and to allow accountants to discuss their findings with the examiners. All broker-

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741 See, e.g., FINRA Rule 4311 (Carrying Agreements). This FINRA rule governs the requirements applicable to FINRA members when entering into agreements for the carrying of any customer accounts in which securities transactions can be effected. Historically, the purpose of this rule has been to ensure that certain functions and responsibilities are clearly allocated to either the introducing or carrying firm, consistent with the requirements of the SRO's and Commission's financial responsibility and other rules and regulations, as applicable. See also Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change Adopting, as Modified by Amendment No. 1, Rules Governing Guarantees, Carrying Agreements, Security Counts and Supervision of General Ledger Accounts in the Consolidated FINRA Rulebook, Exchange Act Release 34-63999 (Mar. 7, 2011), 76 FR 12380 (Mar. 7, 2011).

742 See Books and Records Requirement for Brokers and Dealers Under the Securities Exchange Act of 1934, Exchange Act Release 34-44992 (Nov. 2, 2001) ("[T]he Commission recognizes that for some types of transactions, such as purchases of mutual funds or variable annuities, the customer may simply fill out an application or a subscription agreement that the broker-dealer then forwards directly to the issuer.").

743 See American Bar Association, Report and Recommendations of the Task Force on Private Placement Broker-Dealers 23–24 (2005); see also Exchange Act Release No. 31511 (Nov. 24, 1992), 57 FR 56973 (Dec. 2, 1992).

dealers must file Form Custody, but many of the line items on the form apply only to carrying broker-dealers.

To establish a baseline for competition among broker-dealers, the Commission looks at the status of the broker-dealer industry detailed below. In terms of size, the following tables illustrate the variance among broker-dealers with respect to total capital. The information in the table is based on FOCUS Report data for calendar year 2011.

Broker-Dealer Capital at Calendar Year End 2011[744]
($ millions)

Capital	Number of Firms	Aggregate Total Capital
Less than $500,000	2,506	$347
Greater than or equal to $500,000 and less than $5 million	1,320	$2,212
Greater than or equal to $5 million and less than $50 million	608	$10,520
Greater than or equal to $50 million and less than $100 million	80	$5,672
Greater than or equal to $100 million and less than $500 million	125	$26,655
Greater than or equal to $500 million and less than $1 billion	28	$19,248
Greater than or equal to $1 billion and less than $5 billion	27	$61,284
Greater than or equal to $5 billion and less than $10 billion	6	$41,175
Greater than or equal to $10 billion	9	$175,585
Total	**4,709**	**$342,698**

According to FOCUS Report data, as of December 31, 2011, there were approximately 4,709 broker-dealers registered with the Commission.[745] Nine broker-dealers dominate the broker-dealer industry, holding over half of all capital held by broker-dealers. Of the 4,709 registered broker-dealers, 4,417 firms claimed exemptions from Rule 15c3-3 on their FOCUS Reports. Accordingly, the Commission estimates that there are approximately 292 carrying broker-dealers (4,709 – 4,417 = 292). Further, based on FOCUS Report data, the Commission also estimates that there are approximately 513 broker-dealers that are clearing or carrying firms. The Commission staff has estimated that approximately 18% of broker-dealers registered with

744 The information in this chart is based on FOCUS Report data filed by broker-dealers in 2011.

745 Not all broker-dealers registered with the Commission are SIPC members. According to SIPC, as of March 31, 2012, 217 broker-dealers claimed exemptions from SIPC membership. The Commission therefore estimates that 4,492 (4,709 – 217 = 4,492) broker-dealers are members of SIPC.

FINRA[746] also are registered as investment advisers with the Commission or with a state.[747]

2. Independent Public Accountants that Audit Broker-Dealer Reports

Independent public accountants that audit broker-dealer reports also will be impacted by the rule amendments. Based on the audit reports filed by broker-dealers in 2011, approximately 900 accounting firms audited broker-dealer reports that were filed with the Commission. However, six large accounting firms dominate the market performing audits for approximately 20% of all broker-dealers registered with the Commission, and those broker-dealers audited by the six large accounting firms had total capital that was more than 90% of the total capital of all broker-dealers registered with the Commission.[748] These statistics highlight the current baseline for competition under which the accountants are operating.

Prior to today's amendments, the AICPA established the auditing and attestation standards to be followed by the independent public accountants of broker-dealers (i.e., GAAS). The AICPA's auditing standards are revised and updated from time to time. For example, the AICPA recently revised GAAS (including audit standards that apply to audits of broker-dealer financial statements), and the revised standards were generally effective for fiscal years that ended on or after December 31, 2012.[749] Consequently, the independent public accountants of broker-dealers have from time to time had to familiarize themselves with updates and revisions to GAAS.

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746 Per FINRA's website, there were 4,456 FINRA member firms at year end 2011. See http://www.finra.org/Newsroom/Statistics/.

747 See Commission staff, Study on Investment Advisers and Broker-Dealers, as required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Jan. 2011).

748 This data is based on audited reports filed by broker-dealers in 2011 and FOCUS Report data.

749 See AICPA, Improving the Clarity of Auditing Standards, available at http://www.aicpa.org/InterestAreas/FRC/AuditAttest/Pages/ImprovingClarityASBStandards.aspx. The AICPA announced the clarification and convergence project in July 2008. See http://www.aicpa.org/InterestAreas/FRC/AuditAttest/DownloadableDocuments/Clarity/Archive/ASB_Clarity_%20and_Convergence_(8.5x11).pdf.

3. SIPC Lawsuits Against Accountants

SIPC was established in 1971. In the period from 1971 to 2011, SIPC initiated 324 proceedings under SIPA to liquidate a failed broker-dealer.[750] This results in an average of approximately 8 SIPA proceedings per year, though 109 of the 324 proceedings were initiated in the period from 1971 to 1974, which was the immediate aftermath of the financial crisis of 1968–1970.[751] According to SIPC staff, SIPC has brought 9 lawsuits against accountants since 1971, which is one lawsuit for every 36 SIPA proceedings.[752] The SIPC staff reports that two of these lawsuits were brought after the 2001 New York decision discussed in section II.B.6.iii. of this release and three lawsuits were brought in liquidation proceedings that were active at or about the same time as the 2001 New York decision. The suits initiated around the time of the 2001 decision and thereafter were brought in jurisdictions other than New York.

4. Overview of Broker-Dealer Reporting, Auditing, and Notification Requirements Before Today's Amendments

i. Broker-Dealer Reporting

Before today's amendments, Rule 17a-5 generally required broker-dealers to prepare and file a financial report with the Commission and the broker-dealer's DEA, as well as a report of a PCAOB-registered independent public accountant covering the financial report. Brokers-dealers also were required to file concurrently with the audited financial report a material inadequacy report prepared by the independent public accountant.

With regard to the material inadequacy report, broker-dealers generally made representations to their independent public accountants about their compliance with certain

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750 See SIPC, Annual Report 2011, at 6.

751 Id. See also Commission, Study of Unsafe and Unsound Practices of Brokers and Dealers: Report and Recommendations of the Securities and Exchange Commission (December 1971) (discussing the financial crisis of 1968–1970). Since its inception through 2001, SIPC initiated 299 proceedings under SIPA.

752 See discussion above in section II.B.6. of this release.

financial responsibility rules in a representation letter.[753] However, broker-dealers did not file reports with the Commission or their DEA containing such representations. GAAS does not prescribe specific or standardized representations to be made by a broker-dealer to its accountant with regard to an attestation engagement performed under Rule 17a-5.[754] Therefore, broker-dealers' representations to their independent public accountant relating to compliance with certain financial responsibility rules varied depending on what was required by the terms of the individual engagements.

ii. Engagement of the Accountant

As noted above, prior to today's amendments, broker-dealers generally were required to file with the Commission: (1) a report of an independent public accountant based on an audit of the broker-dealer's financial statements and supporting schedules; and (2) a material inadequacy report prepared by the accountant, based on, among other things, a review of a broker-dealer's accounting system, internal accounting control, and procedures for safeguarding securities. The accountant was required to be registered with the PCAOB. However, Rule 17a-5 required that the audit be performed in accordance with GAAS, which are issued by the AICPA. Consequently, the standard setting body for broker-dealer audits has been the AICPA (rather than the PCAOB) notwithstanding the requirement that broker-dealers be audited by a PCAOB-registered independent public accountant.[755]

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753 See, e.g., AICPA Broker-Dealer Audit Guide app. H (sample representation letter).

754 According to GAAS, auditors "should consider obtaining a representation letter" in an examination or review engagement, and "specific written representations will depend on the circumstances of the engagement and the nature of the subject matter and the criteria." See AICPA, AT Section 101 at ¶ .60. Further, while the AICPA Broker-Dealer Audit Guide contains a sample representation letter, publications such as this guide "are not auditing standards" but are "recommendations on the application of the [auditing standards] in specific circumstances, including engagements for entities in specialized industries." See AICPA, AU Section 150, at ¶ .05.

755 See below discussion in section VII.C.1.i. of this release.

With regard to the independent public accountant's preparation of the material inadequacy report, Rule 17a-5 required that the scope of the accountant's review be sufficient to provide "reasonable assurance" that any material inadequacies[756] existing at the date of examination would be disclosed. As discussed above in section II.D.3. of this release, the AICPA Broker-Dealer Audit Guide provided guidance regarding preparation of the material inadequacy report. Specifically, AICPA guidance stated that the material inadequacy report should address what the independent public accountant concluded in its "study" of the adequacy of the broker-dealer's practices and procedures in complying with the financial responsibility rules in relation to the definition of material inadequacy as stated in Rule 17a-5. The requirement to issue a "study" does not generally exist outside the context of broker-dealer audits, however, and, while auditing standards at one time referred to the performance of a study, current auditing standards no longer contain such references.

If the broker-dealer was exempt from Rule 15c3-3, Rule 17a-5 required the independent public accountant to ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to the independent public accountant's attention to indicate that the exemption had not been complied with during the period since the last examination.

iii. Filing of Annual Reports with SIPC

Prior to today's amendments, broker-dealers that are members of SIPC were required to

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756 Prior to today's amendments, paragraph (g)(3) of Rule 17a-5 describes a "material inadequacy" in a broker-dealer's accounting system, internal accounting controls, procedures for safeguarding securities, and practices and procedures to include "any condition which has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to: (i) inhibit a broker or dealer from promptly completing securities transactions or promptly discharging his responsibilities to customers, other brokers or dealers or creditors; (ii) result in material financial loss; (iii) result in material misstatements in the broker's or dealer's financial statements; or (iv) result in violations of the Commission's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in [(i) through (iii) above]." 17 CFR 240.17a-5.

file only limited information with SIPC. This information is elicited on Form SIPC-6, the "General Assessment Payment Form" and Form SIPC-7, the "Annual General Assessment Reconciliation." In addition, for any period during which the SIPC assessment was not a minimum assessment as provided for in section 4(d)(1)(c) of SIPA, paragraph (e)(4) of Rule 17a-5 generally required broker-dealers to submit to SIPC a supplemental report on the status of the membership of the broker-dealer in SIPC. The supplemental report, among other things, had to include a comparison of the amounts reflected in the annual financial report the broker-dealer filed with the Commission with amounts reported on Form SIPC-7. Form SIPC-6 is filed for the first half of the fiscal year and Form SIPC-7 is filed at the end of the fiscal year with a place to deduct the assessment due and paid as reflected on Form SIPC-6. These forms elicit information from a broker-dealer that is a SIPC member about the broker-dealer's sources of revenue attributable to its securities business.

Prior to today's amendments, broker-dealers did not file with SIPC the annual audited financial statements and accompanying schedules and reports they filed with the Commission and their DEA under Rule 17a-5. Therefore, for example, broker-dealers did not file their balance sheets, which contain information concerning their assets, liabilities, and net worth, or notes to their financial statements with SIPC. This information is necessary to understand the financial conditions of the broker-dealer and, therefore, in order for SIPC to determine whether the SIPC Fund is appropriately sized to the risks of the broker-dealer industry.

iv. Notification Requirements

Prior to today's amendments, the reporting provisions of Rule 17a-5 included references to the term "material inadequacy."[757] The term also was used in the Rule 17a-5 and Rule 17a-11

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[757] See supra note 756, at 216.

notification provisions discussed below.

Rule 17a-5 required that if, during the course of the audit, the independent public accountant determined that any material inadequacies existed, the independent public accountant was required to inform the CFO of the broker-dealer, who was required to give notice to the Commission and the broker-dealer's DEA within 24 hours. The rule also provided that the broker-dealer must furnish the independent public accountant with the notice. If the independent public accountant failed to receive the notice within the 24-hour period, or if the accountant disagreed with the statements contained in the notice, the accountant was required to inform the Commission and the DEA within the next 24 hours and describe any material inadequacies found to exist or, if the broker-dealer filed a notice, detail the aspects of the broker-dealer's notice with which the accountant did not agree.

In addition, Rule 17a-11 required that when a broker-dealer discovers a material inadequacy, or is notified by its independent public accountant under Rule 17a-5 that a material inadequacy exists, the broker-dealer must notify the Commission and its DEA and must transmit a report stating what the broker-dealer has done or is doing to correct the situation.

v. Information Provided to Customers

Prior to today's amendments, Rule 17a-5 provided that, if the independent public accountant commented on any material inadequacies, the financial information a broker-dealer was required to send to customers annually must include a statement that a copy of the accountant's report and comments was available for customers' inspection. In addition, Rule 17a-5 provided a conditional exemption from the requirement that a broker-dealer send paper copies of financial information to customers, if the broker-dealer was not required during the prior year to give notice of a material inadequacy.

vi. **Access to Accountants**

Prior to today's amendments, carrying and clearing broker-dealers were not required to provide Commission and DEA examination staff access to their independent public accountants and accountant work papers. Such access would enable Commission and DEA examiners to obtain information, for example, regarding areas on which the accountants focused in order to plan and conduct risk-based examinations of carrying and clearing broker-dealers.

vii. **Form Custody**

Generally, prior to today's amendments, broker-dealers were not required to provide comprehensive or consolidated information about their custody practices to the Commission or their DEA. Some information relating to a broker-dealer's custody practices is included in a broker-dealer's exchange membership agreements and clearing agreements, and in the books and records of the broker-dealer. In addition, some information is included on Form ADV and, therefore, if the broker-dealer also is a registered investment adviser, the information is available to the Commission. Although Commission and DEA examiners could obtain the information provided on Form Custody through detailed examinations of the broker-dealer's books and records and by requesting information from other sources, the Commission and the broker-dealer's DEA did not have a profile of a broker-dealer's custodial activities that could serve as a starting point to perform more focused examinations.

C. Costs and Benefits of the Rule Amendments

This section discusses costs and benefits of the rule amendments and new forms for the affected parties against the economic baseline identified above, both in terms of each of the specific changes from the baseline, as well as in terms of the overall impact. In considering ese costs, benefits, and impacts, this discussion addresses, among other things, comments received, modifications made to the proposed amendments and form, and reasonable alternatives, where applicable.

The costs incurred by a broker-dealer to comply with the rule amendments and new form generally will depend on its size and the complexity of its business activities. Because the size and complexity of broker-dealers vary significantly as indicated in the economic baseline, their costs could vary significantly. In some cases, the Commission is providing estimates of the average cost per broker-dealer across all broker-dealers, taking into consideration the variance in the size of broker-dealers and the complexity of their business activities.

1. Broker-Dealer Annual Reporting Amendments

i. Changing the Broker-Dealer Audit Standard Setter from the AICPA to the PCAOB and the Standards from GAAS to PCAOB Standards

Today's amendments require that audits of broker-dealer financial statements and schedules be conducted in accordance with the standards of the PCAOB, thereby replacing the AICPA as the standard setter. The amendments also require that broker-dealers file one of two new reports – either a compliance report or an exemption report – and a report of an independent public accountant based on an examination of the compliance report or a review of the exemption report. This section discusses the costs and benefits of the change from the AICPA to the PCAOB as the standard setter for broker-dealer audits and the corresponding change from GAAS to PCAOB standards with respect to the audit of the financial statements and schedules. The costs and benefits of requiring the use of PCAOB standards with respect to examinations and reviews of the new compliance report and exemption report are discussed separately below in section VII.C.1.iii. of this economic analysis regarding the engagement of the accountant.

The change from the AICPA to the PCAOB as standard setter for broker-dealer audits and the corresponding change from GAAS to PCAOB auditing standards for audits of broker-dealer financial reports and supporting schedules provides several benefits. By requiring that these audits be conducted in accordance with PCAOB standards, the amendments align Rule 17a-5 with statutory provisions. As discussed above, the Sarbanes-Oxley Act amended the Exchange Act to require that certain broker-dealer financial reports filed with the Commission be audited by an accounting firm registered with the PCAOB. The Dodd-Frank Act, enacted in July 2010, amended the Sarbanes-Oxley Act to provide the PCAOB with explicit authority to, among other things, establish (subject to Commission approval) auditing and related attestation, quality control, ethics, and independence standards for registered public accounting firms with respect to their preparation of audit reports to be included in broker-dealer filings with the Commission, and the authority to conduct an inspection program of registered public accounting firms that audit broker-dealers.[758] However, Rule 17a-5 provided that broker-dealer audits be performed in accordance with GAAS; namely, auditing standards issued by the AICPA.

After today's amendments, the PCAOB will be the standard setter for two types of entities: issuers that are public companies and broker-dealers. Given this mandate, the PCAOB can focus on establishing standards tailored to these types of entities. For example, with respect to the audit of the financial report, the PCAOB has proposed a standard for auditing supplemental information accompanying audited financial statements filed with the Commission, including supporting schedules broker-dealers must file with the Commission and the broker-dealer's DEA, such as schedules regarding the computation of net capital and the customer reserve requirement and information related to the broker-dealer's possession or control of

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[758] See Pub. L. No. 111-203 § 982.

customer securities.[759] In addition, the PCAOB included the Commission's proposal to amend Rule 17a-5 as one of the factors that led the PCAOB to "reexamine its requirements regarding supplemental information."[760] Consequently, the PCAOB has proposed a standard that would be used for the supplemental reports to the broker-dealer's financial report.[761] The PCAOB stated that "[t]he proposed standard enhances existing PCAOB standards by: (1) [r]equiring the auditor to perform certain audit procedures to test and evaluate the supplemental information, and (2) [e]stablishing requirements that promote enhanced coordination between the work performed on the supplemental information with work performed on the financial statement audit and other engagements, such as a compliance attestation engagement for brokers and dealers."[762]

The change to the PCAOB as the audit standard setter for broker-dealers should facilitate the development of the PCAOB's permanent inspection program as contemplated by the Dodd-Frank Act, because audits of broker-dealers will be inspected by the PCAOB in accordance with its own standards, and not those of another standard setter, and because of feedback that can be obtained through the inspections process regarding gaps and areas that may need improvement. Further, the Commission has direct oversight authority over the PCAOB, including the ability to approve or disapprove the PCAOB's rules.[763] This may help to increase investor confidence in

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759 See Proposed Auditing Standard, Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards, PCAOB Release No. 2011-05, PCAOB Rulemaking Docket Matter No. 036, 3 (July 12, 2011) ("PCAOB Proposed Auditing Standard for Supplemental Information"). As discussed above, the PCAOB has also proposed standards for attestation engagements related to broker-dealer compliance or exemption reports. See PCAOB Proposing Release.

760 See PCAOB Proposed Auditing Standard for Supplemental Information at 2–3.

761 Id. at 2 ("The proposed standard would benefit investors and other users of financial statements by updating and enhancing the required audit procedures when the auditor of the financial statements is engaged to audit and report on whether supplemental information accompanying the financial statements is fairly stated, in all material respects, in relation to the financial statements as a whole.").

762 Id. at 4–5.

763 Section 107 of the Sarbanes-Oxley Act states that no rule of the PCAOB "shall become effective without prior approval of the Commission in accordance with this section, other than as provided in section

the independent public accountants that audit broker-dealers. In addition, as previously stated, the Commission has greater confidence in the quality of audits conducted by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.[764]

As an alternative approach, one commenter argued that GAAS should apply for audits of non-carrying broker-dealers.[765] Another commenter stated that PCAOB standards should apply only for broker-dealers "permanently subject to PCAOB inspection," and that the Commission should not require that audits of broker-dealers be performed in accordance with PCAOB standards for non-issuer broker-dealers until the PCAOB determines which non-issuer broker-dealers will be subject to its permanent inspection program.[766]

The Commission has determined that all audits of broker-dealer financial statements and supporting schedules should be performed in accordance with PCAOB standards for several reasons. First, allowing the use of more than one auditing standard would introduce inconsistencies in audits of broker-dealer financial reports. Second, allowing the use of non-PCAOB auditing standards for certain broker-dealer audits would reduce the benefits discussed above of requiring that all audits of broker-dealer financial reports be conducted in accordance with PCAOB standards. Third, as discussed in more detail below, the switch from GAAS to PCAOB standards should not result in significant incremental costs.

Independent public accountants that audit issuers are already familiar with PCAOB audit standards, which should ease any transition to PCAOB standards for their audits of broker-

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103(a)(3)(B) with respect to initial or transitional standards." See Pub. L. No. 107-204 § 107. This section also states that the Commission "shall approve a proposed rule, if it finds that the rule is consistent with the requirements of this Act and the securities laws, or is necessary or appropriate in the public interest or for the protection of investors", and generally provides that the proposed rule procedures follow the same rule filing procedure for SROs under section 19(b) of the Exchange Act. Id.

764 See Custody of Funds or Securities of Clients by Investment Advisers, 75 FR at 1456.

765 See Citrin Letter.

766 See AICPA Letter.

dealers. Although the retention of two standards could reduce the incremental costs of switching from GAAS to PCAOB standards for some independent public accountants that do not audit issuers, it would not reduce the incremental costs for all such independent public accountants. For example, a requirement that the financial statements of one class of broker-dealer be audited in accordance with GAAS and the financial statements of another class of broker-dealer be audited in accordance with PCAOB standards would avoid the incremental costs only for independent public accountants that limit their audit engagements to the former class of broker-dealer. These independent public accountants would not need to stay current with PCAOB standards and adopt their procedures to those standards. However, independent public accountants that were engaged to audit broker-dealers in both classes would need to stay current with both sets of standards and adopt their procedures to both sets of standards, which could increase their incremental costs. Further, the PCAOB may determine, subject to Commission approval, to adopt specific auditing standards for certain types of broker-dealers (for example, carrying and non-carrying broker-dealers). This could decrease costs for certain broker-dealer audits.

The Commission received several comments on the costs of its proposal to replace GAAS with PCAOB standards with respect to audits of broker-dealer financial reports. Several commenters stated that the Commission did not address the costs associated with the change from GAAS to PCAOB standards.[767] One commenter also stated that the transition to PCAOB standards from GAAS may require substantial revisions to broker-dealer audit programs.[768]

Current PCAOB standards for audits of financial information generally incorporate concepts and requirements contained within GAAS, thereby minimizing the potential costs of

767 See, e.g., McGladrey Letter; SIFMA Letter.

768 See ABA Letter.

this change to independent public accountants that audit broker-dealers. For example, in April 2003, the PCAOB adopted interim auditing standards consisting of GAAS then in existence, to the extent not superseded or amended by the PCAOB.[769] The PCAOB's website lists 50 such standards, including, for example, a standard relating to auditing accounting estimates (AU 342) and a standard relating to auditing fair value measurements and disclosures (AU 328).[770] The PCAOB has adopted, and the Commission has approved, 16 PCAOB auditing standards, beginning with a standard relating to references in audit reports to PCAOB standards.[771]

While some independent public accountants of broker-dealers may incur one-time implementation costs to update their broker-dealer audit programs to reflect PCAOB standards, the costs should not be significant. As stated above, most of the PCAOB's current standards for audits of financial reports incorporate concepts and requirements contained within GAAS. Thus, the independent public accountants of broker-dealers already should be familiar with many of the PCAOB's standards. In addition, as discussed in the economic baseline, the AICPA from time-to-time updates and revises its standards. On such an occurrence, an independent public accountant would need to take steps to become familiar with the updates and revisions and change its broker-dealer audit program accordingly. This need for continuing education presumably already is priced into the audit fees independent public accountants charge broker-dealers.

In contrast to the views expressed by some commenters, the Commission does not expect that a requirement that an audit of financial statements and supporting schedules be conducted in

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769 See PCAOB Auditing Standards (AS) and Interim Auditing Standards (AU) (2013), available at www.pcaobus.org/standards/auditing.

770 Id.

771 See PCAOB Auditing Standard No. 1 (AS No. 1). At least one of these audit standards would not apply to audits of broker-dealer financial reports. See PCAOB Auditing Standard No. 5, "An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements."

accordance with standards of the PCAOB instead of with GAAS will result in substantial changes for broker-dealer audit programs and therefore the Commission does not anticipate that this change will result in significant costs to broker-dealers in the form of increased audit fees.[772]

ii. Requirement to File New Reports

Under the amendments, a broker-dealer will need to file one of two new reports: a compliance report or an exemption report.[773] A carrying broker-dealer (i.e., one that does not claim an exemption from Rule 15c3-3) must file the compliance report, and a broker-dealer that claimed an exemption from Rule 15c3-3 throughout the most recent fiscal year must file the exemption report. In the reports, a broker-dealer must make certain statements and provide certain information relating to the financial responsibility rules. In addition to preparing and filing the compliance report, a carrying broker-dealer must engage the PCAOB-registered independent public accountant to prepare a report based on an examination of certain statements in the broker-dealer's compliance report.[774] A broker-dealer that claimed an exemption from Rule 15c3-3 throughout the most recently ended fiscal year must engage the PCAOB-registered independent public accountant to prepare a report based on a review of certain statements in the broker-dealer's exemption report. In each case, the examination or review must be conducted in accordance with PCAOB standards.

a. Compliance Report

Under the amendments, a carrying broker-dealer must prepare and file with the Commission a new compliance report each year, along with a report prepared by a PCAOB-

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772 As discussed in section V. of this release, the Commission has delayed the compliance date for this requirement to provide sufficient time for broker-dealers and their accountants to prepare to comply with the new requirement.

773 See discussion above in sections II.B.1., II.B.3., and II.B.4. of this release.

774 See paragraphs (f)(1) and (g)(2)(i) of Rule 17a-5.

registered independent public accountant based on an examination of certain statements made in the compliance report in accordance with PCAOB standards.[775] The compliance report must contain statements as to whether: (1) the broker-dealer has established and maintained Internal Control Over Compliance; (2) the Internal Control Over Compliance of the broker-dealer was effective during the most recent fiscal year; (3) the Internal Control Over Compliance of the broker-dealer was effective as of the end of the most recent fiscal year; (4) the broker-dealer was in compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3 as of the end of the most recent fiscal year; and (5) the information the broker-dealer used to state whether it was in compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3 was derived from the books and records of the broker-dealer. In addition, if applicable, the compliance report must contain a description of: (1) each identified material weakness in the Internal Control Over Compliance during the most recent fiscal year, including those that were identified as of the end of the fiscal year; and (2) any instance of non-compliance with Rule 15c3-1 or paragraph (e) of Rule 15c3-3 as of the end of the most recent fiscal year.

The compliance report requirements provide a number of benefits. For example, specifying and standardizing the statements required in the compliance report should promote consistent compliance with Rule 17a-5 and should ensure that the Commission receives information relating to aspects of a carrying broker-dealer's compliance with the financial responsibility rules that are of particular concern. Although, as discussed above in section II.D.3. of this release, current auditing standards require that independent public accountants obtain written representations from management as part of the audits of financial statements and attestation engagements, GAAS only provide examples of management representations and do

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775 See discussion above in sections II.B.1., II.B.3., and II.D.3. of this release.

not mandate that specific management representations be made. By clearly specifying and standardizing the statements, the compliance report should increase consistency with respect to the matters examined by the independent public accountants as part of the examination of the compliance report.

The specification and standardization of the statements also should facilitate Commission and DEA oversight of broker-dealer compliance with the financial responsibility rules to the benefit of broker-dealer customers, by helping the Commission and DEAs to more quickly identify broker-dealers with potential problems. Moreover, as adopted, the final rule requires a broker-dealer's compliance report to include information regarding whether the broker-dealer's internal control was effective as of the end of the fiscal year, in addition to information regarding whether there were material weaknesses in the Internal Control Over Compliance during the fiscal year. This will provide the Commission and the DEA with information on whether the broker-dealer has taken action by the end of the fiscal year to cure any material weaknesses in the Internal Control Over Compliance that existed during the fiscal year.

Requiring the compliance report to be filed with the Commission and the broker-dealer's DEA also should increase broker-dealers' focus on ensuring the accuracy of the statements being made and enhance compliance with the financial responsibility rules given the penalties for false filings. For example, filers are subject to penalties for willfully making false statements in any application, report, or document filed with the Commission.[776]

One commenter stated that incremental benefits of having the assertion in the compliance report with respect to internal controls pertain to the whole year rather than the fiscal year end

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776 See, e.g., 15 U.S.C. 78ff(a).

does not justify the costs.[777] In response, the Commission notes that key requirements in the financial responsibility rules must be complied with on an on-going basis throughout the year. Therefore, it is critical to have internal controls over compliance with these rules that are effective throughout the year rather than just at fiscal year end. Therefore, the Commission believes that there are benefits to having a carrying broker-dealer state that its Internal Control Over Compliance was effective throughout the year.

Broker-dealers will incur costs associated with preparing the compliance report. The level of effort required by carrying broker-dealers to prepare a compliance report will depend on the nature of the activities of the broker-dealer. For example, the controls necessary for a carrying broker-dealer that engages in limited custodial activities generally should be less complex than the controls necessary for a carrying broker-dealer that engages in more extensive custodial activities. Therefore, a carrying broker-dealer with limited custodial activities should have to expend less effort to make its statements in the compliance report relating to the effectiveness of its Internal Control Over Compliance. To the extent that the amount of custodial activity is related to the size of a broker-dealer, the cost of preparing the compliance report should be lower for smaller carrying broker-dealers.

The Commission estimated in the proposing release that, on average, carrying broker-dealers would spend approximately 60 hours each year to prepare the proposed compliance report.[778] One commenter stated that the proposal did not "address the additional costs broker-dealers would incur in preparing Compliance Reports."[779] However, the commenter did not comment on the estimated hour burden or provide specific data and analysis on the additional

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777 See E&Y Letter.

778 See Broker-Dealer Reports, 76 FR 37596.

779 See SIFMA Letter.

costs that broker-dealers would incur in preparing compliance reports. Another commenter stated that the proposed estimate of 60 hours "is not an accurate estimate of the time burden to complete the Compliance Report" and that the burdens in the proposing release are understated.[780] This commenter, however, did not provide a quantified alternative estimate of the costs or specific data to support its statement.

The Commission is retaining the 60-hour estimate for the reasons discussed below. The final rules contain two changes from the proposal that could result in lower costs than if the rules had been adopted as proposed: (1) elimination of the concepts of "material non-compliance" and "compliance in all material respects" with Rule 15c3-1 and 15c3-3 for the purposes of reporting in the compliance report; and (2) a narrowing of these statements and description requirements from compliance with all of the financial responsibility rules to compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3.

As previously discussed, many commenters raised concerns about how firms would determine whether an instance of non-compliance constitutes material non-compliance.[781] Commenters urged the Commission to provide guidance with additional specific examples or quantitative and qualitative factors to be considered when determining whether non-compliance was material,[782] or proposing alternate definitions or examples of non-compliance that should not be regarded as material.[783] Under the rules as adopted, broker-dealers will not be required to conduct a separate evaluation of materiality when determining instances of non-compliance that

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780 See Van Kampen/Invesco Letter.

781 See ABA Letter; CAI Letter; CAQ Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter; PWC Letter; SIFMA Letter; Van Kampen/Invesco Letter.

See ABA Letter; CAQ Letter; E&Y Letter; KPMG Letter; McGladrey Letter; PWC Letter.

See SIFMA Letter.

must be reported. This should reduce the likelihood that inconsistent approaches be taken both among broker-dealers and between broker-dealers and their independent public accountants.

The "material non-compliance" and "compliance in all material respects" concepts were designed to limit the types of instances of non-compliance that would need to be identified in the report. To retain a limiting principle, the final rule focuses on provisions that trigger notification requirements when they are not complied with, namely, Rule 15c3-1 and the customer reserve requirement in paragraph (e) of Rule 15c3-3.[784] Any instances of non-compliance with these requirements as of the fiscal year end must be described in the compliance report. As stated in the proposing release, failing to maintain the required minimum amount of net capital under Rule 15c3-1 or failing to maintain the minimum deposit requirement in a special reserve bank account under Rule 15c3-3 would have been instances of material non-compliance under the proposed rule.[785] Accordingly, under the proposal, a broker-dealer would have been required to describe all instances of non-compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3. Under the proposal, a broker-dealer also would have been required to describe instances of material non-compliance with Rule 17a-13 and the Account Statement Rules. The final rule is narrower in that a broker-dealer only is required to describe instances of non-compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3. While the final rules increase costs relative to the baseline, they should result in modestly lower costs to broker-dealers relative to the proposal.

The final rule also retains the proposed requirement that the carrying broker-dealer provide a description of each identified material weakness in the internal control of the broker-dealer over compliance with the financial responsibility rules, but, in conformity with other

784 See 17 CFR 240.15c3-1(a)(6)(iv)(B), (a)(6)(v), (a)(7)(ii), (a)(7)(iii), (c)(2)(x)(B)(1), (c)(2)(x)(F)(3); 17 CFR 240.17a-11(b)–(c); 17 CFR 240.15c3-3(i).

785 See Broker-Dealer Reports, 76 FR at 37577.

modifications to the proposal, the final rule specifies that the material weaknesses include those identified during the most recent fiscal year as well as those that were identified as of the end of the fiscal year.[786] The Commission believes that the modifications to the final rule discussed above may modestly reduce the hour burden of the final rule as compared to the hour burden that would have resulted from the proposed rule; namely, because a broker-dealer will not need to evaluate whether instances of non-compliance with the financial responsibility rules are material and will only need to report instances of non-compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3. While these modifications will result in additional costs to broker-dealers over the baseline, they are not expected to increase costs over those estimated for the proposed rule. This is because the proposed statement as to whether the broker-dealer's Internal Control Over Compliance was effective during the most recent fiscal year, and the related statement about material weakness, would also cover the fiscal year end. As noted above, the modification to require two statements (one covering the fiscal year and one covering the fiscal year end) was prompted by commenter suggestions that broker-dealers be permitted to report the remediation of a material weakness, or whether a material weakness still exists, at the end of the fiscal year. These changes will provide information to the Commission and DEAs as to whether material weaknesses during the year have been remediated as of the fiscal year end. They also afford the broker-dealer the opportunity to state in the report that a material weakness has been remediated, if applicable.

The changes discussed above, in some cases, may result in a modest reduction in burden relative to the proposal. However, while some commenters suggested that the proposing release underestimated the burden, the Commission is not changing its estimate of the time required for

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[786] See 17 CFR 240.17a-5(d)(3)(i)(B).

a broker-dealer to prepare the compliance report. The Commission notes that, while commenters questioned the estimate, they did not provide data that would enable the Commission to revise its estimate.

The Commission, however, is updating its estimates of the number of broker-dealers that would be required to file the compliance report, which affects the cost estimates. The Commission now estimates that there are approximately 292 carrying broker-dealers. Therefore, the Commission estimates that the time required for all 292 carrying broker-dealers to prepare the report is approximately 17,520 hours per year.[787] Further, the Commission estimates that the total cost[788] associated with this requirement is approximately $5.6 million per year.[789]

b. Exemption Report

Broker-dealers that claim an exemption from Rule 15c3-3 are required to file an exemption report and a report of the independent public accountant based on a review of the exemption report. The exemption report must contain the following statements made to the best knowledge and belief of the broker-dealer: (1) a statement that identifies the provisions in

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787 See discussion above in section VI.D.1.ii. of this release. 60 hours x 292 carrying broker-dealers = 17,520 hours per year.

788 For purposes of this economic analysis, salary data is from the Securities Industry and Financial Markets Association ("SIFMA") Report on Management and Professional Earnings in the Securities Industry 2011 ("SIFMA Report on Management and Professional Earnings in the Securities Industry"), which provides base salary and bonus information for middle-management and professional positions within the securities industry. The salary costs derived from the report and referenced in this cost benefit section are modified to account for an 1800-hour work year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead.

789 See discussion above in section VI.D.1.ii. of this release. Based on staff experience, the Commission believes that a carrying broker-dealer likely would have a Compliance Manager gather information necessary to validate the statements to be provided and that it would take the Compliance Manager approximately 45 hours to perform this task. In addition, the Commission believes that a carrying broker-dealer likely would have a Chief Compliance Officer review the information and make the attestation and that it would take the Chief Compliance Officer approximately 15 hours per year to perform this task. According to the SIFMA Report on Management and Professional Earnings in the Securities Industry, 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, the hourly cost of a Compliance Manager is approximately $279/hour, and the hourly cost of a Chief Compliance Officer is approximately $433/hour. 292 carrying broker-dealers x 45 hours x $279 = $3,666,060. 292 carrying broker-dealers x 15 hours x $433 = $1,896,540. $3,666,060 + $1,896,540 = $5,562,600 per year.

paragraph (k) of Rule 15c3-3 under which the broker-dealer claimed an exemption from Rule 15c3-3; (2) a statement the broker-dealer met the identified exemption provisions in paragraph (k) of Rule 15c3-3 throughout the most recent fiscal year without exception or that it met the identified exemption provisions in paragraph (k) of Rule 15c3-3 throughout the most recent fiscal year except as described in the exemption report; and (3) if applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified provisions in paragraph (k) of Rule 15c3-3 and that briefly describes the nature of each exception and the approximate date(s) on which the exception existed.

The preparation of exemption reports by broker-dealers that claim an exemption from Rule 15c3-3 throughout the most recent fiscal year, as well as reviews of certain statements in the exemption reports by independent public accountants, should strengthen and facilitate consistent compliance with the Commission's financial responsibility rules, for many of the same reasons identified above with respect to the compliance report. Among other things, these reports should enhance compliance with the exemption provisions in Rule 15c3-3, thereby providing better protection of customer assets. This increased focus is enhanced further by requiring the direct filing of the exemption report with the Commission and the broker-dealer's DEA because of the potential penalties for false statements. In addition, the Commission and the broker-dealer's DEA will benefit from the information provided in the exemption report in conducting their supervisory oversight of the broker-dealer.

The Commission considered an alternative suggested by one commenter to replace the exemption report with a box to check on the FOCUS Report.[790] After careful consideration of this alternative, the Commission determined that it is not an appropriate alternative to the

[790] See Angel Letter.

exemption report. As discussed above in section II.B.4.iii. of this release, a broker-dealer claiming an exemption from Rule 15c3-3 already is required to indicate the basis for the exemption on its FOCUS Report.[791] Second, the exemption report requires the broker-dealer to make certain statements that the independent public accountant must review. Thus, the exemption report will provide a standardized statement across all broker-dealers claiming an exemption from Rule 15c3-3 for the independent public accountant to review. Third, the exemption report will provide the Commission and the broker-dealer's DEA with more information than currently is reported by non-carrying broker-dealer's in the FOCUS Report. Specifically, it requires the broker-dealer to, among other things, state either that it met the identified exemption provisions in paragraph (k) throughout the most recent fiscal year without exception or that it met the identified exemption provisions throughout the most recent fiscal year except as described in the report. This will provide the Commission and the broker-dealer's DEA with information as to whether a broker-dealer is meeting the exemption provisions of paragraph (k) of Rule 15c3-3 (not simply that the broker-dealer is claiming the exemption as is reported in the FOCUS Report). The Commission expects that non-carrying broker-dealers generally track exceptions as part of monitoring compliance with the exemption provisions in paragraph (k) of Rule 15c3-3. Fourth, requiring that the exemption report be filed with the Commission should increase broker-dealers' focus on the statements being made, facilitating consistent compliance with the exemption provisions in Rule 15c3-3, and therefore, providing better protection of customer assets. Further, employing a "check the box" alternative would not substantially reduce compliance costs because the broker-dealer would need to take steps to

791 See Item 24 of Part IIa of the FOCUS Report.

ascertain that it has a valid basis for claiming the exemption, whether or not these steps result in an exemption report or "check the box."

The Commission estimated that it would take a non-carrying broker-dealer approximately five hours to prepare and file the proposed exemption report.[792] The Commission did not receive comments specifically addressing this estimate. However, because the rule was modified from the proposal to also require the identification of exceptions to the exemption provisions, the Commission is increasing the estimate to seven hours.[793] The Commission now estimates that there are approximately 4,417 non-carrying broker-dealers that must file exemption reports. Therefore, the Commission estimates that the annual reporting burden for all non-carrying broker-dealers to prepare and file the exemption report is approximately 30,919 hours per year.[794] The Commission estimates that the total industry-wide cost to prepare the exemption report is approximately $9.3 million per year.[795]

iii. Engagement of the Accountant

As discussed above, the amendments to Rule 17a-5 eliminate the requirement that the broker-dealer's independent public accountant prepare, and the broker-dealer file with the

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792 See Broker-Dealer Reports, 76 FR at 37596.

793 See discussion above in section VI.D.1.iii. of this release.

794 See discussion above in section VI.D.1.iii. of this release. 7 hours x 4,417 non-carrying broker-dealers = 30,919 hours per year. See the discussion below regarding the external costs associated with obtaining the accountant's report on the exemption report.

795 See discussion above in section VI.D.1.iii. of this release. Based on staff experience, a non-carrying broker-dealer likely would have a Compliance Manager gather information necessary to validate the information to be provided in the exemption report, and it would take the Compliance Manager approximately six hours to perform this task. In addition, a non-carrying broker-dealer likely would have a Chief Compliance Officer review the information and make the attestation, and it would take the Chief Compliance Officer approximately one hour to perform this task. According to the SIFMA Report on Management and Professional Earnings in the Securities Industry, 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, the hourly cost of a Compliance Manager is approximately $279/hour, and the hourly cost of a Chief Compliance Officer is approximately $433/hour. 4,417 non-carrying broker-dealers x 6 hours x $279 = $7,394,058 per year. 4,417 non-carrying broker-dealers x 1 hour x $433 = $1,912,561 per year. $7,394,058 + $1,912,561 = $9,306,619 per year.

Commission and its DEA concurrently with its annual audited financial statements, a material inadequacy report, based on, among other things, a review of a broker-dealer's accounting system, internal accounting control, and procedures for safeguarding securities. The amendments replace this requirement with a requirement, among other things, that the broker-dealer file with its annual reports a report prepared by an accountant covering either the broker-dealer's compliance report or exemption report, as applicable. The accountant engaged by the broker-dealer must, as part of the engagement, undertake to prepare its reports based on an examination of certain statements in the compliance report or a review of certain statements in the exemption report, as applicable, in accordance with PCAOB standards.

With regard to the independent public accountant's preparation of the material inadequacy report, Rule 17a-5 required that the scope of the accountant's review be sufficient to provide "reasonable assurance" that any material inadequacies existing at the date of examination would be disclosed. If the broker-dealer was exempt from Rule 15c3-3, Rule 17a-5 provided that the accountant must ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to the accountant's attention to indicate that the conditions of the exemption had not been complied with since the last examination. As discussed above, AICPA guidance provided that the material inadequacy report should address what the independent public accountant concluded in its "study" of the adequacy of the broker-dealer's practices and procedures in complying with the financial responsibility rules in relation to the definition of material inadequacy as stated in Rule 17a-5.[796]

However, in the PCAOB's first report on the progress of its interim inspection program of broker-dealer audits, the PCAOB stated that as to 21 of the 23 audits inspected, the accountant

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796 See AICPA Broker-Dealer Audit Guide at ¶ 3.77.

"failed to perform sufficient audit procedures to obtain reasonable assurance that any material inadequacies found to exist since the date of the last examination . . . would have been disclosed in the accountant's supplement report."[797] Further, for all of the 14 audits of broker-dealers that claimed an exemption from Rule 15c3-3, the PCAOB stated that the accountant "did not perform sufficient procedures to ascertain that the broker or dealer complied with the conditions of the exemption."[798] The deficiencies noted in the PCAOB's report on the progress of the interim inspection program provide further support for the amendments that the Commission is adopting today to establish the foundation for the PCAOB's development of standards that are tailored to Rule 17a-5, and to strengthen and facilitate consistent compliance with broker-dealer audit and reporting requirements.

Generally, the engagement of accountant amendments should result in higher levels of compliance with the Commission's financial responsibility rules by increasing the focus of carrying broker-dealers and their independent public accountants on specific statements made in the compliance report relating to the broker-dealer's compliance, and internal control over compliance, with the financial responsibility rules and increasing the focus of non-carrying broker-dealers and their independent public accountants on whether the broker-dealer meets the exemption provisions in paragraph (k) of Rule 15c3-3. These amendments also clarify the scope and the standards that apply to broker-dealer audits and conform language in the rule with terminology in existing audit literature, which should reduce inconsistencies in broker-dealer compliance with Rule 17a-5. The replacement of the material inadequacy report with the report based on an examination of the compliance report or review of the exemption report facilitates the Commission's objective to provide clear and consistent terminology focused separately on

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797 See PCAOB Inspection Report at iii.

798 Id.

compliance with the financial responsibility rules and internal control over compliance with the financial responsibility rules.

With regard to the examination of the compliance report, the amendments are intended to encourage greater focus by the independent public accountant on Internal Control Over Compliance, including, in particular, broker-dealer custody practices. By specifying the statements that must be made by a broker-dealer to the Commission, and hence, examined by the auditor, the compliance report should provide clarity and facilitate consistent compliance with Rule 17a-5 by independent public accountants. Additionally, the focus of independent public accountants on internal control over the custody practices of broker-dealers should better identify broker-dealers that have weak internal controls for safeguarding investor securities and cash. Similarly, with regard to the review of the exemption report, the amendments encourage greater focus by the accountant on whether the broker-dealer has appropriately claimed an exemption from Rule 15c3-3 by, among other things, reviewing whether the broker-dealer's statements in the exemption report as to meeting the exemption provisions without or with exceptions, and, if applicable, identifying exceptions to meeting those provisions, were fairly stated.[799] As stated above, the terminology in Rule 17a-5 with regard to the material inadequacy report was outdated and inconsistent with current audit practices.

The PCAOB stated that its proposed attestation standards for examining compliance reports and reviewing exemption reports were "tailored" to the proposed amendments to Rule 17a-5.[800] These standards, if adopted, are expected to establish a single and broker-dealer-specific approach to examining compliance reports and reviewing exemption reports and are

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799 As stated above, a review engagement is designed to provide a moderate level of assurance, and the accountant's conclusion could state, for example, that no information came to the accountant's attention that indicates that the exemption report is not fairly stated in all material respects.

800 See PCAOB Proposing Release at 5.

expected to enable the accountant to scale the engagement based on the broker-dealer's size and complexity.

Based on its estimates of the costs associated with the cost of an internal control report under Rule 206(4)-2, the Commission estimated that the external cost to a carrying broker-dealer of obtaining the independent public accountant's report based on an examination of the proposed compliance report would be an average incremental cost of approximately $150,000 per carrying broker-dealer per year.[801] Based on staff experience, including communications with broker-dealers, broker-dealer independent public accountants, and independent public accountant industry groups, the Commission estimated that the external cost to a non-carrying broker-dealer of obtaining the independent public accountant's report based on a review of the proposed exemption report would cost an average of approximately $3,000 per non-carrying broker-dealer per year.[802] Before today's amendments, independent public accountants of broker-dealers were required to prepare a material inadequacy report. As that report is no longer required, the costs associated with engaging the independent public accountant to prepare a material inadequacy report have been eliminated and replaced by the costs associated with engaging the independent public accountant to prepare a report covering the compliance report or the exemption report.

Therefore, the incremental cost of today's amendments related to the engagement of the independent public accountant is the amount that the cost exceeds the cost of engaging the independent public accountant to prepare the material inadequacy report. However, the

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801 See Broker-Dealer Reports, 76 FR at 37599. See also discussion above in section VI.D.1.vii.b. of this release.

802 See Broker-Dealer Reports, 76 FR at 37600. The Commission estimated that the average cost of an audit of a non-carrying broker-dealer's financial report was approximately $30,000 per year, based on a weighted average of estimates of that cost for broker-dealers with varying levels of net income. The Commission further estimated that the additional cost for a review of the exemption report would be an average of approximately $3,000 per non-carrying broker-dealer per year. Id. See also discussion above in section VI.D.1.vii.c. of this release.

Commission has not previously estimated the average cost of preparing the material inadequacy report. Consequently, the Commission is retaining the cost estimates set forth in the proposing release, while recognizing that costs could be lower as a result of cost savings attributable to the elimination of the material inadequacy report requirements.

The Commission received various comments regarding the engagement of accountant provisions as they relate to examining or reviewing the proposed compliance reports and exemption reports, respectively. One commenter stated that the Commission underestimated the cost of examining the compliance report and that the Commission may need to consider the PCAOB's proposed rules before it can reasonably estimate this cost.[803] Another commenter stated that the proposed amendments have "the potential to double the total current audit fees and have a material impact" on firms.[804] A third commenter stated that the economic analysis was "inconclusive" because the PCAOB has not yet established auditing and attestation standards for broker-dealers.[805] The commenters, however, did not provide quantified alternative cost estimates.

The Commission acknowledges that the total costs associated with these requirements will depend on the final PCAOB standards for attestation engagements to examine compliance reports or review exemption reports. However, as the PCAOB's proposed standards were tailored to the proposed amendments, nothing in those standards causes the Commission to change its estimates of the costs associated with these requirements, or to question that the benefits will justify the costs.

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803 See ABA Letter.

804 See Van Kampen/Invesco Letter.

805 See CAI Letter.

Before today's amendments, Rule 17a-5 required the independent public accountant to, among other things, review the accounting system, internal accounting control, and procedures for safeguarding securities of the broker-dealer, including appropriate tests, for the period since the prior examination date. The scope of the independent public accountant's review was required to be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the auditor examination would be disclosed. Similarly, an examination of a compliance report performed under the PCAOB's attestation standard for examination engagements would require that the auditor obtain reasonable assurance to express an opinion on whether the broker-dealer's statements in the compliance report are fairly stated, in all material respects.[806]

Moreover, before today's amendments, if a broker-dealer was exempt from Rule15c3-3, Rule 17a-5 required the independent public accountant to "ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to [the independent public accountant's] attention to indicate that the exemption had not been complied with during the period since [the independent public accountant's] last examination."[807] The PCAOB's proposed review standard for the exemption report would require that the independent public accountant make inquiries and perform other procedures that are commensurate with the auditor's responsibility to obtain moderate assurance that the broker-dealer meets the identified conditions for an exemption from Rule 15c3-3.[808] These procedures would include evaluating

806 See PCAOB Proposing Release at 5. An examination engagement is designed to provide a high level of assurance. See, e.g., PCAOB Interim Attestation Standard, AT Section 101 at ¶ .54. In this case, the accountant's conclusion will be expressed in the form of an opinion. For example, the accountant's conclusion based on an examination of an assertion could state that in the accountant's opinion, [the assertion] is fairly stated in all material respects. See, e.g., PCAOB Interim Attestation Standard, AT Section 101 at ¶ .84.

807 See 17 CFR 240.17a-5(g)(2).

808 See PCAOB Proposing Release at 8.

relevant evidence obtained from the audit of the financial statements and supporting schedules and are designed to enable the auditor to scale the review engagement based on the broker-dealer's size and complexity.[809]

The compliance report as adopted includes an additional statement (relative to the proposal) as to whether the broker-dealer's Internal Control Over Compliance was effective as of the end of the most recent fiscal year. Therefore, costs of compliance with the final rules may be higher than costs of compliance with the proposed rules to the extent Internal Control Over Compliance has changed near or as of the fiscal year end. However, this increased cost is not expected to be significant, since the procedures needed to opine on these matters as of the fiscal year end should not be materially different from the procedures employed to opine as to the effectiveness of internal control over the course of the fiscal year.

As proposed, the broker-dealer would have been required to assert whether it was in compliance, in all material respects, with all of the financial responsibility rules as of its fiscal year end. As adopted, the broker-dealer must assert whether it is in compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3 (i.e., a narrower range of rule compliance than proposed). This modification of the broker-dealer's assertion could result in lower costs for accountants' reports on the compliance report as compared to the proposal as the scope of the matters to be covered by accountants' examinations will be narrower.

Although these modifications could modestly lower costs associated with the accountant's report covering the compliance report as compared to the proposal, the Commission is not changing its estimate of costs associated with accountants' reports covering compliance reports and exemption reports. Based on updated data, the Commission now estimates that there

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809 Id. at 9.

are approximately 292 carrying broker-dealers. The Commission therefore estimates that the industry-wide annual average incremental external reporting cost of accountants' reports based on examinations of compliance reports is approximately $44 million per year ($150,000 times 292 carrying broker-dealers = $43,800,000).[810] Based on updated data, the Commission now estimates that there are approximately 4,417 non-carrying broker-dealers. The Commission therefore estimates that the total industry-wide annual reporting cost of accountant's reports based on reviews of exemption reports is approximately $13.3 million per year (4,417 non-carrying broker-dealers times $3,000 = $13,251,000).[811] The Commission therefore estimates that the total industry-wide incremental external annual reporting cost to broker-dealers associated with the accountants' reports covering the compliance report and exemption report is approximately $57.3 million per year.

Finally, one commenter suggested that the Commission use an "agreed-upon procedures" engagement for the exemption report.[812] This alternative was considered. The final rule, however, requires a review engagement as proposed. Under an "agreed-upon procedures" engagement, the independent public accountant is engaged by a client to issue a report of findings based on specific procedures performed on subject matter that the specified parties believe are appropriate.[813] Additionally, in an "agreed-upon procedures" engagement, the independent public accountant does not perform an examination or a review, and does not provide an opinion or negative assurance. Thus, no conclusion would be rendered as to the broker-dealer's statements in the exemption report.

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810 See discussion above in section VI.D.1.vii.b. of this release.

811 See discussion above in section VI.D.1.vii.c. of this release.

812 See E&Y Letter.

813 See PCAOB Interim Attestation Standard, AT Section 201 at ¶ .03.

Another commenter stated that the benefit of receiving an audit report covering the exemption report would not justify the cost[814] and, similarly, a second commenter did not see a benefit from the auditor attestation of the exemption report.[815] As noted above, before today's amendments, if a broker-dealer was exempt from Rule15c3-3, Rule 17a-5 required the independent public accountant to "ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to [the independent public accountant's] attention to indicate that the exemption had not been complied with during the period since [the independent public accountant's] last examination."[816] Consequently, the current rule requires the independent public accountant to reach a conclusion with respect to a broker-dealer's claimed exemption from Rule 15c3-3.

The Commission believes the rule should continue to require a conclusion from the independent public accountant on the broker-dealer's claimed exemption from Rule 15c3-3 because of the importance of safeguarding customer securities and cash. While the Commission anticipates there will be costs related to the audit of the exemption report, the Commission does not believe it would be appropriate to use a lower standard (i.e., the agreed-upon procedures standard) or have no requirement for the independent public accountant to perform any work with respect to the exemption report.

iv. Filing of Annual Reports with SIPC

The amendments to Rule 17a-5 require broker-dealers that are SIPC members to file their annual reports with SIPC. SIPC plays an important role in the securities markets by serving as a backstop to protect customers of a failed broker-dealer that cannot promptly return customer

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814 See Citrin Letter.

815 See Angel Letter.

816 See 17 CFR 240.17a-5(g)(2).

securities and funds. In this capacity, SIPC has a legitimate interest in receiving the annual reports of its broker-dealer members to assist it with its maintenance of the SIPC Fund and to monitor trends in the broker-dealer industry. For example, SIPC presently obtains revenue information from broker-dealers, through Form SIPC-7, to determine how best to structure broker-dealer assessments to maintain the SIPC Fund at an appropriate level. However, the information collected in the form is limited and may not assist SIPC in assessing whether the SIPC Fund is appropriately sized to the risks of a large broker-dealer failure. The annual reports contain much more detailed information about the assets, liabilities, income, net capital, and Rule 15c3-3 customer reserve requirements of broker-dealers, and also include, for carrying broker-dealers, a compliance report containing information about the broker-dealer's compliance with, and controls over compliance with, the broker-dealer financial responsibility rules. The annual reports also generally include the independent public accountant's reports covering the financial report and compliance report or exemption report, as applicable, prepared by the broker-dealer. This information also will assist SIPC in monitoring the financial strength of broker-dealers and, therefore, in assessing the adequacy of the SIPC Fund.

In addition, by receiving the annual reports, SIPC may be able to overcome a potential legal hurdle to pursuing claims against a broker-dealer's accountant where the accountant's failure to adhere to professional standards in auditing a broker-dealer causes a loss to the SIPC Fund. As discussed in section II.B.6. of this release, SIPC has sought to recover money damages from the broker-dealer's independent public accountant based on an alleged failure to comply with auditing standards, but at least one court has held under New York law that SIPC could not maintain a claim because it was not a recipient of the annual audit filing and could not have relied on it.[817]

SIPC's improved ability to maintain the SIPC Fund will benefit investors. First, if the SIPC Fund is appropriately sized, customers of a failed broker-dealer in a SIPA liquidation should be able to recover their assets more quickly through advances from the fund than if the fund is not adequate. Also, to the extent the amendments overcome a potential legal hurdle to pursuing claims against a broker-dealer's accountant, the ability to recover damages from the broker-dealer's accountant in the context of a SIPA liquidation proceeding could increase the size of the estate of a failed broker-dealer. Increasing the size of the estate could benefit customers with claims that cannot be fully satisfied through distributions of customer property held by the failed broker-dealer and the SIPC advances.

The new requirement that broker-dealers that are members of SIPC file their annual reports with SIPC will increase these broker-dealers' compliance costs.[818] In the proposing release, the Commission estimated that it would take broker-dealers approximately 30 minutes to prepare and file the annual reports with SIPC, and commenters did not disagree with this estimate. Thus, the Commission estimates that the annual industry-wide reporting burden associated with this amendment is approximately 2,246 hours per year (1/2 hour times 4,492 SIPC members = 2,246 hours) and that the total annual cost is approximately $694,000.[819] There would be postage costs associated with sending a copy of the annual report to SIPC that are

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817 See SIPC v. BDO Seidman, LLP, 746 N.E.2d 1042 (N.Y. 2001); aff'd, 245 F.3d 174 (2d Cir. 2001).

818 See Broker-Dealer Reports, 76 FR at 37596.

819 Based on staff experience, a broker-dealer likely would have a Financial Reporting Manager prepare an additional copy of its annual report and mail it to SIPC. According to the SIFMA Report on Management and Professional Earnings in the Securities Industry, 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, the hourly cost of a Financial Reporting Manager is approximately $309/hour. 4,492 SIPC-member broker-dealers x 1/2 hour x $309 = $694,014.

estimated to be, on average,[820] approximately $12.05 per broker-dealer per year.[821] Thus, the Commission estimates that the total annual postage costs associated with sending a copy of the annual report to SIPC would be approximately $54,128 per year for all broker-dealers that are SIPC members.[822]

While they did not provide estimates of potential litigation costs, several commenters stated that the Commission did not address the potential costs and benefits of requiring broker-dealers to file copies of their annual reports with SIPC, including potential litigation costs for independent public accountants.[823] The Commission recognizes that there may be increased litigation costs (or reserves for potential litigation costs) for accountants as a result of the amendment and that to the extent that there are such costs, some of them may be passed on to broker-dealers in the form of increased fees charged by broker-dealers' independent public accountants. However, commenters did not provide estimates of potential litigation costs, and Commission staff were unable to find readily-available public information from which to estimate specific costs of possible litigation. To the extent that SIPC does bring an individual lawsuit as a direct result of this amendment (e.g., a suit brought in New York), there would be costs in terms of legal fees. Based on staff experience, depending on the complexity, scope, and

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820 The number of pages of an annual report, and consequently the associated postage costs, likely will vary significantly based on the size of the broker-dealer and the types of business in which it engages.

821 Based on Commission staff experience with annual report filings of broker-dealers under Rule 17a-5, the Commission staff estimates that approximately 50% of broker-dealers file their annual reports using an overnight mail delivery service. These broker-dealers would consequently incur higher postage costs than broker-dealers which choose to mail their annual reports using first class mail or delivery methods other than overnight mail. Therefore, postages costs will vary depending on the size of the annual report and method of delivery. The Commission estimates that the cost to mail the additional reports would be, on average, $12.05 per broker-dealer. As of October 2012, the $12.05 rate is an average rate of the cost of an Express Mail Flat Rate Envelope of $18.95 and a Priority Mail Flat Rate Envelope of $5.15, based on costs obtained on the website of the U.S. Postal Service, available at www.usps.gov. ($18.95 + $5.15) = $24.10/2 = $12.05.

822 4,492 broker-dealers x $12.05 = $54,128.

823 See, e.g., CAQ Letter; Deloitte Letter; KPMG Letter.

length of the litigation, the costs to defend an individual case could be quite signficant given the hourly fees charged by outside counsel. However, the Commission does not believe these costs would be significant in the aggregate. As indicated in the economic baseline, SIPC initiates a small number of proceedings each year, and most of these proceedings have not involved litigation by SIPC against the firm's independent public accountant. Moreover, SIPC continued to bring lawsuits against broker-dealer accountants after the 2001 New York decision in jurisdictions other than New York.[824] Consequently, while the amendment removes one potential legal hurdle to such suits, it may not significantly increase the frequency with which SIPC brings such lawsuits. Moreover, the other elements of any relevant cause of action would be unaffected. Accordingly, the Commission continues to believe that the requirement to file copies of the annual reports with SIPC is appropriate.

v. Notification Requirements

As discussed above in section II.F. of this release, the Commission is amending the notification provisions in Rule 17a-5 and is making conforming amendments to Rule 17a-11. Prior to today's amendments, paragraph (h)(2) of Rule 17a-5 provided that if, during the course of the audit or interim work, the independent public accountant determined that any "material inadequacies" existed, the independent public accountant was required to inform the CFO of the broker-dealer, who, in turn, was required to give notice to the Commission and the broker-dealer's DEA within 24 hours in accordance with the provisions of Rule 17a-11.[825]

Under Rule 17a-11, a broker-dealer must provide notice to the Commission and its DEA in certain circumstances.[826] For example, paragraph (b)(1) of Rule 17a-11 requires a broker-

824 See SIPC v. BDO Seidman, LLP, 746 N.E.2d 1042 (N.Y. 2001); aff'd, 245 F.3d 174 (2d Cir. 2001).

825 See 17 CFR 240.17a-5(h)(2).

826 See 17 CFR 240.17a-11.

dealer to give notice if its net capital declines below the minimum amount required under Rule 15c3-1.[827] Before today's amendments, Rule 17a-11 required that whenever a broker-dealer discovered, or was notified by an independent public accountant of the existence of any material inadequacy, the broker-dealer must give notice to the Commission and transmit a report to the Commission stating what the broker or dealer has done or is doing to correct the situation. Rule 15c3-1 and Rule 15c3-3 also require broker-dealers to provide notification in certain circumstances.[828] For example, paragraph (i) of Rule 15c3-3 requires a carrying broker-dealer to immediately notify the Commission and its DEA if it fails to make a deposit into its customer reserve account as required by paragraph (e) of Rule 15c3-3.[829]

a. Amendments to Rule 17a-5

The Commission proposed amending the notification provisions in Rule 17a-5 to replace the term "material inadequacy" with the term "material non-compliance." The term "material non-compliance" was defined in the context of the compliance report, which was required to be prepared and filed by carrying broker-dealers. This provision would therefore have applied to broker-dealers that filed compliance reports with the Commission. The Commission also proposed amending the notification process. Under the proposed new process, the accountant would be required to notify the Commission and the broker-dealer's DEA directly.

The Commission received numerous comments in response to this proposal.[830] Most of these commenters objected to the proposed notification process.[831] Among the reasons given

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827 See 17 CFR 240.17a-11(b)(1).

828 See, e.g., 17 CFR 240.15c3-1(a)(6)(iv)(B); 17 CFR 240.15c3-1(a)(6)(v); 17 CFR 240.15c3-1(a)(7)(ii); 17 CFR 240.15c3-1(c)(2)(x)(C)(1); 17 CFR 240.15c3-1(e); 17 CFR 240.15c3-1d(c)(2); 17 CFR 240.15c3-3(i).

829 See 17 CFR 240.15c3-3(i).

830 See ABA Letter; CAI Letter; CAQ Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter; PWC Letter; SIFMA Letter; Van Kampen/Invesco Letter.

were that it would be inappropriate to require the accountant to notify the Commission and the DEA directly, because, among other things, the broker-dealer is principally responsible for compliance with the securities laws, including timely notification;[832] that PCAOB standards provide that "the practitioner should not take on the role of the responsible party;"[833] and that PCAOB attestation standards (which were referenced in the proposing release) clearly provide that management is responsible for the subject matter to which it is asserting, and not the accountant.[834] In addition to suggestions that the notification process that existed prior to today's amendments should not be changed,[835] one commenter stated that the rule should require simultaneous notice by the accountant to the Commission and to the firm's management.[836] In addition, one commenter asked whether the notification provisions apply to a review of the exemption report.[837] Another commenter stated that non-compliance also will trigger a Rule 17a-11 notice, which would be duplicative and create confusion.[838]

The final rule requires that if the accountant determines that there are any instances of non-compliance (as opposed to an instance of material non-compliance, as proposed) with the financial responsibility rules during the course of preparing the accountant's reports, the accountant must immediately notify the CFO of the broker-dealer of the nature of the non-compliance. If the accountant provides notice of an instance of non-compliance, the broker-

831 See ABA Letter; CAI Letter; CAQ Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter; PWC Letter; Van Kampen/Invesco Letter.

832 See Deloitte Letter.

833 See KPMG Letter. See also PCAOB Interim Attestation Standard, AT Section 101 at ¶ 13.

834 See PWC Letter. See also PCAOB Interim Attestation Standard, AT Section 101 at ¶¶ 11–13.

835 See, e.g., ABA Letter; E&Y Letter; McGladrey Letter.

836 See Van Kampen/Invesco Letter.

837 See KPMG Letter.

838 See ABA Letter.

dealer must notify the Commission and its DEA, but only if required to do so by existing provisions of Rule 15c3-1, Rule 15c3-3, or Rule 17a-11 that require such notification.[839] Consequently, the final rule requires that any instance of non-compliance identified by the accountant will trigger a notification by the broker-dealer to the Commission and the firm's DEA to the same extent that notification is required if discovered by the broker-dealer other than in connection with its annual audit. Therefore, under the final rule, if the accountant determines that an instance of non-compliance with the financial responsibility rules exists, the accountant is not required to make a determination of whether that instance of non-compliance is material. This modification likely will result in a lower burden relative to the proposal on the independent public accountant as the accountant will not need to analyze whether an instance of non-compliance is material to determine whether the notification requirement has been triggered. On the other hand, the independent public accountant will need to provide notice to the broker-dealer of all instances of non-compliance rather than only instances of material non-compliance. Therefore, the modification will result in more required notifications from the independent public accountant to the broker-dealer.

Under the final rule, the independent public accountant also will be required to provide notice to the broker-dealer if the accountant determines that any material weaknesses exist. As

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839 Under Rule 17a-11, a broker-dealer must provide notice to the Commission and its DEA in certain circumstances. For example, paragraph (b)(1) of Rule 17a-11 requires a broker-dealer to give notice if its net capital declines below the minimum amount required under Rule 15c3-1. In addition, Rule 15c3-1 and Rule 15c3-3 require broker-dealers to provide notifications in certain circumstances. For example, paragraph (a)(6)(iv) of Rule 15c3-1 requires a broker-dealer that operates as a specialist or market-maker and that operates under the provisions of paragraph (a)(6) of Rule 15c3-1 to obtain certain representations from the broker-dealer that carries its market maker or specialist account. The representations include that the broker-dealer carrying the account will provide a notification under Rule 17a-11 if the market maker or specialist fails to deposit the required amount of equity into the account within the required time frame as prescribed in paragraph (a)(6) of Rule 15c3-1. In addition, under paragraph (i) of Rule 15c3-3, a carrying broker-dealer must immediately notify the Commission and its DEA if it fails to make a deposit into its customer reserve account as required by paragraph (e) of Rule 15c3-3.

in the proposal, material weakness is defined with regard to the compliance report and therefore applies only to broker-dealers that file compliance reports. In that report, a carrying broker-dealer must state whether its internal controls were effective during the fiscal year as well as at the end of the fiscal year. Internal controls are not effective if there are one or more material weaknesses in the controls. The broker-dealer also is required to describe any identified material weaknesses. The independent public accountant must undertake to prepare a report based on an examination of certain statements in the compliance report, including the statements as to whether the carrying broker-dealer's internal controls were effective.

As stated above, before today's amendments, Rule 17a-5 required the accountant to notify the broker-dealer if the accountant determined that any material inadequacies existed. The concept of material inadequacy generally applied to all broker-dealers and, therefore, the notification requirement applied with respect to independent public accountant engagements for non-carrying as well as carrying broker-dealers under Rule 17a-5. This requirement, however, may not have produced the intended benefits.

As discussed in section II.D.3. above, PCAOB inspection staff found that in 21 of 23 broker-dealer audits inspected, the accountant "failed to perform sufficient audit procedures to obtain reasonable assurance that any material inadequacies found to exist since the date of the last examination . . . would have been disclosed in the accountant's supplemental report."[840] Material inadequacies which were expected to be reported by the accountant included any condition which contributed substantially to or, if appropriate corrective action was not taken, could reasonably be expected to: (1) inhibit a broker-dealer from promptly completing securities transactions or promptly discharging its responsibilities to customers, other broker-dealers, or

840 See PCAOB Inspection Report, at ii.

creditors; (2) result in material financial loss; (3) result in material misstatements of the broker-dealer's financial statements; or (4) result in violations of the Commission's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in (1) through (3) above. The definition of material weakness is more specific: a material weakness includes a deficiency in internal control such that there is a reasonable possibility that non-compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3 will not be prevented or detected on a timely basis or that non-compliance to a material extent with Rule 15c3-3, except paragraph (e), Rule 17a-13, or the Account Statement Rules will not be prevented or detected on a timely basis.

As discussed above, today's amendments generally replace the term material inadequacy and separate it into two components – a compliance component (non-compliance with the financial responsibility rules) and; for carrying broker-dealers, an internal control component (material weakness in Internal Control Over Compliance). The change is consistent with one of the objectives of the amendments: to provide clear and consistent terminology focused separately on compliance with key financial responsibility rules and internal control over compliance with the financial responsibility rules. The amended notification provisions in Rule 17a-5 reflect this change in terminology.

The Commission proposed amending the notification process so that the accountant would be required to notify the Commission and the broker-dealer's DEA directly. However, the Commission is not adopting this alternative because it agrees with the comments, discussed above, that the notification process in place before today's amendments should be retained.

As stated above, Rule 17a-5 before today's amendments required the accountant to notify e broker-dealer, and the broker-dealer to notify the Commission, if the accountant determined during the course of the audit or interim work that a material inadequacy existed. This requirement generally applied to all broker-dealer audits. The notification provisions in themselves did not direct the accountant to perform specific procedures with respect to the audit – those requirements were contained in other provisions of Rule 17a-5. The notification provisions in Rule 17a-5 were intended to require notification if, during the course of the audit, the accountant became aware of any material inadequacies. As amended, the notification provisions in Rule 17a-5 likewise do not in themselves require the accountant to perform specific procedures with respect to the examination of the financial report or an examination of a compliance report or review of an exemption report. Instead, the notification provisions are triggered when the accountant becomes aware, during the course of preparing the reports of the accountant required under Rule 17a-5, that the broker-dealer is not in compliance with the financial responsibility rules or, during the course of preparing a report based on an examination of a compliance report, that a material weakness exists. These notification requirements are designed to put the broker-dealer in a position to correct controls, processes, and systems that have caused or potentially could cause the firm to not comply with the financial responsibility rules. As discussed throughout this release, the financial responsibility rules serve an important investor protection function by requiring broker-dealers to maintain prudent levels of net capital and take steps to safeguard customer securities and cash.

The requirement to notify the broker-dealer when the independent public accountant determines that the broker-dealer is not in compliance with the financial responsibility rules or that any material weaknesses exist is not expected to increase costs for broker-dealers when compared to the baseline requirement to provide the broker-dealer with notice when the independent public accountant determines that a material inadequacy exists. As discussed above, the notice requirements under today's amendments do not require the independent public accountant to perform specific procedures. Instead, they are triggered when the independent public accountant determines that any non-compliance or material weakness exists during the course of performing procedures to examine the financial report and to examine the compliance report or review the exemption report, as applicable. To the extent the obligation to provide the broker-dealer with notice is factored into the fee charged by the accountant, the Commission notes that before today's amendments the independent public accountant was required to give notice of a material inadequacy. This notification requirement has been eliminated and, therefore, to the extent it was factored into the fee, that cost has been eliminated. The Commission does not believe that the component of the independent public accountants' fee associated with the new notification requirements would be materially different than the component of the fee associated with the material inadequacy notification requirements. Therefore, the Commission believes these requirements would not result in increased compliance costs relative to the requirements in place before today's amendments.

b. Conforming and Technical Amendments to Rule 17a-11

As discussed above in section II.F.2., prior to today's amendments, paragraph (e) of Rule 17a-11 required that whenever a broker-dealer discovered, or was notified by an independent public accountant, pursuant to paragraph (h)(2) of Rule 17a-5 or paragraph (f)(2) of Rule 17a-12, of the existence of any material inadequacy, the broker-dealer was required to give notice to the Commission and transmit a report to the Commission stating what the broker-dealer has done or is doing to correct the situation.

The Commission is adopting conforming amendments to paragraph (e) of Rule 17a-11 to ıbstitute a notice of the existence of any material weakness as defined in paragraph (d)(3)(iii) of

Rule 17a-5 for a notice of the existence of any material inadequacy and to replace a reference to paragraph (h)(2) of Rule 17a-5 with a reference to paragraph (h) of Rule 17a-5.[841] Specifically, the final rule provides that whenever a broker-dealer discovers, or is notified by its accountant under paragraph (h) of Rule 17a-5 of the existence of any material weakness, the broker-dealer must: (1) give notice of the material weakness within 24 hours of the discovery or notification; and (2) transmit a report within 48 hours of the notice stating what the broker-dealer has done or is doing to correct the situation.[842]

The notification requirements, among other things, alert the Commission and the DEA of the need to increase their monitoring of a broker-dealer and to obtain additional information when appropriate in order to address any concerns the Commission or the DEA may have as a result of the notification. A notification of a material weakness will alert the Commission and the broker-dealer's DEA to the existence of a condition that could impact the broker-dealer's ability to remain in compliance with the financial responsibility rules, which serve an important investor protection function by requiring broker-dealers to maintain prudent levels of net capital and take steps to safeguard customer securities and cash. Once alerted, the Commission and the DEA can respond to the situation through, for example, heightened monitoring of the broker-dealer to assess whether it has corrected the problem and whether it is properly safeguarding customer securities and cash.

The Commission believes these amendments will not result in increased compliance costs to broker-dealers. Material weakness is defined with regard to the compliance report and therefore applies only to broker-dealers that file compliance reports (i.e., carrying broker-

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841 The final rule retains a reference to material inadequacy as defined in paragraph (h)(2) of Rule 17a-12, but amendments correct citations to that rule.

842 See paragraph (e) of Rule 17a-11. The rule retains provisions referencing the term material inadequacy as defined in Rule 17a-12.

dealers). In contrast, the concept of material inadequacy generally applied to all broker-dealers and, therefore, the notification requirement applied with respect to independent public accountant engagements under Rule 17a-5 for non-carrying as well as carrying broker-dealers. As discussed above in section VII.B.1. of this release, the Commission estimates that there are approximately 4,709 broker-dealers registered with the Commission and that of those firms, approximately 292 are carrying broker-dealers. Consequently, before today's amendments, the notification requirements with respect to material inadequacy applied to approximately 4,709 broker-dealers, whereas after today's amendments the notification requirement with respect to material weakness will apply to approximately 292 broker-dealers.

The Commission proposed amending paragraph (e) of Rule 17a-11 to delete the references to Rule 17a-5. However, the Commission is not adopting this alternative because it agrees with a commenter that notification should be provided to the Commission when a deficiency in internal control is discovered by the broker-dealer.[843]

vi. Information Provided to Customers

Prior to today's amendments, paragraph (c)(2)(iii) of Rule 17a-5 provided that if, in conjunction with a broker-dealer's most recent audit report, the broker-dealer's independent public accountant commented on any material inadequacies in the broker-dealer's internal controls, its accounting system, or certain of its practices and procedures[844] under paragraphs (g) and (h) of Rule 17a-5, and paragraph (e) of Rule 17a-11, the broker-dealer's audited statements sent to customers were required to include a statement that a copy of the auditor's comments were available for inspection at the Commission's principal office in Washington, DC, and the

[843] See Deloitte Letter.

[844] These practices and procedures include, for example, periodic net capital computations under Rule 15c3-1 and periodic counts of securities under Rule 17a-13.

regional office of the Commission in which the broker-dealer had its principal place of business.[845]

The Commission is revising its proposal with respect to amending paragraph (c)(2) of Rule 17a-5 to be consistent with the new notification provisions in paragraph (h) described above relating to the identification by a broker-dealer's accountant of a material weakness rather than an instance of material non-compliance.[846] Specifically, if, in connection with the most recent annual reports, the report of the independent public accountant on the broker-dealer's compliance report identifies a material weakness, the broker-dealer must include a statement that one or more material weaknesses have been identified and that a copy of the report of the independent public accountant is currently available for the customer's inspection at the principal office of the Commission in Washington, DC, and the regional office of the Commission for the region in which the broker-dealer has its principal place of business.[847]

The Commission does not believe these amendments will result in incremental costs to broker-dealers over the baseline. Material weakness is defined with regard to the compliance report and therefore applies only to broker-dealers that file compliance reports (i.e., carrying broker-dealers). In contrast, the concept of material inadequacy generally applied to all broker-dealers and, therefore, the customer notification requirement applied with respect to independent public accountant engagements under Rule 17a-5 for non-carrying as well as carrying broker-dealers. As discussed above in section VII.B.1. of this release, the Commission estimates that there are approximately 4,709 broker-dealers registered with the Commission and that of those firms, approximately 292 are carrying broker-dealers. Consequently, before today's

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845 See 17 CFR 240.17a-5(c)(2)(iii).

846 See paragraph (c)(2)(iv) of Rule 17a-5.

847 Id.

amendments, the notification requirements with respect to material inadequacy applied to approximately 4,709 broker-dealers, whereas after today's amendments the notification requirement with respect to material weakness will apply to approximately 292 broker-dealers.

Rule 17a-5 also provides a conditional exemption from the requirement to send paper copies of financial information to customers if the broker-dealer mails a financial disclosure statement with summary information and an Internet link to the balance sheet and other information on the broker-dealer's website. Before today's amendments, one of the conditions of the exemption was that the broker-dealer was not required during the prior year to give notice of a material inadequacy. The Commission proposed revising this condition for using website disclosure to provide that the broker-dealer's financial statements must receive an unqualified opinion from the accountant and that neither the broker-dealer nor the accountant identified a material weakness or an instance of material non-compliance.

One commenter stated that a broker-dealer should be able to deliver the financial information available to customers via its website regardless of whether an instance of material non-compliance or material weakness was identified.[848] Another commenter stated that the rule should not require a 100% rate of compliance with the financial responsibility rules to qualify for the exemption.[849] A third commenter stated that the proposed amendment should be eliminated, or replaced with the requirement that broker-dealers include a notice of the material weakness or

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848 See ABA Letter.

849 See CAI Letter. This commenter stated that FINRA has proposed that broker-dealers send customer account statements monthly instead of quarterly, broker-dealers are already potentially facing "extremely high" costs of sending information to customers. FINRA withdrew its proposals to send customer account statements monthly instead of quarterly on July 30, 2012. See SR-FINRA-2009-028, Proposed Rule Change to Adopt FINRA Rule 2231 (Customer Account Statements) in the Consolidated FINRA Rulebook, Withdrawal of Proposed Rule Change (July 30, 2012), available at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p143262.pdf.

non-compliance on customer account statements for a year following its identification.[850]

The Commission has decided not to adopt the proposed condition for qualifying for the conditional exemption. The decision not to adopt should result in lower costs than would have been incurred had the Commission adopted the proposal without modification. Using the Internet to disclose information should be less costly and more efficient for the broker-dealer than mailing paper copies to all customers. It also will benefit customers, since they will be able to access relevant broker-dealer information more efficiently through the Internet (alternatively, customers can request a paper copy by phone at no cost to the customer).[851]

vii. Coordination with Investment Advisers Act Rule 206(4)-2

Advisers Act Rule 206(4)-2 provides that when a registered investment adviser or its related person maintains client funds and securities as a qualified custodian in connection with advisory services provided to clients, the adviser annually must obtain, or receive from its related person, a written internal control report prepared by an independent public accountant registered with, and subject to regular inspection by, the PCAOB. This report must be supported by the accountant's examination of the qualified custodian's custody controls. Under the amendments, a broker-dealer that also acts as a qualified custodian for itself as an investment adviser or for its related investment advisers may use the report of the independent public accountant based on an examination of its compliance report to meet the reporting obligations under Rule 206(4)-2. Therefore, such a broker-dealer will not be required to obtain an internal control report under Rule 206(4)-2 in addition to a report covering the compliance report from its independent public accountant. It also will result in efficiencies as a single audit will be able to address two audit requirements.

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850 See SIFMA Letter.

851 See 17 CFR 240.17a-5(c)(5)(ii), (iv), and (v).

2. Access to Accountant and Audit Documentation

The amendments to Rule 17a-5 require that carrying or clearing broker-dealers agree to allow Commission and DEA staff, if requested in writing for purposes of an examination of the broker-dealer, to review the work papers of the independent public accountant and to allow the accountant to discuss the its findings with the examiners.

This requirement will enable the Commission and DEAs to more efficiently deploy examination resources.[852] Examiners reviewing the accountant's work papers will be able to tailor the scope of their examinations by identifying areas where extensive audit work was performed by the independent public accountant and focusing their examinations on other areas, allowing for more efficient oversight of broker-dealers by the Commission and DEA examination staff. Enabling Commission and DEA examination staff to conduct more focused and efficient examinations of broker-dealers could, in turn, allow for examination resources to be allocated more strategically.

The Commission is amending paragraph (f)(2) of Rule 17a-5 to revise the statement regarding identification of a broker-dealer's independent public accountant that broker-dealers must file each year with the Commission and their DEA (except that if the engagement is of a continuing nature, no further filing is required).[853] The revised statement contains additional information that includes a representation that the independent public accountant has undertaken to provide a report regarding the broker-dealer's financial reports and a report regarding the broker-dealer's compliance or exemption report, as applicable.[854] In addition, the statement

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852 As discussed previously, where an independent public accountant has performed extensive testing of a carrying broker-dealer's custody of securities and cash by confirming holdings at subcustodians, examiners could focus their efforts on matters that had not been the subject of prior testing and review.

853 See discussion above in section III. of this release.

854 See 17 CFR 240. 17a-5(f)(2)(ii).

provided by a clearing or carrying broker-dealer must include representations regarding the access to accountant requirements described above.[855] Therefore, all broker-dealers will generally be required to file a new statement regarding their independent public accountant.

As discussed above in section III. of this release, one commenter stated that, the amendments would discourage or "chill" communications between a broker-dealer and its auditor because of the possibility that an auditor may misconstrue communications from representatives of the broker-dealer and wrongly conclude that the representatives lack knowledge or admit to an issue.[856] Presumably, this "chilling effect" would result from a broker-dealer's desire to avoid the creation of audit documentation memorializing misunderstandings and miscommunications, which when accessed by Commission and DEA examiners could result in regulatory scrutiny. As stated in section III. of this release, the Commission is not persuaded by this comment; while it is possible for miscommunications to occur between representatives of a broker-dealer and its auditor, potential misunderstandings or miscommunications should not limit the ability of the Commission or a DEA to have access to audit documentation or a broker-dealer's independent public accountant. Further, to the extent a misunderstanding or miscommunication between a broker-dealer and its accountant is reflected in the accountant's audit documentation relating to the broker-dealer, the broker-dealer could clarify the nature of the misunderstanding or miscommunication to examiners and how it was rectified if such clarification and rectification is not already described in subsequent audit documentation.

The Commission estimated that the one-time hour burden associated with amending its existing statement and filing the new statement with the Commission, in order to comply with

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See 17 CFR 17a-5(f)(2)(ii)(F)-(G).

856 See CAI Letter.

the proposed amendments, would be an average of approximately two hours on a one-time basis for each broker-dealer, as the statement can be continuing in nature.[857]

As discussed in the PRA, the Commission is revising this estimate for clearing and carrying broker-dealers, as these broker-dealers will likely be required to renegotiate their agreements with their independent public accountants. The Commission estimates that the total one-time cost associated with this burden is approximately $5.2 million.[858] Additionally, the Commission believes there will be postage costs associated with sending the amended statement regarding the accountant and estimates that each mailing will cost approximately $0.45, for a total cost of approximately $6,357 for all broker-dealers on a one-time basis.[859]

In addition, in the proposing release, the Commission estimated that a carrying or clearing broker-dealer's accountant would charge the broker-dealer for time its personnel spend speaking with the Commission or the broker-dealer's DEA or providing them with audit documents and that, on average, the Commission or the broker-dealer's DEA may speak with each accountant for approximately five hours per year. Thus, the Commission estimated that the additional cost of accountant time associated with this amendment to all clearing and carrying

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857 See Broker-Dealer Reports, 76 FR at 37596.

858 See Section VI.D.1.vi. Based on staff experience, a broker-dealer that carries customer accounts or clears transactions likely would have its Controller and an Assistant General Counsel involved in renegotiating the agreement with auditors, and that those discussions would take, on average, approximately four hours. Broker-dealers would likely have an attorney prepare a new notification of designation of accountant, and that task would take the attorney, on average, approximately two hours. According to the SIFMA Report on Management and Professional Earnings in the Securities Industry, 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, the hourly cost of a Controller is approximately $409/hour, the hourly cost of an Assistant General Counsel is approximately $407/hour, and the hourly cost of an Attorney is approximately $378/hour. 513 broker-dealers that carry customer accounts or clear transactions x 4 hours x $409 = $839,268. 513 broker-dealers that carry customer accounts or clear transactions x 4 hours x $407 = $835,164. 4,709 broker-dealers x 2 hours x $378 = $3,560,004. $839,268 + $835,164 + $3,560,004 = $5,234,436.

859 See Section VI.D.1.vi. 4,709 broker-dealers x $0.45 cost for first class postage x 3 mailings = $6,375.15.

broker-dealers would be approximately $660,000 annually.[860] As the Commission now estimates that the number of carrying or clearing broker-dealers is 513, the new estimate is approximately $641,250.[861]

3. Form Custody

The newly adopted Form Custody is to be filed quarterly at the same time that a broker-dealer is required to file its FOCUS Reports. The form elicits information concerning whether, and if so, how, a broker-dealer maintains custody of customer assets and, as discussed above, consolidates information about the broker-dealer's custodial responsibility and relationships with other custodians in one report so that the Commission and other securities regulators will be provided with a comprehensive profile of the broker-dealer's custody practices and arrangements. This should reduce the likelihood that fraudulent conduct, including misappropriation or other misuse of investor assets, can continue undetected. Further, the information provided in Form Custody should aid in the examination of broker-dealers, because the examination staff can use the information provided as another tool to prioritize and plan examinations.

The Form Custody amendments also should enhance investor confidence in the ability of the securities regulators to oversee broker-dealers and broker-dealer custody of investor assets. By establishing a discipline under which broker-dealers are required to report greater detail as to their custodial functions, investor perception as to the safety of their funds and securities held by broker-dealers should improve. Investors may be more willing to provide capital for investment. Further, the requirement by broker-dealers to provide detail as to their custodial practices may

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860 See Section VI.D.1.vii.d. In the proposing release the Commission multiplied 528 clearing and carrying broker-dealers x 5 hours x $250/hour = $660,000.

861 See Section VI.D.1.vii.d. 513 clearing and carrying broker-dealers x $1,250 in increased costs per clearing broker-dealer = $641,250.

prompt them to identify and correct deficiencies. For example, if a broker-dealer preparing the information to be disclosed on the form discovers a discrepancy between its own records and the records of a custodian as to the nature or quantity of assets held by the custodian, the broker-dealer can act to resolve the discrepancy before filing the form.

The Commission estimated that the time required to complete and file Form Custody would be approximately 12 hours per quarter, or 48 hours per year, on average, for each broker-dealer.[862] The Commission did not receive comments regarding this estimate. The Commission now estimates that there are approximately 4,709 broker-dealers that must file Form Custody. The Commission therefore estimates that the total time required to complete and file Form Custody for all 4,709 broker-dealers is approximately 226,032 hours per year (4,709 broker-dealer times four responses per year times 12 hours = 226,032 hours). Further, the Commission estimates that the total cost associated with completing and filing Form Custody is approximately $69.8 million.[863]

One commenter stated that the estimated costs to the industry of $69,179,670 in the proposing release was "staggering," and that such costs would likely indirectly be passed on to customers.[864] The commenter did not disagree with the estimated cost in the proposing release; rather, the commenter focused on the size of the total estimated costs. The Commission notes that the $69 million estimate in the proposing release and the $69.8 million estimate in this

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862 See Broker-Dealer Reports, 76 FR at 37597.

863 Based on staff experience, a broker-dealer likely would have a Financial Reporting Manager complete and file Form Custody. According to the SIFMA Report on Management and Professional Earnings in the Securities Industry, 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, the hourly cost of a Financial Reporting Manager is approximately $309/hour. 4,709 broker-dealers x 48 hours x $309 = $69,843,888.

864 See IMS Letter. The cost of $69,179,670 was reflected in the economic analysis in the proposing release. See Broker-Dealer Reports, 76 FR at 37601. This cost was calculated as an internal cost of the estimated PRA hours and is the total cost divided among 5,057 firms. Id. at 37601 n.215. This internal cost would amount to an average of $13,680 per broker-dealer. Id.

release are estimates of the aggregate cost to the industry. The average cost to an individual broker-dealer would be approximately $15,000 per year.[865] As an average, the costs incurred by a broker-dealer to comply with the requirement to file Form Custody will depend on its size and the complexity of its business activities.

The Commission recognizes that the requirement to file Form Custody will increase compliance costs for broker-dealers and that these costs may be passed on to customers. The Commission, however, believes the investor protection benefits of the Form Custody requirements outweigh these costs. As noted above, Form Custody is designed to assist Commission and DEA examiners in identifying potential misrepresentations relating to broker-dealers' custody of assets. Further, the requirements to file the form will promote greater focus and attention to custody practices by requiring that broker-dealers make specific representations in this regard. The safeguarding of customer securities and cash held by broker-dealers is of paramount importance as demonstrated by recent cases where broker-dealers failed to protect customer securities and cash.[866]

4. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

As discussed above, incremental costs will result from the annual reporting requirement amendments, the access to accountant amendments, and the Form Custody amendments. These incremental costs could result in higher barriers to entry for broker-dealers as compared with the baseline that existed prior to the amendments. This could be the case particularly for carrying broker-dealers given the incremental costs associated with the compliance report requirements, the applicability of the access to accountant amendments to carrying and clearing broker-dealers,

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865 1 broker-dealer x 48 hours x $309 = $14,832.

866 See, e.g., SEC v. Bernard L. Madoff, et al., Litigation Release No. 20889 (Feb. 9, 2009).

and that most of the information elicited in Form Custody relates to carrying broker-dealer activities.

The annual reporting requirements have a mixed effect on competition across broker-dealers. The requirement to prepare and file a compliance report or exemption report may impose a burden on competition for smaller carrying broker-dealers to the extent that it imposes relatively high fixed costs, which would represent a greater amount of net income for smaller broker-dealers. On the other hand, as previously noted, a carrying broker-dealer with limited custodial activities should have to expend less effort to support its statements in the compliance report than a broker-dealer with more extensive custodial activities, and the attendant costs should similarly be lower. While the incremental costs of the annual reporting requirements may be lower for non-carrying broker-dealers (which generally are smaller broker-dealers), the costs could disproportionately impact smaller broker-dealers due to fixed cost components of the cost of compliance with these requirements.

The access to accountant amendments may place a burden on carrying and clearing broker dealers. To the extent that addressing contracts between auditors and broker-dealers is a fixed cost, the rule may impact smaller broker-dealers to a greater extent than it will larger broker-dealers. The amendments should not place a burden on competition for non-carrying broker-dealers.

The requirement to file Form Custody could have a burden on competition because it will increase compliance costs for broker-dealers. However, the requirement should not have a disproportionate effect on smaller broker-dealers. Smaller firms will incur fewer costs to complete Form Custody because less information is required to be disclosed. For example, broker-dealers that introduce customers on a fully disclosed basis and do not have custody of customer funds or assets would leave much of the form blank.

In sum, the costs of compliance resulting from the requirements in these amendments should not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act and in light of the benefits discussed above.

Today's amendments are designed to reduce the likelihood that fraudulent conduct, or lack of appropriate custody procedures or other internal controls, will jeopardize customer securities and funds held by broker-dealers. To the extent that the amendments achieve that goal, investors should be more confident that the customer assets held by broker-dealers are safe. This in turn may promote capital formation as investor assets are able to be allocated more efficiently across the opportunity set.

One commenter asserted that the proposed amendments "place unnecessary regulatory burdens and costs on industry, in general, and smaller firms, in particular" and that "broker-dealers compete against investment advisers who are not burdened by the same regulatory requirements," including the requirements in the proposed amendments.[867] The Commission recognizes, as explained above, that the amendments adopted today impose costs on broker-dealers that could result in higher barriers to entry. However, the Commission is of the opinion that these costs are justified by the numerous and significant benefits, in particular with respect to protection of customer assets, described in this economic analysis.

With respect to the commenter's statement about broker-dealers competing with investment advisers, recent Commission amendments to investment adviser rules are "designed to provide additional safeguards . . . when a registered adviser has custody of client funds or

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[867] See IMS Letter.

securities" including a requirement to undergo an annual surprise examination by an independent public accountant to verify client assets and a requirement to have a report of the internal controls relating to the custody of client assets from an accountant registered with, and subject to inspection by, the PCAOB unless client assets are maintained by an independent custodian.[868] Consequently, the regulations governing investment advisers have been strengthened in recent years through new requirements aimed at safeguarding customer assets. Today's amendments also are aimed at safeguarding customer assets. As both investment advisers and broker-dealers are now subject to new requirements, today's amendments should not create a competitive advantage for either class of registrant. Moreover, the recently adopted requirements for investment advisers and the amendments adopted today are, among other things, part of an effort to strengthen the Commission's rules regarding the safekeeping of customer assets, in part in response to several fraud cases brought by the Commission involving investment advisers and broker-dealers.[869]

If the amendments increase investor confidence in broker-dealers, they will promote capital formation. Moreover, for the reasons discussed above, today's amendments should not unduly restrict competition and should promote capital formation.[870]

The amendments also should increase efficiencies. With respect to the annual reporting amendments, updating the language of Rule 17a-5 to replace outdated or inconsistent audit terminology is designed to ensure that the requirements of the rule are better aligned with applicable current audit standards. Further, the amendments facilitate PCAOB oversight

868 See Custody of Funds or Securities of Clients by Investment Advisers, 75 FR at 1456.

869 Id.

870 The Commission stated in the proposing release that its preliminary view was that the proposed rule amendments promote efficiency, competition, and capital formation and that any burden on competition is justified by the benefits provided by the amendments. See Broker-Dealer Reports, 76 FR at 37598.

authority, including its ability to inspect audits of broker-dealers, by providing that examinations or reviews of broker-dealer annual reports be made in accordance with PCAOB standards. In addition, the amendments strengthen and promote consistent compliance with the financial responsibility rules for broker-dealers that maintain custody of customer securities and funds by increasing the focus of these broker-dealers and their independent public accountants on compliance, and internal control over compliance, with the financial responsibility rules. This, in turn, should help the Commission and the broker-dealer's DEA identify broker-dealers that have weak internal controls for safeguarding investor assets and improve the financial and operational condition of broker-dealers and thereby provide more protection for investor assets held by broker-dealers.

The access to accountant amendments should increase efficiencies by promoting more risk-based examinations by Commission and DEA staff. For example, the examiners in some cases may be able to leverage the work performed by the independent public accountants and, therefore, focus on areas the accountants did not review. Similarly, the Form Custody amendments should increase efficiencies by promoting more risk-based examinations by Commission and DEA staff as they will be able to use the profile of the broker-dealer's custody practices documented in Form Custody to focus their reviews. For this reason, examinations may also place fewer time demands on broker-dealer personnel.

In significant part, the effect of these rules on efficiency and capital formation are linked to the effect of these rules on competition. For example, markets that are competitive and trusted may be expected to promote the efficient allocation of capital. Similarly, rules that promote, or do not unduly restrict, trust in broker-dealers can be accompanied by regulatory benefits that minimize the risk of market failure and thus promote efficiency within the market. Such competitive markets would increase the efficiency by which market participants could transact with broker-dealers.

VIII. FINAL REGULATORY FLEXIBILITY ANALYSIS

The Regulatory Flexibility Act ("RFA")[871] requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a)[872] of the Administrative Procedure Act,[873] as amended by the RFA, generally requires the Commission to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on small entities.[874] Section 605(b) of the RFA provides that this requirement does not apply to any proposed rule or proposed rule amendment, which if adopted, would not "have a significant economic impact on a substantial number of small entities."[875]

The Commission proposed amendments to Rules 17a-5 and 17a-11 and proposed new Form Custody. An Initial Regulatory Flexibility Analysis ("IRFA") was included in the proposing release.[876] This Final Regulatory Flexibility Analysis has been prepared in accordance with the provisions of the RFA.

A. Need for and Objectives of the Amendments and New Form

The final rules amend certain broker-dealer annual reporting, audit, and notification

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[871] 5 U.S.C. 601 et seq.

[872] 5 U.S.C. 603(a).

[873] 5 U.S.C. 551 et seq.

[874] Although section 601(b) of the RFA defines the term small entity, the statute permits agencies to formulate their own definitions. The Commission has adopted definitions for the term "small entity" for the purposes of Commission rulemaking in accordance with the RFA. Those definitions, as relevant to this rulemaking, are set forth in Rule 0-10. See 17 CFR 240.0-10. See Statement of Management on Internal Accounting Control, Exchange Act Release No. 18451 (Jan. 28, 1982), 47 FR 5215 (Feb. 4, 1982).

[875] See 5 U.S.C. 605(b).

[876] See Broker-Dealer Reports, 76 FR at 37601–37602.

requirements. The amendments include a requirement that broker-dealer audits be conducted in accordance with standards of the PCAOB, that broker-dealers file either a compliance report or an exemption report covered by a report prepared by an independent public accountant, and that clearing broker-dealers allow representatives of the Commission or the broker-dealer's DEA to review the documentation associated with certain reports of the broker-dealer's independent public accountant and to allow the accountant to discuss its findings with the representatives when requested in connection with a regulatory examination of the broker-dealer. The amendments also require a broker-dealer to file a new form with its DEA that elicits information about the broker-dealer's practices with respect to the custody of securities and funds of customers and others.

The amendments and new form are designed, among other things, to provide additional safeguards with respect to broker-dealer custody of customer securities and funds, to enhance the ability of the Commission to oversee broker-dealer custody practices, to increase the focus of carrying broker-dealers and their independent public accountants on compliance, and internal control over compliance, with certain financial and custodial requirements, to facilitate the ability of the PCAOB to implement the explicit oversight authority over broker-dealer audits provided to the PCAOB by the Dodd-Frank Act, and to satisfy the internal control report requirement in Rule 206(4)-2 for certain broker-dealers affiliated with, or dually-registered as, investment advisers.

B. Significant Issues Raised by Public Comments

The Commission requested comment with regard to matters discussed in the IRFA, including comments with respect to the number of small entities that may be affected by the proposed rule amendments and whether the effect on small entities would be economically significant.[877]

The Commission did not receive any comments specifically addressing the IRFA. However, several commenters discussed the impact of the proposal on small broker-dealers. One commenter stated that the proposed amendments "place unnecessary regulatory burdens and costs on the industry, in general, and smaller firms in particular."[878] Another commenter stated that small broker-dealers may find the timing of the transition to be a "burden," and requested that the Commission provide a longer transition period.[879] A third commenter suggested that the exemption report and the accountant's report on the exemption report be replaced with a "check box on the FOCUS report" and that with regard to these reports "[t]he amount of paperwork involved for small firms that do not carry customer securities seems rather excessive."[880] A fourth commenter stated that the proposed transition period may burden smaller broker-dealers, and suggested that to facilitate the transition, the Commission should provide examples of best practices and deficiencies, with the cooperation of the AICPA.[881] This commenter also suggested that the effective date for the annual reporting requirements should be one year after publication of the final rule.[882]

The Commission is sensitive to the burdens the rule amendments and new form will have on small broker-dealers. To remove unnecessary burdens, the final rule amendments contain

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877 Id. at 37602.

878 See IMS Letter.

879 See Citrin Letter.

880 See Angel Letter.

881 See Citrin Letter.

882 Id. The commenter also specifically suggested that if non-carrying and smaller broker-dealers must use PCAOB standards, that the Commission should defer the effective date for one year after the approval of the amendments. Id.

certain modifications from the proposal designed to alleviate some of the concerns regarding small broker-dealers.[883] The modifications are discussed in the following paragraphs.

As is discussed above, the Commission has modified the proposed amendments with respect to the exemption report in a manner that will likely result in lower costs for small broker-dealers than would have been the case if the Commission had adopted the proposed amendments without the modifications. In particular, the final rule provides that a broker-dealer can file the exemption report if it "claimed that it was exempt" from Rule 15c3-3 throughout the most recent fiscal year. This modification from the proposal – which provided that a broker-dealer could file the exemption report if the broker-dealer "is exempt from Rule 15c3-3" – is designed to address concerns raised by commenters that a non-carrying broker-dealer might be required to file the compliance report because of an instance during the year in which it did not meet the relied on exemption provision in paragraph (k) of Rule 15c3-3.[884] As discussed in the economic analysis, the compliance report costs are significantly greater than the exemption report costs. The final rule clarifies that a non-carrying broker-dealer that has an exception to meeting the exemption provisions in paragraph (k) of Rule 15c3-3 need not file the compliance report; however, the broker-dealer would be required to identify, to its best knowledge and belief, in its exemption report each exception during the most recent fiscal year, if applicable, including a brief description of the exception and the approximate date on which the exception existed.

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883 As is discussed below, small broker-dealers are in most instances not carrying broker-dealers. See section VIII.C. of this release.

884 See SIFMA Letter. As discussed above in section II.B.1. of this release, there will be cases where a broker-dealer changes its business model to convert from a carrying broker-dealer to a non-carrying broker-dealer during the fiscal year. In this case, the broker-dealer could seek exemptive relief under section 36 of the Exchange Act (15 U.S.C. 78mm) from the requirement to file the compliance report and to instead file the exemption report. In analyzing such a request, the period of time the broker-dealer operated as a carrying broker-dealer would be a relevant consideration.

In addition, only clearing broker-dealers will be subject to the requirements that the Commission is adopting today that provide Commission and DEA examination staff with the ability to review audit documentation associated with broker-dealers' annual audit reports and allow their independent public accountants to discuss findings relating to the audit reports with Commission and DEA examination staff.

To alleviate burdens associated with Form Custody, the Commission has modified the form's instructions to make clear that questions on the form that cannot be answered because the broker-dealer does not engage in a particular activity do not need to be answered.

In response to comments, the Commission also has delayed the effective dates associated with the proposed reporting and attestation amendments, which will provide all broker-dealers, including smaller broker-dealers, with a longer transition period to prepare for the new requirements.

As is discussed above, the Commission considered the comment that it should replace the exemption report with a box to check on the FOCUS Report as the amount of paperwork for small firms "seems rather excessive."[885] After careful consideration of this and other alternatives, the Commission determined that of the alternatives considered, none are appropriate alternatives to the exemption report. Requiring the broker-dealer to (1) create a separate written report stating that it is claiming the exemption and identifying the basis for the exemption, including any identified exceptions in meeting the conditions set forth in § 240.15c3-3(k) and (2) file this report with the Commission and the broker-dealer's DEA should increase broker-dealers' focus on the accuracy of its compliance with the statements being made because of the potential for liability for false statements, enhance compliance with the exemption conditions in

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885 See section II.B.4.iii. of this release.

Rule 15c3-3, and therefore provide better protection of customer assets.

Finally, with respect to the comment that the Commission should provide examples of best practices and deficiencies with the cooperation of the AICPA, the Commission notes that the question of whether further guidance is necessary is best answered after the requirements become effective and practical compliance questions arise. In addition, the Commission will publish a Small Entity Compliance Guide relating to these amendments.

C. Small Entities Subject to the Rules

Paragraph (c) of Rule 0-10 provides that, for purposes of the RFA, a small entity when used with reference to a broker-dealer ("small broker-dealer") means a broker-dealer that: (1) had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d) or, if not required to file such statements, a broker-dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the last business day of the preceding fiscal year (or in the time that it has been in business if shorter); and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization.[886] Based on December 31, 2011 FOCUS Report data, the Commission estimates that there are approximately 812 broker-dealers that are classified as "small" entities for purposes of the RFA. Of these, the Commission estimates that there are approximately eight broker-dealers that are carrying broker-dealers. The Commission estimated for purposes of the IRFA that there were approximately 871 broker-dealers that were classified as small entities for purposes of the RFA and that there were no broker-dealers that were carrying firms that satisfied the definition of a

[886] 17 CFR 240.0-10(c).

small broker-dealer.[887]

D. Reporting, Recordkeeping, and Other Compliance Requirements

The Commission's amendments to Rule 17a-5 retain the current requirement that broker-dealers annually file financial statements and supporting schedules ("financial report") that must be audited by a PCAOB-registered accountant. Under the amendments, the financial report must be audited in accordance with standards of the PCAOB, instead of in accordance with GAAS, as previously required.

In addition to the financial report, the amendments require broker-dealers to file one of two new reports: either a compliance report or an exemption report. If a broker-dealer did not claim that it was exempt from Rule 15c3-3 throughout the most recent fiscal year, the broker-dealer must prepare and file with the Commission a compliance report containing certain statements regarding the broker-dealer's internal control over compliance with the financial responsibility rules and compliance with certain of those rules. Alternatively, if the broker-dealer claimed that it was exempt from Rule 15c3-3 throughout the most recent fiscal year, the broker-dealer must prepare and file with the Commission an exemption report containing a statement that it claimed that it was exempt from Rule 15c3-3 during that period and identify the provisions under which it claimed that it was exempt from Rule 15c3-3.

The amendments to Rule 17a-5 also eliminate the "material inadequacy" concept and, among other things, replace the requirement that the broker-dealer's independent public accountant prepare, and the broker-dealer file with the Commission, a material inadequacy report with a requirement for the accountant to prepare a new report covering either the compliance

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See Broker-Dealer Reports, 76 FR at 37602. Although the Commission received no comments regarding the its initial estimate that there were no small carrying broker-dealers, the estimate is nonetheless being revised based on additional analysis of available information.

report or the exemption report, as applicable. If the broker-dealer is a carrying broker-dealer, the accountant must prepare a report based on an examination, in accordance with PCAOB standards, of certain statements by the broker-dealer in the compliance report. If the broker-dealer claimed an exemption from Rule 15c3-3, the accountant must prepare a report based on a review, in accordance with PCAOB standards, of the exemption report. Broker-dealers must file these reports of the accountant with the Commission along with the financial report and either the compliance report or the exemption report.

Together, the financial report and the compliance report or the exemption report and the accountant's reports covering those reports comprise the annual reports that the broker-dealer must file each fiscal year with the Commission and the broker-dealer's DEA. The amendments require that the broker-dealer also file the annual reports with SIPC if the broker-dealer is a member of SIPC.

Amendments to Rule 17a-5 also require that if, during the course of an audit, a broker-dealer's independent public accountant determines that the broker-dealer is not in compliance with the financial responsibility rules, or that any material weaknesses exist, the accountant must immediately notify the broker-dealer. The broker-dealer must notify the Commission and its DEA of the material weakness and must notify the Commission and the DEA of the non-compliance if that non-compliance would otherwise trigger a notification requirement.

Amendments to Rule 17a-11 require that when a broker-dealer discovers, or is notified by its independent public accountant, of the existence of any material weakness under Rule 17a-5, the broker-dealer must notify the Commission and transmit a report to the Commission stating what the broker-dealer has done or is doing to correct the situation. The amendments substituted the term material weakness for the term material inadequacy with regard to Rule 17a-5.

Under the amendments, carrying broker-dealers or those that clear transactions must agree to allow Commission or DEA examination staff, if requested in writing for purposes of an examination of the broker-dealer, to review "the documentation associated with the reports of the accountant" and to discuss the accountant's findings with the accountant.

The amendments require broker-dealers to file a new "Form Custody" each quarter to elicit information concerning whether a broker-dealer maintains custody of customer and non-customer assets, and, if so, how such assets are maintained. Form Custody must be filed with the broker-dealer's DEA. The DEA must transmit the information obtained from Form Custody to the Commission at the same time that it transmits FOCUS Report data to the Commission under paragraph (a)(4) of Rule 17a-5.

The impact of the amendments on small broker-dealers will be substantially less than on larger firms. Most small broker-dealers are exempt from Rule 15c3-3 and therefore must file the exemption report. As discussed above, the exemption report must be reviewed by the independent public accountant, in lieu of the compliance report, which must be examined by the accountant. In addition, Form Custody would elicit less information from broker-dealers that do not maintain custody of customer assets, and therefore the form should be less burdensome for these broker-dealers.

E. Agency Action to Minimize Effect on Small Entities

Pursuant to section 3(a) of the RFA,[888] the Commission must consider significant alternatives that would accomplish the Commission's stated objectives, while minimizing any significant adverse impact on small entities. In connection with the final rules, the Commission considered the following alternatives: (1) establishing differing compliance or reporting

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[888] 5 U.S.C. 603(c).

requirements or timetables that take into account the resources available to smaller entities; (2) clarifying, consolidating, or simplifying compliance and reporting requirements for smaller entities; (3) the use of performance standards rather than design standards; and (4) exempting smaller entities from coverage of the rules, or any part of the rules.

The Commission considered differing compliance and reporting requirements and timetables in adopting the amendments discussed in this release, which took into account the resources available to smaller entities. For example, as is discussed above, the Commission considered alternatives to the exemption report requirements, which resulted in modifications to the final rule that make clear that broker-dealers claiming exemptions from Rule 15c3-3 will remain subject to those requirements even if certain exceptions arise.[889] This reduces the burden on small broker-dealers that would otherwise be subject to the more resource-intensive compliance and examination report requirements applicable to carrying broker-dealers.

In addition, the Commission, in establishing effective dates for these amendments, considered the resources available to small broker-dealers. In this regard, the Commission is delaying the effective dates for the audit and reporting requirements, which will provide small broker-dealers with greater flexibility in allocating their resources while preparing to comply with applicable amendments.

The Commission also clarified, consolidated, and simplified compliance and reporting requirements for broker-dealers in connection with the amendments. As discussed above, the Commission clarified and simplified requirements applicable to Form Custody by specifying in the final form that broker-dealers are not required to answer questions that do not apply to their business activities. Further, in terms of consolidating regulatory requirements applicable to

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889 See sections II.B.4.iii. and VII.C.1.ii.b. of this release.

broker-dealers, a broker-dealer affiliated with, or dually-registered as, an investment adviser that is subject to the compliance report requirement can use the independent public accountant's examination of the compliance report to satisfy reporting obligations under Advisers Act Rule 206(4)-2.

The Commission generally used design standards rather than performance standards in connection with the final rule amendments because the Commission believes design standards will better accomplish its objectives of enhancing safeguards with respect to broker-dealer custody of securities and funds. The specific disclosure requirements in the final rule will promote comparable and consistent types of disclosures by broker-dealers, which will facilitate the ability of Commission and DEA staff to assess broker-dealer compliance with applicable requirements.

The Commission also considered, and is adopting, amendments that exempt certain types of broker-dealers from certain requirements. For example, broker-dealers that are not clearing broker-dealers, which include most small broker-dealers, do not need to comply with the access to accountant and audit documentation amendments. Most small broker-dealers also will not be subject to the new compliance and examination report requirements, as small broker-dealers are in most instances not carrying broker-dealers.

In addition, if the Commission subsequently determines that it is appropriate to exempt a broker-dealer, or type of broker-dealer, from such requirements, the Commission has existing authority under which it can act. In particular, under Exchange Act section 36, the Commission, by rule, regulation, or order, may exempt any person, or any class or classes of persons, from any rule under the Exchange Act to the extent that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors.[890]

IX. STATUTORY AUTHORITY

The Commission is amending Rule 17a-5 and Rule 17a-11 under the Exchange Act (17 CFR 240.17a-5 and 17 CFR 240.17a-11) and adopting new Form Custody (17 CFR 249.639) pursuant to the authority conferred by the Exchange Act, including sections 15, 17, 23(a) and 36.[891]

List of Subjects in 17 CFR Parts 240 and 249

Brokers, Confidential business information, Fraud, Reporting and recordkeeping requirements, Securities.

Text of the Amendments

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

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

1. The authority citation for part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78l, 78m, 78n, 78n-1, 78o, 78o–4, 78o-10, 78p, 78q, 78q-1, 78s, 78u–5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, 7201 et seq., and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; and Pub. L. 111-203, 939A, 124 Stat. 1376, (2010), unless otherwise noted.

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15 U.S.C. 78mm.

15 U.S.C. 78o, 78q, 78w(a) and 78mm.

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2. Section 240.17a-5 is amended by:

a. In paragraph (a)(2)(i), adding the word "transactions" after the word "clears" and removing the words "shall file" and adding in their place "must file with the Commission."

b. In paragraph (a)(2)(ii), removing the words "shall file" and adding in their place "must file with the Commission" and removing the phrase "date selected for the annual audit of financial statements where said date is other than a calendar quarter" and adding in its place "end of the fiscal year of the broker or dealer where that date is not the end of a calendar quarter.";

c. In paragraph (a)(2)(iii), removing the phrase "who does not carry nor clear transactions nor carry customer accounts shall file" and adding in its place "that neither clears transactions nor carries customer accounts must file with the Commission" and removing the phrase "date selected for the annual audit of financial statements where said date is other than the end of the calendar quarter." and adding in its place "end of the fiscal year of the broker or dealer where that date is not the end of a calendar quarter.";

d. In paragraph (a)(2)(iv), removing the words "shall file" and adding in their place "must file with the Commission" and adding the phrase "("designated examining authority")" after the phrase "section 17(d) of the Act";

e. In paragraph (a)(3), in the first sentence, adding the words "that must be filed with the Commission" after the words "provided for in this paragraph (a)";

f. Redesignating paragraphs (a)(5) and (a)(6) as paragraphs (a)(6) and (a)(7);

g. In newly redesignated paragraph (a)(6)(ii)(A), removing the phrase "(a)(5)(i)" and adding in its place "(a)(6)(i)";

h. Adding new paragraph (a)(5);

i. Revising paragraph (b)(2);

j. In paragraph (b)(4), removing the word "he" and adding in its place "the broker or dealer".

k. Removing paragraph (b)(6);

l. In paragraph (c)(1)(i), removing the phrase "his customers" and adding in its place "customers of the introducing broker or dealer";

m. In paragraph (c)(1)(iii), removing the phrase "in the manner contemplated by the $2,500 minimum net capital requirement of § 240.15c3-1" and adding in its place "and otherwise qualified to maintain net capital of no less than what is required under § 240.15c3-1(a)(2)(iv)";

n. In paragraph (c)(2), in the first sentence, removing the phrase "date of the audited financial statements required by paragraph (d) of this section" and adding in its place "end of the fiscal year of the broker or dealer";

o. In paragraph (c)(2)(i) removing the phrase "balance sheet with appropriate notes prepared in accordance with" and adding in its place "Statement of Financial Condition with appropriate notes prepared in accordance with U.S.";

p. Removing paragraph (c)(2)(iii);

q. Redesignating paragraph (c)(2)(iv) as (c)(2)(iii);

r. In newly redesignated paragraph (c)(2)(iii), removing the phrase "annual audit report of the broker or dealer pursuant to § 240.17a-5" and adding in its place "financial report of the broker or dealer under paragraph (d)(1)(i)(A) of this section" and adding at the end the word "and";

s. Adding new paragraph (c)(2)(iv);

t. In paragraph (c)(4) removing the word "'customer'" and adding in its place "customer";

u. In paragraphs (c)(5)(ii)(A) and (c)(5)(iii), removing the phrases "Web site" and "Web sites" and adding in their place "website" and "websites";

v. Removing paragraph (c)(5)(vi);

w. Revising paragraph (d);

x. In paragraph (e) introductory text, removing the phrase "financial statements" and adding in its place "annual reports" and removing the word "shall" and adding in its place "must";

y. Revising paragraphs (e)(1), (e)(2), (e)(3), and (e)(4);

z. Removing paragraph (e)(5);

aa. Revising paragraphs (f), (g), (h), and (i);

bb. Removing and reserving paragraph (j);

cc. In paragraph (m)(1), removing the word "audit" after the word "annual"; and

dd. In paragraph (n)(2) removing the phrase "audit report" and adding in its place "annual reports"; adding the phrase "in writing" after the word "approved" and removing the phrase "pursuant to paragraph (d)(1)(i) of this section" and adding in its place "of the broker or dealer".

The revisions and additions read as follows:

§ 240.17a-5 Reports to be made by certain brokers and dealers.

(a) * * *

(5) Every broker or dealer subject to this paragraph (a) must file Form Custody (§ 249.639 of this chapter) with its designated examining authority within 17 business days after the

end of each calendar quarter and within 17 business days after the end of the fiscal year of the broker or dealer where that date is not the end of a calendar quarter. The designated examining authority must maintain the information obtained through the filing of Form Custody and transmit the information to the Commission, at such time as it transmits the applicable part of Form X-17A-5 (§ 249.617 of this chapter) as required in paragraph (a)(4) of this section.

* * * * *

(b) * * *

(2) The broker or dealer must attach to the report required by paragraph (b)(1) of this section an oath or affirmation that to the best knowledge and belief of the person making the oath or affirmation the information contained in the report is true and correct. The oath or affirmation must be made before a person duly authorized to administer such oaths or affirmations. If the broker or dealer is a sole proprietorship, the oath or affirmation must be made by the proprietor; if a partnership, by a general partner; if a corporation, by a duly authorized officer; or if a limited liability company or limited liability partnership, by the chief executive officer, chief financial officer, manager, managing member, or those members vested with management authority for the limited liability company or limited liability partnership.

(c) * * *

(2) * * *

(iv) If, in connection with the most recent annual reports required under paragraph (d) of this section, the report of the independent public accountant required under paragraph (d)(1)(i)(C) of this section covering the report of the broker or dealer required under paragraph (d)(1)(i)(B)(1) of this section identifies one or more material weaknesses, a statement by the broker or dealer that one or more material weaknesses have been identified and that a copy of the report of the independent public accountant required under paragraph (d)(1)(i)(C) of this section is currently available for the customer's inspection at the principal office of the Commission in Washington, DC, and the regional office of the Commission for the region in which the broker or dealer has its principal place of business.

* * * * *

(d) Annual reports. (1)(i) Except as provided in paragraphs (d)(1)(iii) and (d)(1)(iv) of this section, every broker or dealer registered under section 15 of the Act must file annually:

(A) A financial report as described in paragraph (d)(2) of this section; and

(B)(1) If the broker or dealer did not claim it was exempt from § 240.15c3-3 throughout the most recent fiscal year, a compliance report as described in paragraph (d)(3) of this section executed by the person who makes the oath or affirmation under paragraph (e)(2) of this section; or

(2) If the broker or dealer did claim that it was exempt from § 240.15c3-3 throughout the most recent fiscal year, an exemption report as described in paragraph (d)(4) of this section executed by the person who makes the oath or affirmation under paragraph (e)(2) of this section;

(C) Except as provided in paragraph (e)(1)(i) of this section, a report prepared by an independent public accountant, under the engagement provisions in paragraph (g) of this section, covering each report required to be filed under paragraphs (d)(1)(i)(A) and (B) of this section.

(ii) The reports required to be filed under this paragraph (d) must be as of the same fiscal year end each year, unless a change is approved in writing by the designated examining authority for the broker or dealer under paragraph (n) of this section. A copy of the written approval must be sent to the Commission's principal office in Washington, DC, and the regional office of the Commission for the region in which the broker or dealer has its principal place of business.

(iii) A broker or dealer succeeding to and continuing the business of another broker or dealer need not file the reports under this paragraph (d) as of a date in the fiscal year in which the succession occurs if the predecessor broker or dealer has filed reports in compliance with this paragraph (d) as of a date in such fiscal year.

(iv) A broker or dealer that is a member of a national securities exchange, has transacted a business in securities solely with or for other members of a national securities exchange, and has not carried any margin account, credit balance, or security for any person who is defined as a customer in paragraph (c)(4) of this section, is not required to file reports under this paragraph (d).

(2) Financial report. The financial report must contain:

(i) A Statement of Financial Condition, a Statement of Income, a Statement of Cash Flows, a Statement of Changes in Stockholders' or Partners' or Sole Proprietor's Equity, and a Statement of Changes in Liabilities Subordinated to Claims of General Creditors. The statements must be prepared in accordance with U.S. generally accepted accounting principles and must be in a format that is consistent with the statements contained in Form X-17A-5 (§ 249.617 of this chapter) Part II or Part IIA. If the Statement of Financial Condition filed in accordance with instructions to Form X-17A-5, Part II or Part IIA, is not consolidated, a summary of financial data, including the assets, liabilities, and net worth or stockholders' equity, for subsidiaries not consolidated in the Part II or Part IIA Statement of Financial Condition as filed by the broker or dealer must be included in the notes to the financial statements reported on by the independent public accountant.

(ii) Supporting schedules that include, from Part II or Part IIA of Form X-17A-5 (§ 249.617 of this chapter), a Computation of Net Capital Under § 240.15c3-1, a Computation for

Determination of the Reserve Requirements under Exhibit A of § 240.15c3-3, and Information Relating to the Possession or Control Requirements Under § 240.15c3-3.

(iii) If either the Computation of Net Capital under § 240.15c3-1 or the Computation for Determination of the Reserve Requirements Under Exhibit A of § 240.15c3-3 in the financial report is materially different from the corresponding computation in the most recent Part II or Part IIA of Form X-17A-5 (§ 249.617 of this chapter) filed by the broker or dealer pursuant to paragraph (a) of this section, a reconciliation, including appropriate explanations, between the computation in the financial report and the computation in the most recent Part II or Part IIA of Form X-17A-5 filed by the broker or dealer. If no material differences exist, a statement so indicating must be included in the financial report.

(3) Compliance report.

(i) The compliance report must contain:

(A) Statements as to whether:

(1) The broker or dealer has established and maintained Internal Control Over Compliance as that term is defined in paragraph (d)(3)(ii) of this section;

(2) The Internal Control Over Compliance of the broker or dealer was effective during the most recent fiscal year;

(3) The Internal Control Over Compliance of the broker or dealer was effective as of the end of the most recent fiscal year;

(4) The broker or dealer was in compliance with §§ 240.15c3-1 and 240.15c3-3(e) as of the end of the most recent fiscal year; and

(5) The information the broker or dealer used to state whether it was in compliance with §§ 240.15c3-1 and 240.15c3-3(e) was derived from the books and records of the broker or dealer.

(B) If applicable, a description of each material weakness in the Internal Control Over Compliance of the broker or dealer during the most recent fiscal year.

(C) If applicable, a description of any instance of non-compliance with §§ 240.15c3-1 or 240.15c3-3(e) as of the end of the most recent fiscal year.

(ii) The term Internal Control Over Compliance means internal controls that have the objective of providing the broker or dealer with reasonable assurance that non-compliance with § 240.15c3-1, § 240.15c3-3, § 240.17a-13, or any rule of the designated examining authority of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer (an "Account Statement Rule") will be prevented or detected on a timely basis.

(iii) The broker or dealer is not permitted to conclude that its Internal Control Over Compliance was effective during the most recent fiscal year if there were one or more material weaknesses in its Internal Control Over Compliance during the most recent fiscal year. The broker or dealer is not permitted to conclude that its Internal Control Over Compliance was effective as of the end of the most recent fiscal year if there were one or more material weaknesses in its internal control as of the end of the most recent fiscal year. A material weakness is a deficiency, or a combination of deficiencies, in Internal Control Over Compliance such that there is a reasonable possibility that non-compliance with §§ 240.15c3-1 or 240.15c3-3(e) will not be prevented or detected on a timely basis or that non-compliance to a material extent with § 240.15c3-3, except for paragraph (e), § 240.17a-13, or any Account Statement Rule will not be prevented or detected on a timely basis. A deficiency in Internal Control Over

Compliance exists ...e design or operation of a control does not allow the management or employees of ... or dealer, in the normal course of performing their assigned functions, to preven... a timely basis non-compliance with § 240.15c3-1, § 240.15c3-3, § 240... Account Statement Rule.

...ption report. The exemption report must contain the following statements made ...wledge and belief of the broker or dealer:

...statement that identifies the provisions in § 240.15c3-3(k) under which the broker or ...med an exemption from § 240.15c3-3;

(ii) A statement that the broker or dealer met the identified exemption provisions in § ...0.15c3-3(k) throughout the most recent fiscal year without exception or that it met the identified exemption provisions in § 240.15c3-3(k) throughout the most recent fiscal year except as described under paragraph (d)(4)(iii) of this section; and

(iii) If applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified exemption provisions in § 240.15c3-3(k) and that briefly describes the nature of each exception and the approximate date(s) on which the exception existed.

(5) The annual reports must be filed not more than sixty (60) calendar days after the end of the fiscal year of the broker or dealer.

(6) The annual reports must be filed at the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the Commission's principal office in Washington, DC, the principal office of the designated examining authority for the broker or dealer, and with the Securities Investor Protection Corporation ("SIPC") if the broker or dealer is a member of SIPC. Copies of the reports must be provided to all self-

regulatory organizations of which the broker or dealer is a member, unless the self-regulatory organization by rule waives this requirement.

(e) * * *

(1)(i) The broker or dealer is not required to engage an independent public accountant to provide the reports required under paragraph (d)(1)(i)(C) of this section if, since the date of the registration of the broker or dealer under section 15 of the Act (15 U.S.C. 78o) or of the previous annual reports filed under paragraph (d) of this section:

(A) The securities business of the broker or dealer has been limited to acting as broker (agent) for the issuer in soliciting subscriptions for securities of the issuer, the broker has promptly transmitted to the issuer all funds and promptly delivered to the subscriber all securities received in connection with the transaction, and the broker has not otherwise held funds or securities for or owed money or securities to customers; or

(B) The securities business of the broker or dealer has been limited to buying and selling evidences of indebtedness secured by mortgage, deed of trust, or other lien upon real estate or leasehold interests, and the broker or dealer has not carried any margin account, credit balance, or security for any securities customer.

(ii) A broker or dealer that files annual reports under paragraph (d) of this section that are not covered by reports prepared by an independent public accountant must include in the oath or affirmation required by paragraph (e)(2) of this section a statement of the facts and circumstances relied upon as a basis for exemption from the requirement that the annual reports filed under paragraph (d) of this section be covered by reports prepared by an independent public accountant.

(2) The broker or dealer must attach to the financial report an oath or affirmation that, to the best knowledge and belief of the person making the oath or affirmation,

(i) The financial report is true and correct; and

(ii) Neither the broker or dealer, nor any partner, officer, director, or equivalent person, as the case may be, has any proprietary interest in any account classified solely as that of a customer.

The oath or affirmation must be made before a person duly authorized to administer such oaths or affirmations. If the broker or dealer is a sole proprietorship, the oath or affirmation must be made by the proprietor; if a partnership, by a general partner; if a corporation, by a duly authorized officer; or if a limited liability company or limited liability partnership, by the chief executive officer, chief financial officer, manager, managing member, or those members vested with management authority for the limited liability company or limited liability partnership.

* * * * *

(3) The annual reports filed under paragraph (d) of this section are not confidential, except that, if the Statement of Financial Condition in a format that is consistent with Form X-17A-5 (§ 249.617 of this chapter), Part II, or Part IIA, is bound separately from the balance of the annual reports filed under paragraph (d) of this section, and each page of the balance of the annual reports is stamped "confidential," then the balance of the annual reports shall be deemed confidential to the extent permitted by law. However, the annual reports, including the confidential portions, will be available for official use by any official or employee of the U.S. or any State, by national securities exchanges and registered national securities associations of which the broker or dealer filing such a report is a member, by the Public Company Accounting Oversight Board, and by any other person if the Commission authorizes disclosure of the annual

reports to that person as being in the public interest. Nothing contained in this paragraph may be construed to be in derogation of the rules of any registered national securities association or national securities exchange that give to customers of a member broker or dealer the right, upon request to the member broker or dealer, to obtain information relative to its financial condition.

(4)(i) The broker or dealer must file with SIPC a report on the SIPC annual general assessment reconciliation or exclusion from membership forms that contains such information and is in such format as determined by SIPC by rule and approved by the Commission.

(ii) Until the earlier of two years after the date paragraph (e)(4)(i) of this section is effective or SIPC adopts a rule under paragraph (e)(4)(i) of this section and the rule is approved by the Commission, the broker or dealer must file with SIPC a supplemental report on the status of the membership of the broker or dealer in SIPC if, under paragraph (d)(1)(i)(C) of this section, the broker or dealer is required to file reports prepared by an independent public accountant. The supplemental report must include the independent public accountant's report on applying agreed-upon procedures based on the performance of the procedures enumerated in paragraph (e)(4)(ii)(C) of this section. The supplemental report must cover the SIPC annual general assessment reconciliation or exclusion from membership forms not previously reported on under this paragraph (e)(4) that were required to be filed on or prior to the date of the annual reports required by paragraph (d) of this section: Provided, that the broker or dealer is not required to file the supplemental report on the SIPC annual general assessment reconciliation or exclusion from membership form for any period during which the SIPC assessment is a specified dollar value as provided for in section 4(d)(1)(c) of the Securities Investor Protection Act of 1970, as amended. The supplemental report must be filed with the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the Commission's principal office in Washington, DC, the principal office of the designated examining authority for the broker or dealer, and the principal office of SIPC. The supplemental report must include the following:

(A) A schedule of assessment payments showing any overpayments applied and overpayments carried forward including: payment dates, amounts, and name of SIPC collection agent to whom mailed; or

(B) If exclusion from membership was claimed, a statement that the broker or dealer qualified for exclusion from membership under the Securities Investor Protection Act of 1970, as amended; and

(C) An independent public accountant's report. The independent public accountant must be engaged to perform the following procedures:

(1) Comparison of listed assessment payments with respective cash disbursements record entries;

(2) For all or any portion of a fiscal year, comparison of amounts reflected in the annual reports required by paragraph (d) of this section with amounts reported in the Annual General Assessment Reconciliation (Form SIPC-7);

(3) Comparison of adjustments reported in Form SIPC-7 with supporting schedules and working papers supporting the adjustments;

(4) Proof of the arithmetical accuracy of the calculations reflected in Form SIPC-7 and in the schedules and working papers supporting any adjustments; and

(5) Comparison of the amount of any overpayment applied with the Form SIPC-7 on which it was computed; or

(6) If exclusion from membership is claimed, a comparison of the income or loss reported in the financial report required by paragraph (d)(2) of this section with the Certification of Exclusion from Membership (Form SIPC-3).

(f)(1) Qualifications of independent public accountant. The independent public accountant must be qualified and independent in accordance with § 210.2-01 of this chapter and the independent public accountant must be registered with the Public Company Accounting Oversight Board if required by the Sarbanes-Oxley Act of 2002.

(2) Statement regarding independent public accountant. (i) Every broker or dealer that is required to file annual reports under paragraph (d) of this section must file no later than December 10 of each year (or 30 calendar days after the effective date of its registration as a broker or dealer, if earlier) a statement as prescribed in paragraph (f)(2)(ii) of this section with the Commission's principal office in Washington, DC, the regional office of the Commission for the region in which its principal place of business is located, and the principal office of the designated examining authority for the broker or dealer. The statement must be dated no later than December 1 (or 20 calendar days after the effective date of its registration as a broker or dealer, if earlier). If the engagement of an independent public accountant is of a continuing nature, providing for successive engagements, no further filing is required. If the engagement is for a single year, or if the most recent engagement has been terminated or amended, a new statement must be filed by the required date.

(ii) The statement must be headed "Statement regarding independent public accountant under Rule 17a-5(f)(2)" and must contain the following information and representations:

(A) Name, address, telephone number, and registration number of the broker or dealer.

(B) Name, address, and telephone number of the independent public accountant.

Compliance exists when the design or operation of a control does not allow the management or employees of the broker or dealer, in the normal course of performing their assigned functions, to prevent or detect on a timely basis non-compliance with § 240.15c3-1, § 240.15c3-3, § 240.17a-13, or any Account Statement Rule.

(4) Exemption report. The exemption report must contain the following statements made to the best knowledge and belief of the broker or dealer:

(i) A statement that identifies the provisions in § 240.15c3-3(k) under which the broker or dealer claimed an exemption from § 240.15c3-3;

(ii) A statement that the broker or dealer met the identified exemption provisions in § 240.15c3-3(k) throughout the most recent fiscal year without exception or that it met the identified exemption provisions in § 240.15c3-3(k) throughout the most recent fiscal year except as described under paragraph (d)(4)(iii) of this section; and

(iii) If applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified exemption provisions in § 240.15c3-3(k) and that briefly describes the nature of each exception and the approximate date(s) on which the exception existed.

(5) The annual reports must be filed not more than sixty (60) calendar days after the end of the fiscal year of the broker or dealer.

(6) The annual reports must be filed at the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the Commission's principal office in Washington, DC, the principal office of the designated examining authority for the broker or dealer, and with the Securities Investor Protection Corporation ("SIPC") if the broker or dealer is a member of SIPC. Copies of the reports must be provided to all self-

reports to that person as being in the public interest. Nothing contained in this paragraph may be construed to be in derogation of the rules of any registered national securities association or national securities exchange that give to customers of a member broker or dealer the right, upon request to the member broker or dealer, to obtain information relative to its financial condition.

(4)(i) The broker or dealer must file with SIPC a report on the SIPC annual general assessment reconciliation or exclusion from membership forms that contains such information and is in such format as determined by SIPC by rule and approved by the Commission.

(ii) Until the earlier of two years after the date paragraph (e)(4)(i) of this section is effective or SIPC adopts a rule under paragraph (e)(4)(i) of this section and the rule is approved by the Commission, the broker or dealer must file with SIPC a supplemental report on the status of the membership of the broker or dealer in SIPC if, under paragraph (d)(1)(i)(C) of this section, the broker or dealer is required to file reports prepared by an independent public accountant. The supplemental report must include the independent public accountant's report on applying agreed-upon procedures based on the performance of the procedures enumerated in paragraph (e)(4)(ii)(C) of this section. The supplemental report must cover the SIPC annual general assessment reconciliation or exclusion from membership forms not previously reported on under this paragraph (e)(4) that were required to be filed on or prior to the date of the annual reports required by paragraph (d) of this section: Provided, that the broker or dealer is not required to file the supplemental report on the SIPC annual general assessment reconciliation or exclusion from membership form for any period during which the SIPC assessment is a specified dollar value as provided for in section 4(d)(1)(c) of the Securities Investor Protection Act of 1970, as amended. The supplemental report must be filed with the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the Commission's principal office in Washington, DC, the principal office of the designated examining authority for the broker or dealer, and the principal office of SIPC. The supplemental report must include the following:

(A) A schedule of assessment payments showing any overpayments applied and overpayments carried forward including: payment dates, amounts, and name of SIPC collection agent to whom mailed; or

(B) If exclusion from membership was claimed, a statement that the broker or dealer qualified for exclusion from membership under the Securities Investor Protection Act of 1970, as amended; and

(C) An independent public accountant's report. The independent public accountant must be engaged to perform the following procedures:

(1) Comparison of listed assessment payments with respective cash disbursements record entries;

(2) For all or any portion of a fiscal year, comparison of amounts reflected in the annual reports required by paragraph (d) of this section with amounts reported in the Annual General Assessment Reconciliation (Form SIPC-7);

(3) Comparison of adjustments reported in Form SIPC-7 with supporting schedules and working papers supporting the adjustments;

(4) Proof of the arithmetical accuracy of the calculations reflected in Form SIPC-7 and in the schedules and working papers supporting any adjustments; and

(5) Comparison of the amount of any overpayment applied with the Form SIPC-7 on which it was computed; or

(6) If exclusion from membership is claimed, a comparison of the income or loss reported in the financial report required by paragraph (d)(2) of this section with the Certification of Exclusion from Membership (Form SIPC-3).

(f)(1) Qualifications of independent public accountant. The independent public accountant must be qualified and independent in accordance with § 210.2-01 of this chapter and the independent public accountant must be registered with the Public Company Accounting Oversight Board if required by the Sarbanes-Oxley Act of 2002.

(2) Statement regarding independent public accountant. (i) Every broker or dealer that is required to file annual reports under paragraph (d) of this section must file no later than December 10 of each year (or 30 calendar days after the effective date of its registration as a broker or dealer, if earlier) a statement as prescribed in paragraph (f)(2)(ii) of this section with the Commission's principal office in Washington, DC, the regional office of the Commission for the region in which its principal place of business is located, and the principal office of the designated examining authority for the broker or dealer. The statement must be dated no later than December 1 (or 20 calendar days after the effective date of its registration as a broker or dealer, if earlier). If the engagement of an independent public accountant is of a continuing nature, providing for successive engagements, no further filing is required. If the engagement is for a single year, or if the most recent engagement has been terminated or amended, a new statement must be filed by the required date.

(ii) The statement must be headed "Statement regarding independent public accountant under Rule 17a-5(f)(2)" and must contain the following information and representations:

(A) Name, address, telephone number, and registration number of the broker or dealer.

(B) Name, address, and telephone number of the independent public accountant.

regulatory organizations of which the broker or dealer is a member, unless the self-regulatory organization by rule waives this requirement.

(e) * * *

(1)(i) The broker or dealer is not required to engage an independent public accountant to provide the reports required under paragraph (d)(1)(i)(C) of this section if, since the date of the registration of the broker or dealer under section 15 of the Act (15 U.S.C. 78o) or of the previous annual reports filed under paragraph (d) of this section:

(A) The securities business of the broker or dealer has been limited to acting as broker (agent) for the issuer in soliciting subscriptions for securities of the issuer, the broker has promptly transmitted to the issuer all funds and promptly delivered to the subscriber all securities received in connection with the transaction, and the broker has not otherwise held funds or securities for or owed money or securities to customers; or

(B) The securities business of the broker or dealer has been limited to buying and selling evidences of indebtedness secured by mortgage, deed of trust, or other lien upon real estate or leasehold interests, and the broker or dealer has not carried any margin account, credit balance, or security for any securities customer.

(ii) A broker or dealer that files annual reports under paragraph (d) of this section that are not covered by reports prepared by an independent public accountant must include in the oath or affirmation required by paragraph (e)(2) of this section a statement of the facts and circumstances relied upon as a basis for exemption from the requirement that the annual reports filed under paragraph (d) of this section be covered by reports prepared by an independent public accountant.

(C) The date of the fiscal year of the annual reports of the broker or dealer covered by the engagement.

(D) Whether the engagement is for a single year or is of a continuing nature.

(E) A representation that the independent public accountant has undertaken the items enumerated in paragraphs (g)(1) and (g)(2) of this section.

(F) Except as provided in paragraph (f)(2)(iii) of this section, a representation that the broker or dealer agrees to allow representatives of the Commission or its designated examining authority, if requested in writing for purposes of an examination of the broker or dealer, to review the audit documentation associated with the reports of the independent public accountant filed under paragraph (d)(1)(i)(C) of this section. For purposes of this paragraph, "audit documentation" has the meaning provided in standards of the Public Company Accounting Oversight Board. The Commission anticipates that, if requested, it will accord confidential treatment to all documents it may obtain from an independent public accountant under this paragraph to the extent permitted by law.

(G) Except as provided in paragraph (f)(2)(iii) of this section, a representation that the broker or dealer agrees to allow the independent public accountant to discuss with representatives of the Commission and its designated examining authority, if requested in writing for purposes of an examination of the broker or dealer, the findings associated with the reports of the independent public accountant filed under paragraph (d)(1)(i)(C) of this section.

(iii) If a broker or dealer neither clears transactions nor carries customer accounts, the broker or dealer is not required to include the representations in paragraphs (f)(2)(ii)(F) and (f)(2)(ii)(G) of this section.

(iv) Any broker or dealer that is not required to file reports prepared by an independent public accountant under paragraph (d)(1)(i)(C) of this section must file a statement required under paragraph (f)(2)(i) of this section indicating the date as of which the unaudited reports will be prepared.

(3) Replacement of accountant. A broker or dealer must file a notice that must be received by the Commission's principal office in Washington, DC, the regional office of the Commission for the region in which its principal place of business is located, and the principal office of the designated examining authority for the broker or dealer not more than 15 business days after:

(i) The broker or dealer has notified the independent public accountant that provided the reports the broker or dealer filed under paragraph (d)(1)(i)(C) of this section for the most recent fiscal year that the independent public accountant's services will not be used in future engagements; or

(ii) The broker or dealer has notified an independent public accountant that was engaged to provide the reports required under paragraph (d)(1)(i)(C) of this section that the engagement has been terminated; or

(iii) An independent public accountant has notified the broker or dealer that the independent public accountant would not continue under an engagement to provide the reports required under paragraph (d)(1)(i)(C) of this section; or

(iv) A new independent public accountant has been engaged to provide the reports required under paragraph (d)(1)(i)(C) of this section without any notice of termination having been given to or by the previously engaged independent public accountant.

(v) The notice must include:

(A) The date of notification of the termination of the engagement or of the engagement of the new independent public accountant, as applicable; and

(B) The details of any issues arising during the 24 months (or the period of the engagement, if less than 24 months) preceding the termination or new engagement relating to any matter of accounting principles or practices, financial statement disclosure, auditing scope or procedure, or compliance with applicable rules of the Commission, which issues, if not resolved to the satisfaction of the former independent public accountant, would have caused the independent public accountant to make reference to them in the report of the independent public accountant. The issues required to be reported include both those resolved to the former independent public accountant's satisfaction and those not resolved to the former accountant's satisfaction. Issues contemplated by this section are those that occur at the decision-making level – that is, between principal financial officers of the broker or dealer and personnel of the accounting firm responsible for rendering its report. The notice must also state whether the accountant's report filed under paragraph (d)(1)(i)(C) of this section for any of the past two fiscal years contained an adverse opinion or a disclaimer of opinion or was qualified as to uncertainties, audit scope, or accounting principles, and must describe the nature of each such adverse opinion, disclaimer of opinion, or qualification. The broker or dealer must also request the former independent public accountant to furnish the broker or dealer with a letter addressed to the Commission stating whether the independent public accountant agrees with the statements contained in the notice of the broker or dealer and, if not, stating the respects in which independent public accountant does not agree. The broker or dealer must file three copies of the notice and the accountant's letter, one copy of which must be manually signed by the sole proprietor, a general partner, or a duly authorized corporate, limited liability company, or limited liability partnership officer or member, as appropriate, and by the independent public accountant, respectively.

(g) Engagement of independent public accountant. The independent public accountant engaged by the broker or dealer to provide the reports required under paragraph (d)(1)(i)(C) of this section must, as part of the engagement, undertake the following, as applicable:

(1) To prepare an independent public accountant's report based on an examination of the financial report required to be filed by the broker or dealer under paragraph (d)(1)(i)(A) of this section in accordance with standards of the Public Company Accounting Oversight Board; and

(2)(i) To prepare an independent public accountant's report based on an examination of the statements required under paragraphs (d)(3)(i)(A)(2), (3), (4), and (5) of this section in the compliance report required to be filed by the broker or dealer under paragraph (d)(1)(i)(B)(1) of this section in accordance with standards of the Public Company Accounting Oversight Board; or

(ii) To prepare an independent public accountant's report based on a review of the statements required under paragraphs (d)(4)(i), (ii), and (iii) of this section in the exemption report required to be filed by the broker or dealer under paragraph (d)(1)(i)(B)(2) of this section in accordance with standards of the Public Company Accounting Oversight Board.

(h) Notification of non-compliance or material weakness. If, during the course of preparing the independent public accountant's reports required under paragraph (d)(1)(i)(C) of this section, the independent public accountant determines that the broker or dealer is not in compliance with §§ 240.15c3-1, 240.15c3-3, or 240.17a-13 or any rule of the designated examining authority of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer, as applicable, or the independent public accountant determines that any material weaknesses (as defined in paragraph (d)(3)(iii) of this section) exist, the independent public accountant must immediately notify the chief financial officer of the broker or dealer of the nature of the non-compliance or material weakness. If the notice from the accountant concerns an instance of non-compliance that would require a broker or dealer to provide a notification under §§ 240.15c3-1, 240.15c3-3, or 240.17a-11, or if the notice concerns a material weakness, the broker or dealer must provide a notification in accordance with §§ 240.15c3-1, 240.15c3-3, or 240.17a-11, as applicable, and provide a copy of the notification to the independent public accountant. If the independent public accountant does not receive the notification within one business day, or if the independent public accountant does not agree with the statements in the notification, then the independent public accountant must notify the Commission and the designated examining authority within one business day. The report from the accountant must, if the broker or dealer failed to file a notification, describe any instances of non-compliance that required a notification under §§ 240.15c3-1, 240.15c3-3, or 240.17a-11, or any material weaknesses. If the broker or dealer filed a notification, the report from the accountant must detail the aspects of the notification of the broker or dealer with which the accountant does not agree.

NOTE TO PARAGRAPH (h): The attention of the broker or dealer and the independent public accountant is called to the fact that under § 240.17a-11(b)(1), among other things, a broker or dealer whose net capital declines below the minimum required pursuant to § 240.15c3-1 shall give notice of such deficiency that same day in accordance with § 240.17a-11(g) and the notice shall specify the broker or dealer's net capital requirement and its current amount of net capital. The attention of the broker or dealer and accountant also is called to the fact that under § 0.15c3-3(i), if a broker or dealer shall fail to make a reserve bank account or special account deposit, as required by § 240.15c3-3, the broker or dealer shall by telegram immediately notify the Commission and the regulatory authority for the broker or dealer, which examines such broker or dealer as to financial responsibility and shall promptly thereafter confirm such notification in writing.

(i) Reports of the independent public accountant required under paragraph (d)(1)(i)(C) of this section.

(1) Technical requirements. The independent public accountant's reports must:

(i) Be dated;

(ii) Be signed manually;

(iii) Indicate the city and state where issued; and

(iv) Identify without detailed enumeration the items covered by the reports.

(2) Representations. The independent public accountant's reports must:

(i) State whether the examinations or review, as applicable, were made in accordance with standards of the Public Company Accounting Oversight Board;

(ii) Identify any examination and, if applicable, review procedures deemed necessary by the independent public accountant under the circumstances of the particular case that have been omitted and the reason for their omission.

(iii) Nothing in this section may be construed to imply authority for the omission of any procedure that independent public accountants would ordinarily employ in the course of an examination or review made for the purpose of expressing the opinions or conclusions required under this section.

(3) Opinion or conclusion to be expressed. The independent public accountant's reports must state clearly:

(i) The opinion of the independent public accountant with respect to the financial report required under paragraph (d)(1)(i)(A) of this section and the accounting principles and practices reflected in that report;

(ii) The opinion of the independent public accountant with respect to the financial report required under paragraph (d)(1)(i)(A) of this section, as to the consistency of the application of the accounting principles, or as to any changes in those principles, that have a material effect on the financial statements; and

(iii)(A) The opinion of the independent public accountant with respect to the statements required under paragraphs (d)(3)(i)(A)(2), (3), (4), and (5) of this section in the compliance report required under paragraph (d)(1)(i)(B)(1) of this section; or

(B) The conclusion of the independent public accountant with respect to the statements required under paragraphs (d)(4)(i), (ii), and (iii) of this section in the exemption report required under paragraph (d)(1)(i)(B)(2) of this section.

(4) Exceptions. Any matters to which the independent public accountant takes exception must be clearly identified, the exceptions must be specifically and clearly stated, and, to the extent practicable, the effect of each such exception on any related items contained in the annual reports required under paragraph (d) of this section must be given.

3. Section 240.17a-11 is amended by:

a. Revising paragraph (e); and

b. In paragraph (h), replacing the citation "17a-5(h)(2)" with the citation "17a-5(h)" and replacing the citation "17a-12(f)(2)" with the citation "17a-12(i)(2)."

The revisions read as follows:

§ 240.17a-11 Notification provision for brokers and dealers.

* * * * *

(e) Whenever any broker or dealer discovers, or is notified by an independent public accountant under § 240.17a-12(i)(2), of the existence of any material inadequacy as defined in § 240.17a-12(h)(2), or whenever any broker or dealer discovers, or is notified by an independent public accountant under § 240.17a-5(h), of the existence of any material weakness as defined in § 240.17a-5(d)(3)(iii), the broker or dealer must:

(1) Give notice, in accordance with paragraph (g) of this section, of the material inadequacy or material weakness within 24 hours of the discovery or notification of the material inadequacy or the material weakness; and

(2) Transmit a report, in accordance with paragraph (g) of this section, within 48 hours of the notice stating what the broker or dealer has done or is doing to correct the situation.

* * * * *

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

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

Authority: 15 U.S.C. 78a et seq. and 7201 et seq.; 12 U.S.C. 5461 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

5. Add Form Custody (referenced in § 249.639) to Part 249 to read as follows:

Subpart G—Forms for Reports To Be Made by Certain Exchange Members, Brokers, and Dealers

* * * * *

§ 249.639 FORM CUSTODY.

This form shall be used for reports of information required by § 240.17a-5 of this chapter.

Note: The text of Form Custody does not, and this amendment will not, appear in the Code of Federal Regulations.

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

FORM CUSTODY
For Broker-Dealers

(Please read instructions before preparing Form.)

Name of Broker/Dealer — As of (Month/Day/Year)

8-
SEC File No. — CRD No.

Address of Principal Place of Business

(No. and Street) (City) (State) (Zip Code)

INSTRUCTIONS

GENERAL INSTRUCTIONS

A. Answer questions applicable to the broker-dealer's business activities and all "Yes" or "No" questions. Questions that cannot be answered because the broker-dealer does not engage in a particular activity do not need to be answered. For example, a broker-dealer that does not hold customer and non-customer funds or securities does not need to answer Items 3.C-3.E.

B. Definitions: for purposes of this Form:

1. "Affiliate" means any person who directly or indirectly controls the broker-dealer or any person who is directly or indirectly controlled by or under common control with the broker-dealer. Ownership of 25% or more of the common stock of an entity is deemed prima facie evidence of control.

2. "Bank" has the same meaning as in 15 U.S.C. 78c(a)(6).

3. "Broker" has the same meaning as in 15 U.S.C. 78c(a)(4).

4. "Dealer" has the same meaning as in 15 U.S.C. 78c(a)(5).

5. "Carrying broker-dealer" means a broker-dealer that carries customer or broker or dealer accounts and receives or holds funds or securities for those customers.

6. "Clearing broker-dealer" means a broker-dealer that clears transactions for itself or accounts of other broker-dealers either on a fully disclosed or omnibus basis.

7. "Customer" has the same meaning as in 17 CFR 240.15c3-3(a)(1).

8. "Free credit balance" means any liabilities of a broker-dealer to customers and non-customers that are subject to immediate cash payment to customers and non-customers on demand, whether resulting from

sales of securities, dividends, interest, deposits, or otherwise, excluding, however, funds in commodity accounts that are segregated in accordance with the Commodity Exchange Act or in a similar manner.

9. "Money Market Fund" means any security issued by an investment company registered under section 8 of the Investment Company Act of 1940 that is considered a money market fund under Investment Company Act Rule 2a-7.

10. "Omnibus account" means an account carried and cleared by another broker-dealer and containing accounts of undisclosed customers on a commingled basis that are carried individually on the books of the broker-dealer introducing the accounts.

11. "Private Fund" means an issuer that would be an investment company as defined in section 3 of the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that Act.

12. "Structured debt" means any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. Structured debt is a broad category of financial instrument and includes, but is not limited to, asset-backed securities such as residential mortgage-backed securities ("RMBS") and other types of structured debt instruments such as collateralized debt obligations ("CDOs"), including synthetic and hybrid CDOs, or collateralized loan obligations ("CLOs").

INSTRUCTIONS FOR SPECIFIC LINE ITEMS

Item 1.A — Answer the question by checking the appropriate box. A broker-dealer must check "Yes" if it introduces any customer accounts to another broker-dealer on a fully disclosed basis. A broker-dealer that carries customer accounts and/or introduces customer accounts on an omnibus basis must check "Yes" if it also introduces one or more customer accounts to another broker-dealer on a fully disclosed basis.

Item 1.B — Item 1.B applies to broker-dealers that introduce customer accounts on a fully disclosed basis to one or more other broker-dealers. If Item 1.B applies, identify each broker-dealer to which customer accounts are introduced on a fully disclosed basis.

Item 2.A — Answer the question by checking the appropriate box. A broker-dealer must check "Yes" if it introduces any customer accounts to another broker-dealer on an omnibus basis. A broker-dealer that carries customer accounts (other than those introduced on an omnibus basis) and/or introduces customer accounts on a fully disclosed basis must check "Yes" if it also introduces one or more customer accounts to another broker-dealer on an omnibus basis.

Item 2.B — Item 2.B applies to broker-dealers that introduce customer accounts on an omnibus basis to one or more other broker-dealers. If Item 2.B applies, identify each broker-dealer to which customer accounts are introduced on an omnibus basis.

Item 3.A — Answer the question by checking the appropriate box. A broker-dealer that introduces customer accounts to another broker-dealer on an omnibus basis is a carrying broker-dealer with respect to those accounts under the Commission's broker-dealer financial responsibility rules. If those accounts are the only accounts carried by the broker-dealer, check "No" in Item 3.A, as those accounts are addressed in Items 2.A and 2.B.

Item 3.B — Answer the question by checking the appropriate box. Answer "Yes" if accounts are carried by the broker-dealer for persons that are not "customers" as that term is defined in Rule 15c3-3 under the Securities Exchange Act of 1934. Examples of persons that are not customers of a broker-dealer include general partners, directors, or principal officers – such as the president, executive vice presidents, treasurer, secretary or any person performing similar functions – of the broker-dealer and accountholders that are themselves broker-dealers (unless such broker-dealer accountholders are required to be treated as customers under Rule 15c3-3).

Item 3.C Identify the types of locations where the broker-dealer holds securities. Only identify types of locations where the broker-dealer holds securities directly in the name of the broker-dealer (*i.e.*, do not identify a type of location if the broker-dealer only holds securities at the location through an intermediary). A location holds securities directly in the name of the broker-dealer if the location is aware of the identity of the broker-dealer and acts directly upon the broker-dealer's instructions. A location holds securities through an intermediary if the location is not aware of the identity of the broker-dealer or will not act on instructions directly from the broker-dealer (*i.e.,* the location holding securities for the broker-dealer would only act on instructions relating to the broker-dealer's securities from the broker-dealer's intermediary). The information required by Items 3.C.i-iii is intended to identify all locations used by the broker-dealer to hold securities listed on the broker-dealer's stock record, and to elicit information concerning the frequency with which the broker-dealer performs reconciliations between the information on its stock record and information about the securities provided by the location. In Item 3.C.i, check all applicable boxes, and in Items 3.C.i-iii provide all applicable information as specified for each Item.

Item 3.D Answer the questions in Items 3.D.i-iii by checking appropriate boxes and entering appropriate financial information, where applicable, and by providing explanations as requested. In Item 3.D.i, check "Other" if a type of security carried by the broker-dealer for customers is not listed on the chart, and for each category of security, indicate by checking the approximate box for the approximate U.S. dollar market value of the securities.

Item 3.E Answer the questions in Items 3.E.i-iii by checking appropriate boxes and entering appropriate financial information, where applicable, and by providing explanations as requested. In Item 3.E.i, check "Other" if a type of security carried by the broker-dealer for persons that are not customers is not listed on the chart, and for each category of security, indicate by checking the appropriate box the approximate U.S. dollar market value of the securities.

Item 4 Answer the questions in Items 4.A.i-iii and 4.B.i-iii by checking appropriate boxes and, if applicable, providing requested information.

Item 5 Answer the questions in Items 5.A and 5.B by checking the appropriate box and, if applicable, providing requested information. A broker-dealer should respond to Item 5.A by checking "Yes" if it employs a vendor to send trade confirmations to customers on its behalf because the broker-dealer is ultimately responsible for complying with its trade confirmation obligations, not the vendor.

Item 6 Answer the questions by checking the appropriate boxes and, if applicable, providing requested information. In Item 6.C, check "Yes" if (i) a broker-dealer sends account statements to persons other than the beneficial owner of the account; or (ii) if a broker-dealer sends account statements to the beneficial owner of an account and duplicate account statements to persons other than the beneficial owner of the account.

Item 7 Answer the question by checking the appropriate box.

Item 8 Answer the questions in Item 8 by checking appropriate boxes and, if applicable, providing requested information.

Item 9 Answer the questions in Item 9 by checking appropriate boxes and, if applicable, providing requested information.

Item 1. **A.** Does the broker-dealer introduce customer accounts on a fully disclosed basis to another broker-dealer?

Yes ☐ No ☐

B. If the answer to question 1.A is "yes," identify below the broker-dealer(s) (by name, SEC No., and CRD No.) to which the customer accounts are introduced on a fully disclosed basis:

____

____

____

Item 2. **A.** Does the broker-dealer introduce customer accounts to another broker-dealer on an omnibus basis?

Yes ☐ No ☐

B. If the answer to question 2.A is "yes," identify below the broker-dealer(s) (by name, SEC No., and CRD No.) to which the customer accounts are introduced on an omnibus basis:

____

____

____

Item 3. **A.** Does the broker-dealer carry securities accounts (*i.e.*, accounts that are not introduced on a fully disclosed basis to another broker-dealer) for customers?

Yes ☐ No ☐

B. Does the broker-dealer carry securities accounts (*i.e.*, accounts that are not introduced on a fully disclosed basis to another broker-dealer) for non-customers?

Yes ☐ No ☐

C. Location of Securities (if the answer to question 3.A and/or 3.B is "yes")

i. Indicate in the chart below the types of U.S. locations used by the broker-dealer to hold securities that it carries by checking each box in the first column that applies. For each type of location selected, indicate in the third column the frequency (*e.g.*, daily, weekly, monthly, quarterly, semi-annually, annually) with which the broker-dealer performs a reconciliation between the information on its stock record and information about the securities provided by the location:

	Location	Reconciliation Frequency
☐	**The broker-dealer's vault**	
☐	**U.S. broker-dealer(s)**	
☐	**The Depository Trust Company**	
☐	**The Options Clearing Corporation**	
☐	**U.S. bank(s)**	
☐	**Transfer agents of mutual fund(s) under the Investment Company Act**	

ii. Indicate in the chart below the types of U.S. locations not identified in Item 3.C.i used by the broker-dealer to hold securities that it carries by describing the type of entity in the first column. For each type of location, indicate in the second column the frequency (*e.g.*, daily, weekly, monthly, quarterly, semi-annually, annually) with which the broker-dealer performs a reconciliation between the information on its stock record and information about the securities provided by location:

Other Types of U.S. Locations	Reconciliation Frequency

iii. Indicate in the chart below the types of foreign locations used by the broker-dealer to hold securities that it carries by describing the type of location in the first column. For each type of location indicate in the second column the frequency (*e.g.*, daily, weekly, monthly, quarterly, semi-annually, annually) with which the broker-dealer performs a reconciliation between the information on its stock record and information about the securities provided by the location:

Non-U.S. Locations	Reconciliation Frequency

D. Securities and Cash Carried for the Accounts of Customers (if the answer to question 3.A is "yes")

i. Indicate by checking the appropriate boxes on the chart below the types and approximate market value of securities that are carried by the broker-dealer for the accounts of customers:

	Type of Securities	**$50 million or less**	**Greater than $50 million to $100 million**	**Greater than $100 million to $500 million**	**Greater than $500 million to $1 billion**	**Greater than $1 billion to $5 billion**	**Greater than $5 billion**
☐	**U.S. Equity Securities**	☐	☐	☐	☐	☐	☐
☐	**Foreign Equity Securities**	☐	☐	☐	☐	☐	☐
☐	**U.S. Listed Options**	☐	☐	☐	☐	☐	☐
☐	**Foreign Listed Options**	☐	☐	☐	☐	☐	☐
☐	**Domestic Corporate Debt**	☐	☐	☐	☐	☐	☐
☐	**Foreign Corporate Debt**	☐	☐	☐	☐	☐	☐
☐	**U.S. Public Finance Debt**	☐	☐	☐	☐	☐	☐
☐	**Foreign Public Finance Debt**	☐	☐	☐	☐	☐	☐
☐	**U.S. Government Debt**	☐	☐	☐	☐	☐	☐
☐	**Foreign Sovereign Debt**	☐	☐	☐	☐	☐	☐
☐	**U.S. Structured Debt**	☐	☐	☐	☐	☐	☐
☐	**Foreign Structured Debt**	☐	☐	☐	☐	☐	☐
☐	**U.S. Mutual Funds**	☐	☐	☐	☐	☐	☐
☐	**Foreign Mutual Funds**	☐	☐	☐	☐	☐	☐
☐	**U.S. Exchange Traded Funds**	☐	☐	☐	☐	☐	☐
☐	**Foreign Exchange Traded Funds**	☐	☐	☐	☐	☐	☐
☐	**U.S. Private Funds**	☐	☐	☐	☐	☐	☐
☐	**Foreign Private Funds**	☐	☐	☐	☐	☐	☐
☐	**Other**	☐	☐	☐	☐	☐	☐

ii. Has the broker-dealer recorded all securities it carries for the accounts of customers on its stock record?

Yes ☐ No ☐

If the answer is "no," explain in the space provided why the broker-dealer has not recorded such securities on its stock record and provide the approximate U.S. dollar market value of such unrecorded securities:

____
____
____

iii. Indicate in the chart below each process used by the broker-dealer with respect to free credit balances in cash accounts it holds for customers by checking all the boxes that apply and providing applicable information:

	Process
☐	Included in a computation under Rule 15c3-3(e)
☐	Held in a bank account under Rule 15c3-3(k)(2)(i)
☐	Swept to a U.S. bank
☐	Swept to a U.S. money market fund
☐	Other (Briefly describe in the space provided below)

E. Securities and Cash Carried for the Accounts of Non-customers (if the answer to question 3.B is "yes")

i. Indicate by checking the appropriate boxes on the chart below the types and approximate market value of securities that are carried by the broker-dealer for the accounts of non-customers:

	Type of Securities	$50 million or less	Greater than $50 million to $100 million	Greater than $100 million to $500 million	Greater than $500 million to $1 billion	Greater than $1 billion to $5 billion	Greater than $5 billion
☐	U.S. Equity Securities	☐	☐	☐	☐	☐	☐
☐	Foreign Equity Securities	☐	☐	☐	☐	☐	☐
☐	U.S. Listed Options	☐	☐	☐	☐	☐	☐
☐	Foreign Listed Options	☐	☐	☐	☐	☐	☐
☐	Domestic Corporate Debt	☐	☐	☐	☐	☐	☐
☐	Foreign Corporate Debt	☐	☐	☐	☐	☐	☐
☐	U.S. Public Finance Debt	☐	☐	☐	☐	☐	☐
☐	Foreign Public Finance Debt	☐	☐	☐	☐	☐	☐
☐	U.S. Government Debt	☐	☐	☐	☐	☐	☐
☐	Foreign Sovereign Debt	☐	☐	☐	☐	☐	☐
☐	U.S. Structured Debt	☐	☐	☐	☐	☐	☐
☐	Foreign Structured Debt	☐	☐	☐	☐	☐	☐

☐	**U.S. Mutual Funds**	☐	☐	☐	☐	☐	☐
☐	**Foreign Mutual Funds**	☐	☐	☐	☐	☐	☐
☐	**U.S. Exchange Traded Funds**	☐	☐	☐	☐	☐	☐
☐	**Foreign Exchange Traded Funds**	☐	☐	☐	☐	☐	☐
☐	**U.S. Private Funds**	☐	☐	☐	☐	☐	☐
☐	**Foreign Private Funds**	☐	☐	☐	☐	☐	☐
☐	**Other**	☐	☐	☐	☐	☐	☐

ii. Has the broker-dealer recorded all securities it carries for the accounts of non-customers on its stock record?

Yes ☐ No ☐

If the answer is "no," explain in the space provided why the broker-dealer has not recorded such securities on its stock record and provide the approximate total U.S. dollar market value of such unrecorded securities:

____

____

____

iii. Indicate in the chart below each process used by the broker-dealer with respect to free credit balances in the securities accounts of non-customers by checking all the boxes that apply and providing applicable information:

	Process
☐	Included in a reserve computation
☐	Swept to a U.S. bank
☐	Swept to a U.S. money market fund
☐	Other (Briefly describe in space provided below) ______________________________ ______________________________ ______________________________ ______________________________ ______________________________ ______________________________

Item 4. Acting as a Carrying Broker-Dealer for Other Broker-Dealers

A. On a fully disclosed basis

i. Does the broker-dealer carry customer accounts for another broker-dealer(s) on a fully disclosed basis?

Yes ☐ No ☐

ii. If the answer to question 4.A.i is "yes," indicate the number of broker-dealers:

______________________.

iii. If the answer to question 4.A.i is "yes," identify any of these broker-dealers that are affiliates of the broker-dealer by name and "SEC File No.":

____
____
____

B. On an omnibus basis

i. Does the broker-dealer carry customer accounts for another broker-dealer(s) on an omnibus basis?

Yes ☐ No ☐

ii. If the answer to question 4.B.i is "yes," indicate the number of broker-dealers: ____________________.

iii. If the answer to question 4.B.i is "yes," identify any of these broker-dealers that are affiliates of the broker-dealer by name and "SEC File No.":

____
____
____

Item 5. A. Does the broker-dealer send trade confirmations directly to customers and other accountholders?

Yes ☐ No ☐

B. If the answer to question 5.A is "no," who sends the trade confirmations to customers and other accountholders? : ____________________.

Item 6. A. Does the broker-dealer send account statements directly to customers and other accountholders?

Yes ☐ No ☐

B. If the answer to question 6.A is "no," who sends the account statements to customers and other accountholders? : ____________________.

C. Does the broker-dealer send account statements to anyone other than the beneficial owner of the account?

Yes ☐ No ☐

Item 7. Does the broker-dealer provide customers and other accountholders with electronic access to information about the securities and cash positions in their accounts?

Yes ☐ No ☐

Item 8. A. Is the broker-dealer also registered as an investment adviser:

i. With the SEC under the Investment Advisers Act of 1940?

Yes ☐ No ☐

ii. With one or more U.S. states under the laws of the state?

Yes ☐ No ☐

If the answer to question 8.A.i or 8.A.ii is "yes," answer each of the following items:

B. Provide the number of investment adviser clients:________________.

C. Complete the following chart concerning the custodians of investment adviser client assets if any (including, if applicable, the broker-dealer):

Column 1: The name of the custodian
Column 2: The identity of the custodian by SEC File No. or CRD No. (if applicable)
Column 3: Whether the broker-dealer/investment adviser has the authority to effect transactions in these advisory client accounts at the custodian
Column 4: Whether the broker-dealer/investment adviser has the authority to withdraw funds and securities out of any accounts at the custodian
Column 5: Whether the custodian sends account statements directly to the investment adviser clients
Column 6: Whether the investment adviser client assets are on the broker-dealer's stock record

1	2	3	4	5	6
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐

Item 9. A. Is the broker-dealer an affiliate of an investment adviser?

Yes ☐ No ☐

B.i. If the answer to Item 9.A is "yes," does the broker-dealer have custody of client assets of the adviser?

Yes ☐ No ☐

B.ii. If the answer to Item 9.B.i is "yes" indicate the approximate U.S. dollar market value of the adviser client assets of which the broker-dealer has custody: ______________________.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Date: July 30, 2013

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 70079 / July 31, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15396

In the Matter of **American Vantage Companies,** **Respondent.**	**ORDER INSTITUTING PROCEEDINGS, MAKING FINDINGS, AND REVOKING REGISTRATION OF SECURITIES PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

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

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Proceedings, Making Findings, and Revoking Registration of Securities Pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

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

1. American Vantage (CIK No. 315428) is a Nevada corporation located in Las Vegas, Nevada. At all times relevant to this proceeding, the securities of American

Vantage have been registered under Exchange Act Section 12(g). As of January 9, 2013, the company's stock (symbol "AVCS") was quoted on OTC Link (previously, "Pink Sheets") operated by OTC Markets Group, Inc., had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. American Vantage has failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder because it has not filed any periodic reports since it filed a Form 10-KSB for the period ended December 31, 2005.

IV.

Section 12(j) of the Exchange Act provides as follows:

> The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

In view of the foregoing, the Commission finds that it is necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

Accordingly, it is hereby ORDERED, pursuant to Section 12(j) of the Exchange Act, that registration of each class of Respondent's securities registered pursuant to Section 12 of the Exchange Act be, and hereby is, revoked.

By the Commission.

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. 70080 / July 31, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15397

In the Matter of **Heartland, Inc.,** **Respondent.**	**ORDER INSTITUTING PROCEEDINGS PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND REVOKING REGISTRATION OF SECURITIES**

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 Heartland, Inc. ("Heartland" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Proceedings, Making Findings, and Revoking Registration of Securities Pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

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

[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.

1. Heartland (CIK No. 1084415) is a Maryland corporation located in Middlesboro, Kentucky. At all times relevant to this proceeding, the securities of Heartland have been registered under Exchange Act Section 12(g). As of March 12, 2013, the company's stock (symbol "HTLJ") was quoted on the OTC Link, had eight market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. Heartland has failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder because it has not filed any periodic reports with the Commission since the period ended September 30, 2011.

IV.

Section 12(j) of the Exchange Act provides as follows:

The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means of instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

In view of the foregoing, the Commission finds that it is necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

Accordingly, it is hereby ORDERED, pursuant to Section 12(j) of the Exchange Act, that registration of each class of Respondent's securities registered pursuant to Section 12 of the Exchange Act 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

SECURITIES EXCHANGE ACT OF 1934
Release No. 70081 / July 31, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15398

In the Matter of **Commonwealth Bankshares, Inc.,** **Respondent.**	**ORDER INSTITUTING PROCEEDINGS, MAKING FINDINGS, AND REVOKING REGISTRATION OF SECURITIES PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

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

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Proceedings, Making Findings, and Revoking Registration of Securities Pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

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

1. Commonwealth Bankshares (CIK No. 835012) is a Virginia corporation located in Norfolk, Virginia. At all times relevant to this proceeding, the securities of

Commonwealth Bankshares have been registered under Exchange Act Section 12(g). As of February 5, 2013, the company's stock (symbol "CWBS") was traded on the over-the-counter markets.

2. Commonwealth Bankshares has failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder because it has not filed any periodic reports since the period ended June 30, 2011.

IV.

Section 12(j) of the Exchange Act provides as follows:

> The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

In view of the foregoing, the Commission finds that it is necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

Accordingly, it is hereby ORDERED, pursuant to Section 12(j) of the Exchange Act, that registration of each class of Respondent's securities registered pursuant to Section 12 of the Exchange Act be, and hereby is, revoked.

By the Commission.

Elizabeth M. Murphy
Secretary

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

Commissioner Paredes not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 70083 / July 31, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3638 / July 31, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15400

In the Matter of **GOELZER INVESTMENT MANAGEMENT, INC. AND GREGORY W. GOELZER** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTIONS 203(e), 203(f), AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 15(b) 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 Goelzer Investment Management, Inc. ("GIM" or "the firm") and Gregory W. Goelzer ("Goelzer").

II.

In anticipation of the institution of these proceedings, Respondents GIM and Goelzer 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 GIM and Goelzer consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Sections 203(e), 203(f), and 203(k) of the Investment

Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

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

Summary

1. This action involves disclosure and compliance failures related to an investment adviser's use of itself as broker to execute client trades. Since at least 2000, GIM, a dually registered investment adviser and broker-dealer based in Indianapolis, inappropriately directed advisory client trades through itself as broker-dealer without considering other options for executing the trades, such as utilizing unaffiliated broker-dealers. GIM had inadequate compliance policies and procedures in effect to ensure that it sought best execution for its clients consistent with its statements in its Form ADV Part II and Part 2A. From 2000 to 2013, GIM misrepresented in its Form ADV Part II[1] and Part 2A that it considered a list of factors and conducted comparative brokerage firm commission rate analysis before recommending itself as broker for its advisory clients, when in fact GIM failed to perform any such analysis. From 2000 to 2011, GIM also misrepresented in its Form ADV Part II that clients who used GIM as their broker stood to benefit from lower commission costs as a result of GIM's aggregation of their trades, when no such benefit was provided. Finally, from 2000 to 2011, GIM failed to disclose in its Form ADV Part II that its advisory fees were negotiable, as required by the Form.

2. Goelzer, GIM's Chief Executive Officer (CEO) and Chief Compliance Officer (CCO), was responsible for completing and filing GIM's Form ADV Part II and Part 2A, for establishing policies and procedures for the firm, and for conducting best execution reviews. Goelzer was therefore responsible for the misstatements in GIM's Form ADV Part II and Part 2A and for the failure to adopt and implement best execution compliance policies and procedures that were consistent with GIM's representations about its recommendation of brokers described in GIM's Form ADV Part II and Part 2A.

Respondents

3. **Goelzer Investment Management, Inc.** is an Indiana corporation founded in 1969 and based in Indianapolis, Indiana. GIM has been dually registered with the Commission as a broker-dealer and investment adviser since 1998.

4. **Gregory W. Goelzer**, age 54, is a resident of Indianapolis, Indiana. Goelzer has been GIM's CEO since 2006 and was GIM's CCO from 1989 to 2012. Through his employment at GIM, Goelzer has been and continues to be associated with a broker-dealer and investment adviser registered with the Commission.

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[1] Commission Form ADV Part II was replaced by Form ADV Part 2A effective October 12, 2010. During most of the period relevant to this Order, GIM utilized a Form ADV Part II. In March 2011, GIM timely filed its first Form ADV Part 2A with the Commission.

Background

5. GIM's principal business is serving as investment adviser to individuals and families. The firm has approximately twenty employees, and has approximately $700 million in assets under management. GIM also maintains a broker-dealer business primarily to support its investment advisory business. While GIM has some retail brokerage customers, most of its brokerage business comes from GIM advisory clients.

6. Since 2005, GIM has managed its advisory client accounts through a team approach. GIM's portfolio managers work in teams to manage five investment strategies: core growth; core value; rising dividend; fixed income; and alternative investments. For each strategy, the portfolio managers maintain a model portfolio of securities. The portfolio managers then allocate client assets among the five model portfolios. As a result, GIM holds similar securities across its client accounts, and when a security is added or subtracted from one of the strategy's model portfolios, GIM buys or sells that security in all client portfolios invested in that strategy. GIM often makes large trades in a security across many client accounts on the same day because of its model portfolio advisory strategy.

7. During his tenure as GIM's CCO, Goelzer was responsible for developing, enforcing, and reviewing annually GIM's investment adviser and broker-dealer compliance policies and procedures. He was also responsible for maintaining and updating GIM's Form ADV. GIM has historically provided new clients with the Form ADV Part II (and Form ADV Part 2A beginning March 2011) before entering into an advisory agreement and has offered in writing the ADV Part II annually to its existing clients. A third-party consultant assisted Goelzer with creating GIM's policies and procedures and with preparing GIM's Form ADV, but Goelzer retained responsibility for ensuring that GIM's compliance policies and procedures were effective and that its Form ADV was complete and accurate.

GIM's Brokerage Business

8. GIM provides basic brokerage services for its advisory clients and clears its trades through an unaffiliated clearing firm. As a standard practice, GIM utilizes its broker-dealer to execute trades for nearly all of its advisory clients, except when a client directs GIM to use a different broker-dealer.

9. Most GIM clients have historically paid brokerage commissions pursuant to GIM's standard commission schedule, which charges commissions depending on the number of shares traded, subject to a minimum commission charge. From 2005 to present, GIM's standard commission schedule has provided for commissions ranging from $0.03 to $0.10 per share, subject to a minimum charge of $20 to $25.[2] GIM clients pay a lower per share commission rate on larger trades than they do on smaller trades.

[2] GIM's commission schedule changed during the relevant period, with rates declining over time, but it has always included a per share charge dependent on the number of shares traded, subject to a minimum commission charge.

GIM's Inaccurate Form ADV Disclosures Relating to Its Brokerage Services

10. Since at least 2000, GIM's Form ADV Part II and Part 2A has included disclosures about GIM's brokerage business and its use of GIM as broker for its advisory clients. These disclosures contained false and misleading statements regarding GIM's decision to use itself as broker and regarding the benefits of clients using GIM as their broker.

11. From 2000 to March 2011, GIM's Form ADV Part II disclosed that transactions for GIM's advisory clients would generally be effected through GIM as broker, "consistent with its obligation to obtain best price and execution." This disclosure was misleading, as GIM did not take steps to ensure that it was seeking best price and execution for its advisory clients. GIM therefore had no basis for stating that execution through GIM was consistent with GIM's best execution obligation.

12. From 2000 through March 2013, GIM's Form ADV Part II and Form ADV Part 2A also misrepresented that GIM's recommendation that clients use GIM as their broker was based on GIM's consideration of several factors, including: the products offered; the level of service; the quality of trade execution; the record keeping and reporting capabilities; the trading platforms offered; and the ability to meet client needs. In fact, GIM failed to evaluate brokerage options for its clients in a manner that was consistent with this disclosure. GIM's Form ADV Part II and Form ADV Part 2A also misrepresented that GIM compared various brokerage firm rates in assessing the reasonableness of commissions, when in fact GIM never compared its commission rates to its competitors.

13. From 2000 to March 2011, GIM's Form ADV Part II included a statement that clients had the option of using a broker other than GIM upon request and that clients might be able to obtain better execution elsewhere. However, the disclosure warned that "clients who do choose another broker/dealer may not always obtain best price and execution when trades are effected at a broker/dealer other than [GIM]. In particular, clients would not be able to participate in and receive the benefits of lower commission costs as a result of [GIM's] use of volume transactions ('block trades')." This statement was misleading, as GIM clients never benefited from lower commissions when GIM aggregated client trades for average pricing purposes. Had GIM treated these aggregated trades as a block for purposes of assessing its commission charge, GIM clients would have saved $309,994 in commission costs from January 2005 through March 2011.

GIM's Failure to Adopt and Implement Policies and Procedures and Seek Best Execution

14. GIM failed to adopt and implement compliance policies and procedures reasonably designed to prevent and detect misrepresentations by GIM such as the representations about the firm's broker selection policy described in GIM's Form ADV Part II and Part 2A. Prior to revisions made in 2013, the only procedures established by GIM relating to selection of brokers and best execution included: (1) review of a best execution report provided by GIM's clearing firm that showed the clearing firm's performance compared to the industry; (2) ensuring that GIM's Form ADV Part II contained disclosures to clients regarding the firm's potential conflict of interest as both adviser and broker-dealer; and (3) a statement that the firm would attempt to utilize batch or block trades to help ensure that clients are receiving best price and execution. GIM did

not adopt or implement other advisory compliance policies and procedures relating to its best execution obligations or its disclosures that it would evaluate brokers on a multitude of factors and compare brokerage rates.

15. GIM also failed to seek best execution for its advisory clients, as it represented that it would in its Form ADV Part II and Part 2A. GIM did not assess itself as broker for its clients and did not compare what it offered clients to the services and costs available at other brokerage firms -- as it claimed it did in its Form ADV Part II and Part 2A -- despite discussions among GIM senior management regarding the availability of more cost-effective options at non-affiliated broker-dealers. Nor did GIM conduct any analysis of its brokerage services that gave it a basis for using itself as broker. Instead, GIM used itself as broker for its advisory clients by default rather than as a result of a best execution analysis.

16. As CCO, Goelzer was responsible for developing and enforcing policies and procedures for GIM that were reasonably designed to detect and prevent violations of the Advisers Act. Goelzer failed to develop or enforce compliance policies and procedures for GIM that addressed how GIM sought best execution for its clients in a manner that was consistent with the representations in its Form ADV Part II and Part 2A.

GIM's Failure to Disclose Negotiability of Advisory Fees

17. From 2000 to March 2011, GIM's Form ADV Part II disclosed that GIM offered advisory services under two fee structures: fee-based and wrap-fee based. GIM disclosed an annual fee schedule for each structure. Historically, more than 95% of its advisory clients have been under the fee-based structure. GIM's disclosed fee-based schedule did not reflect what many GIM advisory clients were actually paying, and for the last several years all new advisory clients have been offered a lower fee schedule than GIM's disclosed fee-based schedule. According to a 2010 study of GIM's fee structures, only approximately 25% of GIM's clients paid fees according to GIM's disclosed fee-based schedule, with the remainder paying according to modified schedules, most of which were substantially discounted from the disclosed fee-based schedule. According to the 2010 study, GIM had 65 different fee arrangements among its 288 clients.

18. Item 1.D. of Form ADV Part II required investment advisers to disclose whether their fees are negotiable. Prior to March 2011, GIM never disclosed in its Form ADV Part II that its fees were negotiable, despite the fact that approximately 75% of its clients were on reduced fee schedules compared to the standard schedule GIM disclosed in its Form ADV Part II.

Violations

19. As a result of the conduct described above, GIM willfully violated Sections 206(2) and 206(4) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser, and Rule 206(4)-7 promulgated thereunder, which, among other things, requires that an investment adviser adopt and implement written policies and procedures reasonably designed to prevent violations, by the investment adviser or its supervised persons, of the Advisers Act and the rules adopted thereunder.

20. As a result of the conduct described above, Goelzer caused GIM's violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder.

21. As a result of the conduct described above, GIM and Goelzer 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 under the Advisers Act or willfully to omit to state in any such application or report any material fact which is required to be stated therein.

GIM's Remedial Efforts

22. In determining to accept the Offers, the Commission considered remedial acts promptly undertaken by Respondent GIM.

Undertakings

23. Respondent GIM has undertaken to:

24. Compliance Consultant. During the Commission's investigation, GIM hired a compliance consultant (the "Consultant") to conduct a comprehensive review of GIM's compliance program. The Consultant completed its work in March 2013 and submitted a report detailing its work, findings, and recommendations to GIM in March 2013, which GIM shared with the Commission staff. GIM has implemented all of the Consultant's recommendations. GIM will retain the Consultant going forward to assist GIM in implementing its new compliance program. The Consultant's work includes, but is not limited to:

a. The Consultant conducted an on-site review of GIM's business and GIM's implementation of the firm's policies and procedures.

b. The Consultant drafted new policies and procedures and a code of ethics for GIM's broker-dealer and investment advisory business, and assisted GIM in their implementation. GIM's new policies and procedures and code of ethics included extensive changes to GIM's best execution policy.

c. The Consultant assisted in the development and implementation of a new supervisory framework and internal controls.

d. The Consultant conducted an annual review to assess the adequacy and effectiveness of GIM's new policies and procedures. This review included examination of GIM's Form ADV and best execution practices, and updating of GIM's Form ADV.

e. The Consultant will conduct annual compliance reviews of GIM for the years ended December 31, 2013 and December 31, 2014.

In determining whether to accept the Offers, the Commission has considered these undertakings.

25. Separation of Chief Compliance Officer From Other Officer Positions. For a period of five (5) years from the entry of this Order, GIM shall employ a Chief Compliance Officer whose sole responsibility will be serving in that position. During this period, the person GIM designates as Chief Compliance Officer shall not simultaneously hold any other officer or employee position at GIM while serving as Chief Compliance Officer.

26. Recordkeeping. GIM shall preserve for a period of not less than six (6) years from the end of the fiscal year last used, the first two (2) years in an easily accessible place, any record of GIM's compliance with the undertakings set forth in this Order.

27. Notice to Advisory Clients. Within ten (10) days of the entry of this Order, GIM shall post prominently on its principal website a summary of this Order in a form and location acceptable to the Commission staff, with a hyperlink to the entire Order. GIM shall maintain the posting and hyperlink on GIM's website for a period of twelve (12) months from the entry of this Order. Within thirty (30) days of the entry of this Order, GIM shall provide a copy of the Order to each of GIM's existing advisory clients as of the entry of this Order via mail, email, or such other method as may be acceptable to the Commission staff, together with a cover letter in a form not unacceptable to the Commission staff. Furthermore, for a period of twelve (12) months from the entry of this Order, to the extent that GIM is required to deliver a brochure to a client and/or prospective client pursuant to Rule 204-3 of the Advisers Act, GIM shall also provide a copy of this Order to such client and/or prospective client at the same time that GIM delivers the brochure.

28. Deadlines. For good cause shown, the Commission staff may extend any of the procedural dates relating to the undertakings. Deadlines for procedural dates shall be counted in calendar days, except that if the last day falls on a weekend or federal holiday, the next business day shall be considered to be the last day.

29. Certifications of Compliance by Respondent. GIM shall certify, in writing, compliance with its 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 GIM agrees to provide such evidence. The certification and supporting material shall be submitted to Paul Montoya, Assistant Regional Director, Asset Management Unit, Chicago Regional Office, Securities and Exchange Commission, 175 W. Jackson Blvd., Suite 900, Chicago, IL, 60604, or such other address as the Commission staff may provide, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than sixty (60) days from the date of the completion of the undertakings.

IV.

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

Accordingly, pursuant to Section 15(b) of the Exchange Act and Sections 203(e), 203(f), and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondents GIM and Goelzer cease and desist from committing or causing any violations and any future violations of Sections 206(2), 206(4), and 207 of the Advisers Act and Rule 206(4)-7 promulgated thereunder.

B. Respondents GIM and Goelzer are censured.

C. Respondent GIM shall pay disgorgement and prejudgment interest as follows:

(1) GIM shall pay disgorgement of $309,994, consistent with the provisions of this Subsection C. Within ten (10) days of the entry of this Order, GIM shall deposit the full amount of the disgorgement (the "Disgorgement Fund") into an escrow account acceptable to the Commission staff and GIM shall provide the Commission staff with evidence of such deposit in a form acceptable to the Commission staff. In addition, within ten (10) days of the entry of this Order, GIM shall pay prejudgment interest of $53,799 to the Commission for transmittal to the United States Treasury, in the manner provided in Subsection D below. If timely deposit of the Disgorgement Fund or timely payment of the prejudgment interest is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600.

(2) GIM shall be responsible for administering the Disgorgement Fund. GIM shall pay applicable portions of the Disgorgement Fund to affected current and former advisory clients who did not receive reduced commissions for trades that GIM aggregated with other client trades, pursuant to a disbursement schedule (the "Disbursement Schedule") that has been reviewed and approved by the Commission staff, in accordance with this Subsection C. No portion of the Disgorgement Fund shall be paid to any client account in which Respondent GIM or Respondent Goelzer has a financial interest. Any such funds shall be transferred to the Commission for transfer to the United States Treasury in accordance with Subsection D below. For any current and former advisory client that is due an amount totaling less than ten dollars ($10.00), where such amount cannot be credited to a current client account at GIM, GIM shall instead pay such amount to the Commission for transfer to the United States Treasury in the manner provided in Subsection D below.

(3) GIM shall complete the transmission of all amounts otherwise payable to affected advisory clients pursuant to the Disbursement Schedule within sixty (60) days of the entry of this Order, unless such time period is extended as provided for in Subsection C.8 below.

(4) If GIM does not distribute or return any portion of the Disgorgement Fund for any reason, including an inability to locate an affected advisory client or any factors beyond GIM's control, or if GIM has not transferred any portion of the Disgorgement Fund to a client because that client is due less than $10.00, GIM shall transfer any such undistributed funds to the Commission for transmittal to the United States Treasury after the final accounting provided for in this Subsection C is approved by the Commission. Any such payment shall be made in accordance with Subsection D below.

(5) GIM shall be responsible for any and all tax compliance responsibilities associated with the Disgorgement Fund and may retain any professional services necessary. The costs and expenses of any such professional services shall be borne by GIM and shall not be paid out of the Disgorgement Fund.

(6) Within one hundred and eighty (180) days after the date of entry of this Order, GIM shall submit for Commission approval a final accounting of the disposition of the Disgorgement Fund. The final accounting shall be on a standardized accounting form to be provided by the Commission staff and shall include, but not be limited to: (i) the amount paid to each payee; (ii) the date of each payment; (iii) the check number or other identifier of money transferred; (iv) the date and amount of any returned payment; and (v) any amounts to be forwarded to the Commission for transfer to the United States Treasury. In addition, GIM shall provide to Commission staff a cover letter representing that all of the requirements of this Subsection C have been completed and that the information requested has been accurately reported to the Commission ("the certification"). Also included in the certification should be a description of any efforts to locate a prospective payee whose payment was returned or to whom payment was not made for any reason.

(7) GIM shall submit proof and supporting documentation of such payment (whether in the form of fee credits, cancelled checks, or otherwise) in a form acceptable to the Commission staff and under a cover letter that identifies GIM as a Respondent in these proceedings and the file number of these proceedings to Paul Montoya, Assistant Regional Director, Asset Management Unit, Chicago Regional Office, Securities and Exchange Commission, 175 W. Jackson Blvd., Suite 900, Chicago, IL, 60604, or such other address the Commission staff may provide. GIM shall provide any and all supporting documentation for the accounting and certification to the Commission staff upon its request and shall cooperate with any additional requests by the Commission staff in connection with the accounting and certification.

(8) After GIM has submitted the final accounting to the Commission staff, the staff shall submit the final accounting to the Commission for approval and shall request Commission approval to send any remaining amount to the United States Treasury.

(9) The Commission staff may extend any of the procedural dates set forth in this Subsection C for good cause shown. Deadlines for dates relating to the Disgorgement Fund shall be counted in calendar days, except that if the last day falls on a weekend or federal holiday the next business day shall be considered to be the last day.

D. Respondent GIM shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of $100,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in one of the following ways:

(1) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or

(2) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying GIM as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Paul Montoya, Assistant Regional Director, Asset Management Unit, Chicago Regional Office, Securities and Exchange Commission, 175 W. Jackson Blvd., Suite 900, Chicago, IL, 60604, or such other address as the Commission staff may provide.

E. Respondent Goelzer shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of $35,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in accordance with Subsection D above.

F. Respondent GIM shall comply with the undertakings enumerated in Section III, paragraphs 24 through 29 above.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Paredes not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3637 / July 31, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15399

In the Matter of

A.R. Schmeidler & Co., Inc.

Respondent.

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 15(b)(4) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTIONS 203(e) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940 AGAINST A. R. SCHMEIDLER & CO., INC., MAKING FINDINGS, IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 15(b)(4) of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against A.R. Schmeidler & Co., Inc. ("ARS," "Company," 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 them and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 15(b)(4) of the Exchange Act and Sections 203(e) and 203(k) of the Advisers Act against A.R. Schmeidler & Co., Inc., Making Findings, Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

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

Summary

This matter involves the failure by ARS, a dually registered investment adviser and broker-dealer, to seek best execution in breach of its fiduciary duty under the Advisers Act in connection with certain of its advisory clients, and a failure to implement policies and procedures reasonably designed to prevent those violations.

ARS served as an investment adviser and introducing broker-dealer for certain clients who paid the Company both investment advisory fees and brokerage commissions. Beginning in 2007, ARS failed to seek best execution. As a result, ARS violated Section 206(2) of the Advisers Act.

ARS's failure to implement procedures reasonably designed to prevent its best execution violations further violated Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder.

Respondent

1. ARS is, and at all times relevant herein has been, a dually registered investment adviser and broker-dealer with the Securities and Exchange Commission. Founded in 1971, ARS was acquired by Hudson Valley Bank in 2004 and has operated as a subsidiary of Hudson Valley Bank since that acquisition. ARS's principal place of business is New York, New York.

Background

2. Since at least 2005, ARS has provided investment advisory services for clients. ARS's clients generally executed advisory agreements that included language authorizing ARS to, among other things, select brokers and dealers to execute trades. Unless clients specifically instructed ARS to utilize a particular broker-dealer, ARS selected itself as the broker-dealer and provided services as an introducing broker. In 2005, ARS engaged a new firm to provide certain execution, clearance and custody services (the "Clearing Firm"). At that time, ARS reduced the commission rate for accounts whose trades were executed through ARS as broker-dealer from 8 cents to 6 cents per share. Accordingly, clients of ARS whose trades were executed through ARS as broker-dealer generally paid a commission of 6 cents per share during the relevant time. The commission rate of 6 cents per share was applied consistently for all clients, regardless of whether they maintained taxable or non-taxable accounts.

3. ARS and the Clearing Firm agreed to split the 6 cents per share commission between themselves as follows: In 2005 and 2006, ARS retained 80% of the commissions (or 4.8

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

cents per share) generated by taxable client accounts with the Clearing Firm retaining the remaining 20% (or 1.2 cents per share). The Clearing Firm retained 100% of the commissions generated by non-taxable accounts, including ERISA accounts. ARS retained none of these commissions.

4. In February 2007, ARS and the Clearing Firm renegotiated their agreement, with the result that ARS's share of the commissions charged to clients with taxable accounts increased to 90%, without altering the allocation of responsibilities between ARS as an introducing broker and the Clearing Firm as a clearing broker. This new amendment gave ARS an additional 0.6 cents per share of the commissions from taxable accounts—or a total of 5.4 cents per share (90%), rather than the previous 4.8 cents per share (80%). The Clearing Firm continued to retain 100% of the commissions generated by non-taxable accounts, including ERISA accounts. ARS retained none of the commissions generated by non-taxable accounts.

5. Upon entering the new amendment with the Clearing Firm, ARS did not conduct sufficient analysis to determine whether it properly sought best execution for trades executed on behalf of advisory clients with taxable accounts.[2]

6. Finally, although ARS's written policies and procedures governed how to discharge the Company's best execution obligations for advisory clients, the Company failed to implement such policies and procedures.

7. As a result of the conduct described above, ARS willfully 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, by failing to conduct a sufficient best execution analysis.[3]

8. Further, as a result of the conduct described above, ARS willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder,[4]

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[2] "[M]oney managers should periodically and systematically evaluate the execution performance of broker-dealers executing their transactions." *Interpretive Release Concerning Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, Exchange Act Release No. 34-23170, 51 Fed. Reg. 16004, *14 (Apr. 23, 1986).

[3] "[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 *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963)).

[4] 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)).

which requires investment advisers to implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder.[5]

Undertakings

Respondent has undertaken to:

9. Engage a qualified independent consultant ("Independent Consultant") to assist ARS in developing and implementing policies and procedures reasonably designed to promote compliance with its duty to seek best execution for its advisory clients. Such engagement shall last until the aforementioned policies and procedures are completed and implemented.

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

11. Certify, in writing, compliance with the undertakings set forth above. The certification shall identify the undertaking, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Respondent agrees to provide such evidence. The certification and supporting material shall be submitted to Robert Keyes, Division of Enforcement, Securities and Exchange Commission, 3 World Financial Center, Suite 400, New York, New York, 10281-1022, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than sixty (60) days from the date of the completion of the undertakings.

IV.

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

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[5] "Proof of scienter is not required to establish a violation of Section 206(4) of the Advisers Act." *In the matter of Wunderlich Securities, Inc.*, Investment Advisers Act Rel. No. 3211, 2011 WL 2098195, at *8 (May 27, 2011) (citing *SEC v. Steadman*, 967 F.2d 636, 647 (D.C. Cir. 1992)).

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

A. ARS shall cease and desist from committing or causing any violations and any future violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder.

B. ARS is censured.

C. ARS shall pay disgorgement and pre-judgment interest as follows:

(1) ARS shall pay disgorgement of $757,876.88 and pre-judgment interest of $78,688.57 (the "Disgorgement Fund") consistent with the provisions of this Subsection C. Within ten (10) days of the entry of this Order, ARS shall deposit the full amount of the Disgorgement Fund into an escrow account acceptable to the Commission staff and ARS shall provide the Commission staff with evidence of such deposit in a form acceptable to the Commission staff. If timely deposit of the Disgorgement Fund is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600.

(2) ARS shall be responsible for administering the Disgorgement Fund. ARS shall pay applicable portions of the Disgorgement Fund to affected current and former advisory clients pursuant to a disbursement calculation (the "Calculation") that has been submitted to, reviewed and approved by the Commission staff in accordance with this Subsection C. If the total amount otherwise payable to a client is less than $25.00, ARS shall instead pay such amount to the Commission for transmittal to the United States Treasury as provided in this Subsection C.

(3) ARS shall, within sixty (60) days from the entry of this Order, submit a proposed Calculation to the Commission staff for its review and approval that identifies, at a minimum: (i) the name and account number of each affected advisory client; (ii) the exact amount of the payment to be made to such client; and (iii) a description of the client transactions ("Relevant Transactions") to which the client's payment relates. ARS also shall provide to the Commission staff such additional information and supporting documentation relating to the Relevant Transactions as the Commission staff may request for the purpose of its review. No portion of the Disgorgement Fund shall be paid to any client account directly or indirectly in the name of or for the benefit of ARS. In the event of one or more objections by the Commission staff to ARS's proposed Calculation and/or any of its information or supporting documentation, ARS shall submit a revised Calculation for the review and approval of the Commission staff and/or additional information or supporting documentation within ten (10) days of the date that ARS is notified of the objection, which revised Calculation shall be subject to all of the provisions of this Subsection C.

(4) ARS shall complete the transmission of all amounts otherwise payable to affected advisory clients pursuant to a Calculation approved by the Commission staff within one hundred and twenty (120) days of the entry of this Order, unless such time period is extended as provided in paragraph (9) of this Subsection C.

(5) If ARS does not distribute or return any portion of the Disgorgement Fund for any reason, including an inability to locate an affected advisory client or any factors beyond ARS's control, or if ARS has not transferred any portion of the Disgorgement Fund to a client because that client is due less than $25.00, ARS shall transfer any such undistributed funds to the Commission for transmittal to the United States Treasury after the final accounting provided for in this Subsection C is approved by the Commission. ARS may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request. Payment may also be made directly from a bank account or by credit or debit card via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm. Respondent may also pay by certified check, bank cashier's check, or United States postal money order payable to the Securities and Exchange Commission, which shall be delivered or mailed to

Enterprise Services Center
Accounts Receivable Branch
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

and submitted under cover letter that identifies ARS as the 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 Robert Keyes, Division of Enforcement, Securities and Exchange Commission, 3 World Financial Center, New York, New York 10281-1022.

(6) ARS shall be responsible for any and all tax compliance responsibilities associated with the Disgorgement Fund and may retain any professional services necessary. The costs and expenses of any such professional services shall be borne by ARS and shall not be paid out of the Disgorgement Fund.

(7) Within two hundred and ten (210) days after the date of entry of this Order, ARS shall submit to the Commission staff for its approval a final accounting and certification of the disposition of the Disgorgement Fund, which final accounting and certification shall be in a format to be provided by the Commission staff. The final accounting and certification shall include, but not be limited to: (i) the amount paid to each payee; (ii) the date of each payment; (iii) the check number or other identifier of money transferred; (iv) the date and amount of any returned payment; (v) a description of any effort to locate a prospective payee whose payment was returned or to whom

payment was not made for any reason; and (vi) any amounts to be forwarded to the Commission for transfer to the United States Treasury. ARS shall submit proof and supporting documentation of such payment (whether in the form of fee credits, cancelled checks, or otherwise) in a form acceptable to the Commission staff and under a cover letter that identifies ARS as the Respondent in these proceedings and the file number of these proceedings to Robert Keyes, Division of Enforcement, Securities and Exchange Commission, 3 World Financial Center, Suite 400, New York, New York, 10281-1022. ARS shall provide any and all supporting documentation for the accounting and certification to the Commission staff upon its request and shall cooperate with any additional requests by the Commission staff in connection with the accounting and certification.

(8) After ARS has submitted the final accounting to the Commission staff, the staff shall submit the final accounting to the Commission for approval and shall request Commission approval to send any remaining amount to the United States Treasury.

(9) The Commission staff may extend any of the procedural dates set forth in this Subsection C for good cause shown. Deadlines for dates relating to the Disgorgement Fund shall be counted in calendar days, except that if the last day falls on a weekend or federal holiday the next business day shall be considered to be the last day.

D. ARS shall, within 10 days of the entry of this Order, pay a civil monetary penalty of $175,000 to the Securities and Exchange Commission. If timely payment of a civil penalty is not made, additional interest shall accrue pursuant to 31 USC § 3717. Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request. Payment may also be made directly from a bank account or by credit or debit card via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm. Respondent may also pay by certified check, bank cashier's check, or United States postal money order payable to the Securities and Exchange Commission, which shall be delivered or mailed to

Enterprise Services Center
Accounts Receivable Branch
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

and submitted under cover letter that identifies ARS as the 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 Robert Keyes, Division of Enforcement, Securities and Exchange Commission, 3 World Financial Center, New York, New York 10281-1022.

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

G. Respondent shall comply with the undertakings enumerated in Paragraphs 9-11 above.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Paredes not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9436 / July 31, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15399

In the Matter of **A.R. Schmeidler & Co., Inc.,** **Respondent.**	**ORDER UNDER RULE 602(e) OF THE SECURITIES ACT OF 1933 GRANTING A WAIVER OF THE RULE 602(c)(3) DISQUALIFICATION PROVISION**

I.

Respondent A.R. Schmeidler & Co., Inc. ("ARS" or "Respondent") has submitted a letter, dated July 30, 2013, requesting a waiver of the Rule 602(c)(3) disqualification from the exemption from registration under Regulation E arising from ARS's settlement of administrative proceedings commenced by the Commission.

II.

On July 31, 2013, pursuant to ARS's Offer of Settlement, the Commission issued an Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 15(b)(4) of the Securities Exchange Act of 1934 and Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 against A.R. Schmeidler & Co., Inc., Making Findings, Imposing Remedial Sanctions and a Cease-and-Desist Order (the "Order"). Under the Order, the Commission found that ARS willfully violated Sections 206(2) and 206(4) of the Investment Advisers Act of 1940 (the "Advisers Act") and Rule 206(4)-7 promulgated thereunder by failing to (1) seek best execution for advisory client transactions in breach of its fiduciary duty and (2) implement procedures reasonably designed to prevent its best execution violations. In the Order, the Commission ordered that (A) ARS cease and desist from committing or causing any violations and any future violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder; (B) ARS is censured; (C) ARS pay disgorgement of $757,876.88 and pre-judgment interest of

$78,688.57; (D) ARS pay a civil monetary penalty of $175,000; and (E) ARS comply with the undertakings enumerated in Paragraphs 9-11 of the Order.

III.

The Regulation E exemption is unavailable for the securities of small business investment company issuers or business development company issuers if, among other things, any investment adviser or underwriter for the securities to be offered is subject to an order of the Commission entered pursuant to Section 15(b) of the Securities Exchange Act of 1934 (the "Exchange Act") or Section 203(e) of the Advisers Act. 17 C.F.R. § 230.602(c)(3). Rule 602(e) of the Securities Act of 1933 ("Securities Act") provides, however, that the disqualification "shall not apply . . . if the Commission determines, upon a showing of good cause, that it is not necessary under the circumstances that the exemption be denied." 17 C.F.R. § 230.602(e).

IV.

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

Accordingly, **IT IS ORDERED**, pursuant to Rule 602(e) under the Securities Act, that a waiver from the application of the disqualification provision of Rule 602(c)(3) under the Securities Act resulting from the entry of the Order is hereby granted.

By the Commission.

Elizabeth M. Murphy
Secretary

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

Commissioner Walter,
Commissioner Paredes
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3640 / July 31, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15402

In the Matter of **CHAUNCEY C. MAYFIELD and MAYFIELDGENTRY REALTY ADVISORS, LLC** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTIONS 203(e) AND 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 Sections 203(e) and 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Chauncey C. Mayfield ("Mayfield") and MayfieldGentry Realty Advisors, LLC ("MGRA") (together, "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, Respondents consent to the Commission's jurisdiction over them and the subject matter of these proceedings and to the entry of this Order Instituting Administrative Proceedings Pursuant to Sections 203(e) and 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Mayfield is the president, CEO, and majority shareholder of MGRA, an investment adviser registered with the Commission since 2004. Mayfield, 56 years old, is a resident of Fort Lauderdale, Florida.

2. On July 2, 2013, a final judgment was entered by consent against Mayfield and MGRA, permanently enjoining them 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, and Sections 206(1) and 206(2) of the Advisers Act, in the civil action entitled United States Securities and Exchange Commission v. Kwame Kilpatrick, et al., Civil Action Number 12-CV-12109, in the United States District Court for the Eastern District of Michigan.

3. The Commission's complaint alleged that, throughout 2007, former Detroit Mayor Kwame M. Kilpatrick ("Kilpatrick") and former Detroit Treasurer Jeffrey W. Beasley ("Beasley") secretly solicited and received lavish gifts from Mayfield and MGRA. The complaint further alleged that Mayfield and MGRA supplied Kilpatrick and Beasley with more than $125,000 worth of entertainment and travel, including multiple flights on private jets, concert tickets, hotel rooms, and limousines. The complaint further alleged that at the same time Mayfield and MGRA secretly provided these gifts, they were seeking approval from the trustees of the Detroit public employee pension funds, including Kilpatrick and Beasley, for over $115 million in investments. The complaint also alleged that the failure by Kilpatrick, Beasley, Mayfield, and MGRA to disclose these gifts and the resulting conflicts of interest constituted a fraud on the pension funds.

4. On February 7, 2013, Mayfield pled guilty to one count of Conspiracy to Influence or Reward Local Public Officials in violation of Title 18 United States Code, Sections 371 and 666(a), before the United States District Court for the Eastern District of Michigan, in United States v. Jeffrey Beasley, et al., Crim. No. 12-20030.

5. The count of the criminal information to which Mayfield pled guilty alleged, inter alia, that Mayfield gave things of value worth over $180,000 to Beasley and other conspirators in an effort to influence and reward them relating to their power as public officials in connection with their decisions as to how to invest the pension money of Detroit's two public employee pension funds.

IV.

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

1. On June 26, 2013, a final judgment was entered by consent against Mayfield and MGRA, permanently enjoining them from future violations of Sections 206(1) and 206(2) of the Advisers Act, in the civil action entitled United States Securities and Exchange

Commission v. MayfieldGentry Realty Advisors, LLC, et al., Civil Action Number 13-CV-12520, in the United States District Court for the Eastern District of Michigan.

2. The Commission's complaint alleged that, in early 2008, Mayfield and MGRA misappropriated approximately $3.1 million belonging to one of the Detroit public employee pension funds and used the money to purchase two retail shopping centers on behalf of MGRA affiliates. The complaint further alleged that, for more than four years, Mayfield and MGRA did not tell the pension fund about the misappropriation. During that time period, Mayfield and MGRA regularly provided investment advisory services to the pension fund.

V.

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

Accordingly, pursuant to Sections 203(e) and 203(f) of the Advisers Act, it is hereby ORDERED that:

A. Respondent Mayfield be barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and

B. Respondent MGRA's registration as an investment adviser is revoked.

Any reapplication for association by Respondent Mayfield 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 Mayfield, 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 Gallagher not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9437 / July 31, 2013

SECURITIES EXCHANGE ACT OF 1934
Release No. 70086 / July 31, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3639 / July 31, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15401

In the Matter of **ABN AMRO Bank, N.V.** **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, AND 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**

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"), and Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against ABN AMRO Bank, N.V. ("Respondent" or "ABN").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the

Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Sections 15(b) and 21C of the Securities Exchange Act of 1934, and 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 ("Order"), as set forth below.

III.

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

Summary

Since at least 2004, in violation of Section 15(a) of the Exchange Act and Section 203(a) of the Advisers Act, ABN and certain of its retail and private banking affiliates, predominantly in The Netherlands, France and Switzerland, regularly solicited, effected transactions in securities with and for, and, for compensation, provided investment advice to, persons in the United States, without being registered with the Commission as a broker-dealer or investment adviser, and without qualifying for an exception or exemption from registration. In addition, ABN violated Sections 5(a) and 5(c) of the Securities Act by engaging in transactions that were not registered in the United States and that did not qualify for an exemption from registration under the Securities Act. ABN became aware of this conduct in 2004, but failed to address it adequately, and did not voluntarily report until 2008.

Respondent

ABN AMRO Bank N.V., at the commencement of the conduct described herein, was an international banking group organized under Dutch law, offering banking products and financial services, including regularly effecting transactions in securities for the account of others, and, as part of its regular business, buying and selling securities for its own account, in 56 countries and territories on six continents. In October 2007, ABN was acquired by a consortium of Fortis N.V. and Fortis SA/NV ("Fortis"), the Royal Bank of Scotland Group plc ("RBS"), and Banco Santander S.A. ("Santander"). In October 2008, the Dutch government bought Fortis Bank (Nederland) N.V., including its interests in ABN, and in December 2008, replaced Fortis as a stakeholder in RFS Holdings, the entity that managed ABN. ABN's various businesses around the globe have been separated from ABN and integrated in line with each of the new respective owners. The operations directly involved in the violations here have been assumed by the Dutch Central Bank.

Background

1. Since at least 2004, ABN and certain of its retail and private banking affiliates, predominantly in The Netherlands, France and Switzerland, provided securities transactional and

advisory services to 5,527 accounts in the United States ("U.S. Persons") holding approximately €792 million ($966 million at an exchange rate of $1.22) and solicited transactions in a number of those accounts through telephonic contacts and correspondence. Although ABN was soliciting, and regularly effecting transactions in securities with and for U.S. Persons, it did not register in the United States as a broker-dealer. Nor did it satisfy the conditions for an exemption from broker-dealer registration for foreign broker-dealers pursuant to Rule 15a-6 under the Exchange Act.

2. In addition, ABN, for compensation, engaged in the business of advising U.S Persons as to the advisability of investing in, purchasing, or selling securities, without registering as an investment adviser under the Advisers Act. ABN acted as an investment adviser for its fee-based advisory accounts with U.S. Persons by providing investment advice, making investment decisions for its customers, and/or recommending the investment in or sale of securities, via telephone calls or mailings into the United States. ABN has never been registered with the Commission as an investment adviser and was neither exempted nor prohibited from registration.

3. Most of the relevant accounts were held by existing foreign brokerage clients of ABN who continued to receive brokerage and investment advice services after moving to the United States on a non-temporary basis, as well as by persons who maintained a primary residence in the United States but opened an account with an ABN foreign brokerage affiliate while abroad. ABN did not maintain sufficient procedures to prevent retail and private banking affiliates of ABN, predominantly in Europe, from providing non-exempt broker-dealer and investment adviser services to U.S. Persons. It appears that the ABN personnel who provided broker-dealer and investment advisory services to U.S. Persons did not know that their continued provision of services to clients who had moved to the United States on a non-temporary basis violated the U.S. securities laws.

4. "BU NL," ABN's primary consumer and commercial business unit in the Netherlands, and "BU PC," ABN's Private Client business unit in the Netherlands, Switzerland and France (the two largest ABN Private Client operations) were responsible for a majority of the registration violations at ABN. These businesses accounted for approximately 96% of the U.S. Person accounts in question. In some instances, there was no registration statement filed or in effect, nor any available exemption from registration, for securities issued or underwritten by ABN that were offered or sold to U.S. Persons.

5. ABN charged U.S. Persons commissions and other forms of transaction-related compensation, as well as special compensation for investment advice. Between 2004 and 2008, ABN received approximately $2,943,408 in net profit from commissions and other fees from U.S. Persons.

6. As a result of the conduct described above, ABN willfully[1] violated Section 5(a) and 5(c) of the Securities Act, Section 15(a) of the Exchange Act, and Section 203(a) of the Advisers Act.

Respondent's Remedial Efforts

In determining whether to accept the Offer, the Commission considered the remedial acts that were taken by Respondent and cooperation afforded the Commission staff.

Undertakings

Respondent has undertaken to:

1. Conduct a thorough review of all Commercial and Merchant Banking investment accounts as well as all commercial investment accounts within Retail and Private Banking held at local branches of ABN to determine whether they include any U.S. Person accounts (other than such accounts for which securities may be offered or sold to U.S. Persons pursuant to available exemptions). This group of accounts was not originally included by ABN in the original U.S. Person accounts that it disclosed to the staff. ABN has already reviewed these accounts through an initial computer query but has agreed to undertake a more rigorous manual review to confirm compliance. In addition, ABN has agreed to continue its efforts to contact the owners of the "ringfenced" accounts identified above that cannot be closed due to local regulations prohibiting the closing of accounts without customer notification. ABN will also ensure that no fees are being charged on those accounts, and that business from those accounts is not being solicited.

2. Certify, in writing, within one year of the date the Order in this matter, 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 ABN agrees that it will provide such evidence. The certification and supporting material shall be submitted to Douglas McAllister, Assistant Director, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than sixty (60) days from the date of the completion of the undertakings.

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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 person "'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)).

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 8A of the Securities Act, Sections 15(b) and 21C of the Exchange Act and Sections 203(e) and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondent shall cease and desist from committing or causing any violations and any future violations of Sections 5(a) and 5(c) of the Securities Act, Section 15(a) of the Exchange Act, and Section 203(a) of the Advisers Act;

B. Respondent is censured;

C. Respondent shall comply with the undertakings enumerated above;

D. Respondent shall, within 5 days of the entry of this Order, pay disgorgement of \$2,943,408, prejudgment interest of \$604,000, and a civil money penalty of \$2,000,000, to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 and 31 U.S.C. 3717. Payment must be made in one of the following ways:

(1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
(2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or
(3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter that identifies ABN AMRO Bank N.V. 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 Gerald W. Hodgkins, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., N.E., Washington, D.C. 20549.

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. 70088 / July 31, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15403

In the Matter of **Steven M. Ray,** **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 Steven M. Ray ("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. Respondent, Steven M. Ray, age 44, is a resident of Frisco, Texas. From approximately September 2007 through approximately March 2010, Respondent was associated

with Overland Energy, Inc., an unregistered broker that effected transactions in securities for the accounts of certain oil and gas issuers and their investors.

2. On June 30, 2011, an interlocutory judgment was entered by consent against Respondent, permanently enjoining him from future violations of Section 15(a)(1) of the Exchange Act, in the civil action entitled *Securities and Exchange Commission v. Garry B. Smith, et al.*, Civil Action Number 4:10-CV-613, in the United States District Court for the Eastern District of Texas, Sherman Division.

3. The Commission's complaint alleged that, among other things, Respondent and others induced, or attempted to induce, the purchase or sale of securities without being registered as a broker or dealer, or being associated with a registered broker or dealer in accordance with the federal securities laws. The complaint alleged that Respondent acted as a broker by, among other things, soliciting investors to purchase securities, negotiating between the issuer and the investor, and receiving transaction-related compensation.

IV.

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

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act that Respondent be, and hereby is:

> barred from association with any broker or dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and

> barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary